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EXPOSURE DRAFT

Proposed Statement of Financial Accounting Standards

Accounting for Certain Derivative Instruments and Certain Hedging Activities

an amendment of FASB Statement No. 133

This Exposure Draft of a proposed Statement of Financial Accounting Standards is issued by the Board for public comment. Written comments should be addressed to:

Director of Research and Technical Activities
File Reference No. 207-A

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Financial Accounting Standards Board
of the Financial Accounting Foundation

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Proposed Statement of Financial Accounting Standards

Accounting for Certain Derivative Instruments and Certain Hedging Activities

an amendment of FASB Statement No. 133

March 3, 2000

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Proposed Statement of Financial Accounting Standards

Accounting for Certain Derivative Instruments and Certain Hedging Activities

an amendment of FASB Statement No. 133

March 3, 2000

INTRODUCTION

1. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, (collectively referred to as derivatives) and for hedging activities. The Board has undertaken this Statement to address a limited number of issues causing implementation difficulties for a large number of entities when applying Statement 133.

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

a. The normal purchases and normal sales exception in paragraph 10(b) may apply to contracts that implicitly or explicitly permit net settlement, as discussed in paragraphs 9(a) and 57(c)(1), and contracts that have a market mechanism to facilitate net settlement, as discussed in paragraphs 9(b) and 57(c)(2).
b. The specific risks that can be identified as the hedged risk are redefined so that in a hedge of interest rate risk, the risk of changes in the benchmark interest rate[1] would be the hedged risk.
c. Recognized foreign-currency-denominated debt instruments[2] may be the hedged item in fair value hedges or cash flow hedges.
d. Certain intercompany derivatives may be designated as the hedging instruments in cash flow hedges of foreign currency risk in the consolidated financial statements if those intercompany derivatives are offset by unrelated third-party contracts on a net basis.

3. This Statement also amends Statement 133 for decisions made by the Board relating to the Derivatives Implementation Group (DIG) process. Certain interpretations of Statement 133 resulting from the DIG process required specific amendments to clarify the guidance in Statement 133 and are incorporated in this Statement.

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[1]Benchmark interest rate is defined in paragraph 4(ee) of this Statement.

[2]Throughout this Statement, foreign-currency-denominated debt instruments refer to either assets or liabilities.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendments to Statement 133

4. FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* is amended as follows:

Amendment Related to Normal Purchases and Normal Sales

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

> *Normal purchases and normal sales.* Normal purchases and normal sales are contracts that provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. However, contracts that have a price based on an underlying unrelated to the asset being sold or purchased (such as the S&P index) or that are denominated in a foreign currency that does not meet the criteria in paragraphs 15(a) and 15(b) shall not be considered normal purchases and normal sales. Contracts that contain net settlement provisions as described in paragraphs 9(a) and 9(b) may qualify for the normal purchases and normal sales exception if it is probable that the contracts will not settle net and will result in physical delivery. Net settlement of similar contracts should be rare and would call into question the classification of such contracts as normal purchases or normal sales. Contracts that require cash settlements or otherwise settle gains or losses on a periodic basis do not qualify for this exception. For contracts that qualify for the normal purchases and normal sales exception, the entity must document the basis for concluding that it is probable that the contract will result in physical delivery.

Amendments to Define Interest Rate Risk

b. Paragraph 21 is amended as follows:

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

> If the hedged item is all or a portion of a debt security (or a portfolio of similar debt securities) that is classified as held-to-maturity in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* the designated risk being hedged is (1) the risk of changes in its fair value attributable to credit risk, foreign exchange risk, or both or (2) if the hedged

item is an option component of a held-to-maturity security that permits its prepayment, the designated risk being hedged is the risk of changes in the entire fair value of that option component.

(2) In the parenthetical sentence of subparagraph (d), *market* and *or foreign exchange rates* are deleted.

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

(4) In subparagraph (f)(3), *(referred to as foreign exchange risk)* is added after the words *exchange rates.*

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

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

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

> The benchmark interest rate being hedged in a hedge of interest rate risk must be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Ordinarily, an entity should designate the same benchmark interest rate as the risk being hedged for similar hedges, consistent with paragraph 62; use of different interest rates for similar hedges should be rare and must be justified. The benchmark interest rate being hedged in a hedge of interest rate risk should not reflect greater credit risk than is inherent in the hedged item. For example, in the United States, if a U.S. government or AAA-rated financial instrument is the hedged item, the **LIBOR swap rate** cannot be the designated benchmark interest rate in a hedge of interest rate risk because the LIBOR swap rate reflects greater credit risk than the rate for U.S. government or AAA-rated financial instruments. However, the risk designated as being hedged could potentially be the risk of changes in the overall fair value of the entire hedged item if an entity wanted to designate a fair value hedging relationship involving a LIBOR-based swap and a U.S. government or AAA-rated financial instrument, provided that the other criteria for a fair value hedge have been met.

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

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

c. Paragraph 29 is amended as follows:

(1) In the first sentence of subparagraph (e), *default or changes in the obligor's creditworthiness* is replaced by *credit risk, foreign exchange risk, or both.*

(2) In the last sentence of subparagraph (e), *changes in market interest rates* is replaced by *interest rate risk.*

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

(4) In subparagraph (h)(3), *(referred to as foreign exchange risk)* is added after *rates.*

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

(6) In subparagraph (h), the following sentences are added after the second sentence:

> The benchmark interest rate being hedged in a hedge of interest rate risk must be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Ordinarily, an entity should designate the same benchmark interest rate as the risk being hedged for similar hedges, consistent with paragraph 62; use of different interest rates for similar hedges should be rare and must be justified. The benchmark interest rate being hedged in a hedge of interest rate risk should not reflect greater credit risk than is inherent in the hedged transactions. For example, in the United States, if the hedged transaction is the forecasted purchase or sale of a AAA-rated financial instrument, the LIBOR swap rate cannot be the designated benchmark interest rate in a hedge of interest rate risk because the LIBOR swap rate reflects greater credit risk than the rate for AAA-rated financial instruments. In a cash flow hedge of the variable cash inflow or outflow of an existing financial asset or liability, the designated risk being hedged cannot be the risk of changes in its cash flows attributable to changes in the benchmark interest rate if the cash

flows of the hedged item are explicitly based on a different index. For example, if the interest payments on a recognized floating-rate financial instrument indexed to the prime rate are the hedged transactions, base Treasury rates cannot be the benchmark interest rate designated as the hedged risk.

d. Paragraph 54 is amended as follows:

   (1) In the second sentence, *market interest rates, changes in foreign currency exchange rates,* is replaced by *the benchmark interest rate.*

   (2) In the third and fourth (parenthetical) sentences, *market* is deleted.

   (3) In the penultimate sentence of footnote 14, *market interest rates* is replaced by *interest rate risk.*

e. In the first sentence of paragraph 90, *market* is deleted.

Amendments Related to Hedging Recognized Foreign-Currency-Denominated Debt Instruments

f. In paragraph 21(c)(1), *(for example, if foreign exchange risk is hedged, a foreign-currency-denominated asset for which a foreign currency transaction gain or loss is recognized in earnings)* is deleted.

g. In the first sentence of paragraph 29(d), *(for example, if foreign exchange risk is hedged, the forecasted acquisition of a foreign-currency-denominated asset for which a foreign currency transaction gain or loss will be recognized in earnings)* is deleted.

h. Paragraph 36 is amended as follows:

   (1) In the first sentence, *Consistent with the functional currency concept in Statement 52,* is deleted.

   (2) In subparagraph (a), *, a recognized foreign-currency-denominated debt instrument,* is added before *or an available-for-sale security.*

   (3) In subparagraph (b), *, an unrecognized firm commitment, a recognized foreign-currency-denominated debt instrument,* is added after *A cash flow hedge of a forecasted foreign-currency-denominated transaction.*

(4) The second and third sentences are replaced as follows:

The criterion in paragraph 21(c)(1) requiring that the hedged item not be an asset or liability that is remeasured with the changes in fair value attributable to the hedged risk reported currently in earnings does not apply to foreign-currency-denominated debt instruments that require remeasurement of the carrying value at spot exchange rates based on paragraph 15 of Statement 52. Similarly, the criterion in the first sentence of paragraph 29(d) requiring that the forecasted transaction not be the acquisition of an asset or the incurrence of a liability that will subsequently be remeasured with changes in fair value attributable to the hedged risk reported currently in earnings does not apply to the forecasted acquisition or incurrence of foreign-currency-denominated debt instruments that will require remeasurement of the carrying value at spot exchange rates based on paragraph 15 of Statement 52.

i. Paragraph 38 is amended as follows:

(1) In the heading, *A recognized foreign-currency-denominated debt instrument or an* is added before *Available-for-sale security.*

(2) In the first sentence, *a recognized foreign-currency-denominated debt instrument or* is added before *an available-for-sale security.*

(3) In the second sentence, *a recognized foreign-currency-denominated debt instrument or* is added before *an available-for-sale debt security.*

j. In the second sentence of paragraph 40, *either* is replaced by *a recognized foreign-currency-denominated debt instrument, a firm commitment,*.

Amendments Related to Intercompany Derivatives

k. In the last sentence of paragraph 36, *in a fair value hedge or in a cash flow hedge of an existing foreign-currency-denominated debt instrument* is added after *can be a hedging instrument.*

l. The following paragraphs are added after paragraph 40:

40A. A foreign currency derivative instrument that has been entered into with another member of a consolidated group (such as a treasury center) can be a hedging instrument in a foreign currency cash flow hedge of a forecasted borrowing, purchase, or sale or an unrecognized firm commitment in the consolidated financial statements only if the following two conditions are satisfied. (That foreign currency derivative instrument is hereafter in this section referred to as an *internal derivative.*)

a. From the perspective of the member of the consolidated group using the derivative as a hedging instrument (hereafter in this section referred to as the *hedging affiliate*), the criteria for foreign currency cash flow hedge accounting in paragraph 40 must be satisfied.
b. The member of the consolidated group not using the derivative as a hedging instrument (hereafter in this section referred to as the *issuing affiliate*) must either (1) enter into a derivative contract with an unrelated third party to offset the exposure that results from that internal derivative or (2) enter into derivative contracts with unrelated third parties that would offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivative contracts. Hedge accounting may not be applied in consolidated financial statements if an internal derivative is not offset by a third-party derivative either individually or on a net basis.

40B. If a member of a consolidated group chooses to offset exposure arising from multiple internal derivative contracts on an aggregate or net basis, the derivatives issued to hedging affiliates may qualify as foreign currency cash flow hedges of a forecasted borrowing, purchase, or sale or an unrecognized firm commitment in the consolidated financial statements only if all of the following conditions are satisfied:

a. The issuing affiliate enters into a derivative instrument with an unrelated third party to offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivative contracts and the derivative contract with the unrelated third party generates equal or closely approximating gains and losses when compared with the aggregate or net losses and gains generated by the derivative contracts issued to affiliates.
b. Internal derivatives that are not designated as hedging instruments and all nonderivative contracts are excluded from the determination of the foreign currency exposure on a net basis that is offset by the third-party derivative.
c. Foreign currency exposure that is offset by a single net third-party contract arises from internal derivative contracts that involve the same currency and that mature within the same 31-day period. The offsetting net third-party derivative related to that group of contracts must offset the aggregate or net exposure to that currency, must mature within the same 31-day period, and must be entered into within 3 business days after the designation of the internal derivatives as hedging instruments.
d. The issuing affiliate tracks the exposure that it acquires from each hedging affiliate and maintains documentation supporting linkage of each derivative contract and the offsetting aggregate or net derivative contract with an unrelated third party.

e. The issuing affiliate does not alter or terminate the offsetting derivative with an unrelated third party unless the hedging affiliate initiates that action. If the issuing affiliate does alter or terminate the offsetting third-party derivative (which should be rare), the hedging affiliate must prospectively cease hedge accounting for the internal derivatives that are offset by that third-party derivative.
f. If an internal derivative that is included in determining the foreign currency exposure on a net basis is modified or dedesignated as a hedging instrument, compliance with this paragraph must be reassessed.

40C. A member of a consolidated group is not permitted to offset exposure arising from multiple internal derivative contracts on an aggregate or net basis for foreign currency cash flow exposure related to recognized foreign-currency-denominated debt instruments.

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

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

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

n. Paragraph 33 is replaced by the following:

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

o. The following is added at the end of paragraph 45(b)(4):

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

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

p. In the last sentence of paragraph 37, *and the conditions in paragraphs 40(a) and 40(b)* is added between *paragraphs 20 and 21* and *are met.*

q. In the third sentence of paragraph 38, *and the conditions in paragraphs 40(a) and 40(b)* is added between *paragraphs 20 and 21* and *are met.*

r. In paragraph 42, *provided the conditions in paragraphs 40(a) and 40(b) are met* is added to the end of the first sentence.

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

s. Paragraph 40 is amended as follows:

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

> For consolidated financial statements, either (1) the operating unit that has the foreign currency exposure is a party to the hedging instrument or (2) another member of the consolidated group that has the same functional currency as that operating unit (subject to the restrictions in this subparagraph and related footnote) is a party to the hedging instrument. To qualify for applying the guidance in (2) above, there may be no intervening subsidiary with a different functional currency.* (Refer to paragraphs 40A and 40B for conditions for which an intercompany foreign currency derivative can be the hedging instrument in a cash flow hedge of foreign exchange risk.)
>
> *For example, if a dollar-functional, second-tier subsidiary has a Euro exposure, the dollar-functional consolidated parent company could designate its U.S. dollar–Euro derivative as a hedge of the second-tier subsidiary's exposure provided that the functional currency of the intervening first-tier subsidiary (that is, the parent of the second-tier subsidiary) is also the U.S. dollar. In contrast, if the functional currency of the intervening first-tier subsidiary was the Japanese yen (thus requiring the financial statements of the second-tier subsidiary to be translated into yen before the yen-denominated financial statements of the first-tier subsidiary are translated into U.S. dollars for consolidation), the consolidated parent company could not designate its U.S. dollar–Euro derivative as a hedge of the second-tier subsidiary's exposure.

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

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

t. Paragraph 58 is amended as follows:

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

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

Also, in order for a contract that meets the net settlement provisions of paragraphs 9(a) and 57(c)(1) and the market mechanism provisions of paragraphs 9(b) and 57(c)(2) to qualify for the exception, net settlement of similar contracts must be rare.

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

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

u. Paragraph 61 is amended as follows:

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

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

v. Paragraph 68 is amended as follows:

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

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

(that is, able to be settled by either party prior to its scheduled maturity), except as indicated in the following sentences. This criterion does not apply to an interest-bearing asset or liability that is prepayable solely due to an embedded call option provided that the hedging interest rate swap contains an

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

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

x. Paragraph 115 is amended as follows:

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

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

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

y. Paragraph 134 is amended as follows:

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

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

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

z. In paragraph 155, *Example 2* is replaced by *Example 5.*

aa. The last sentence of paragraph 161 is deleted.

bb. Paragraph 169 is amended as follows:

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

(2) The third sentence and the fourth (parenthetical) sentence are deleted.

(3) In the fifth sentence, *a proportion of the forward contract* is replaced by *a proportion of the hedging instrument in the original hedge relationship with respect to the proportion of the forward contract.*

(4) In the last sentence, *and if the dedesignated proportion of the forward contract is not designated anew as a cash flow hedge of the foreign-currency-denominated receivable* is added after *After that date.*

cc. Paragraph 197 is replaced as follows:

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

Scope Application: Paragraph 10(b) excludes contracts that require future delivery of commodities that are readily convertible to cash from the accounting for derivatives if the commodities will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. However, that paragraph also states that contracts that are denominated in a foreign currency that does not meet the criteria in paragraphs 15(a) and 15(b) shall not be considered normal purchases and normal sales. Because the Japanese yen is not the functional currency of either party to the contract and the purchase of corn is transacted internationally in many different currencies, the contract does not qualify for the normal purchases and normal sales exception. The contract is a compound derivative comprising a U.S. dollar-denominated forward contract for the purchase of corn and an embedded foreign currency swap from the purchaser's functional currency (the U.S. dollar) to yen. Consistent with the last sentence of footnote 13 to paragraph 49, the compound derivative cannot be separated into its components (representing the foreign currency derivative and the forward commodity contract) and accounted for separately under Statement 133.

dd. Paragraph 200 is amended as follows:

(1) The second bullet is amended as follows:

(a) In the first sentence, *owned by the policyholder and* is deleted.

(b) The second sentence is deleted.

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

(d) In the penultimate sentence, *not be viewed as a direct investment because the policyholder does not own those investments, which are assets recorded in the general account of the insurance company* is replaced by *contain an embedded derivative (the equity index-based derivative) that meets all the requirements of paragraph 12 of Statement 133 for separate accounting.*

(e) The last sentence is replaced by the following:

The economic characteristics and risks of the embedded derivative would not be clearly and closely related to the economic characteristics and risks of the host contract (that is, the host contract is a debt instrument and the embedded option is equity-indexed), the hybrid instrument would not be remeasured at fair value with changes in fair value reported in earnings as they occur under GAAP, and a separate instrument with the same terms as the embedded derivative instrument would be a derivative instrument pursuant to paragraphs 6–11 of Statement 133.

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

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

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

Amendments to the Glossary of Statement 133

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

Benchmark interest rate

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

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

LIBOR swap rate

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

Effective Date and Transition

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

6. The following transition provisions are effective for entities that have adopted Statement 133 prior to June 15, 2000.

a. At the date of initial application, an entity may elect to derecognize in the balance sheet any derivative instrument that would qualify under this Statement as a normal purchase or normal sales contract and record a cumulative effect of a change in accounting principle as described in paragraph 20 of APB Opinion No. 20, *Accounting*

Changes. The election to derecognize may not be applied to only some of an entity's normal purchases and normal sales contracts and must be applied on an all-or-none basis. That election to derecognize a derivative instrument may be applied retroactively to the beginning of any fiscal quarter for which financial statements have not been issued.

b. At the date of initial application, an entity must dedesignate the market interest rate as the hedged risk in a hedge of interest rate risk. An entity is permitted to designate anew the benchmark interest rate as the hedged risk in a hedge of interest rate risk.
c. At the date of initial application, an entity may designate a recognized foreign-currency-denominated debt instrument as the hedged item in a hedge of foreign exchange risk pursuant to paragraphs 21 and 29 of Statement 133, as amended by this Statement. An entity may also designate intercompany derivatives that meet the requirements in paragraph 4(l) of this Statement (paragraphs 40A and 40B of Statement 133) as hedging instruments in cash flow hedges of foreign exchange risk when those intercompany derivatives have been offset on only a net basis with third-party derivatives. Any such designations shall be made on a prospective basis.

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

Appendix A

BACKGROUND INFORMATION, BASIS FOR CONCLUSIONS, AND ALTERNATIVE VIEW

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Appendix A

BACKGROUND INFORMATION, BASIS FOR CONCLUSIONS, AND ALTERNATIVE VIEW

Introduction

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

Background Information

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

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

9. Of the six issues, the Board determined that it would be appropriate to amend Statement 133 for four of those issues (identified as the normal purchases and normal sales exception, hedging the benchmark interest rate, hedging recognized foreign-currency-denominated debt instruments, and hedging with intercompany derivatives). The Board determined that amending Statement 133 for the remaining two issues (identified as partial-term hedging and purchased option hedges) would conflict with the basic model of Statement 133. The Board also concluded that additional amendments to Statement 133 would be appropriate to clarify the Statement as a result of certain interpretations of Statement 133 cleared by the Board relating to the DIG process.

Amendments to Statement 133

Normal Purchases and Normal Sales Exception

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

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

Hedging the Benchmark Interest Rate

12. This Statement amends Statement 133 to permit the *benchmark interest rate* to be designated as the hedged risk in a hedge of interest rate risk. Statement 133 Implementation Issue No. E1, "Hedging the Risk-Free Interest Rate," provided implementation guidance for Statement 133 that indicated that the hedged risk in a hedge of interest rate risk would be the *market interest rate,* defined as the risk-free rate plus the credit sector spread appropriate for the hedged item at the inception of the hedge. Comments received by the Board indicated (a) that the concept of market interest rate risk as defined in Implementation Issue E1 differed from the common understanding of interest rate risk by market participants, (b) that the guidance in Implementation Issue E1 was inconsistent with present hedging activities, and (c) that measuring the change in fair value of the hedged item attributable to changes in credit sector spreads would be difficult because consistent sector spread data are not readily available in the market.

13. The Board decided that, with respect to the separation of interest rate risk and credit risk, the risk of changes in credit sector spread and any credit spread attributable to a specific borrower should be encompassed in credit risk rather than interest rate risk. Un-

der that approach, an entity would be permitted to designate the risk of changes in the risk-free rate as the hedged risk. Under that notion, the remaining spread above that rate would be deemed to reflect credit risk. The Board concluded that considering all the effects of credit risk together was more understandable and more operational than the distinction between interest rate risk and credit risk in Implementation Issue E1.

14. The Board decided that, in the United States, the interest rate on direct Treasury obligations of the U.S. government provides the best measure of the risk-free rate. The Board considered defining interest rate risk based only on Treasury rates in the United States. However, the Board decided that there were several compelling reasons to make a practical exception and, therefore, extended the definition of interest rate risk to include interest rate swap rates based on the London Interbank Offered Rate (LIBOR). The Board has been informed that

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

Because the Board decided that interest rate risk should be defined to include a rate that is not fully risk-free, it developed the general term *benchmark interest rate,* to encompass both risk-free rates and rates based on the LIBOR swap curve.

15. The Board also considered whether other rates in the U.S. financial markets meet the definition of benchmark interest rate and whether those rates should be permitted to be designated as the hedged risk in a hedge of interest rate risk. The Board decided that while other rates such as the commercial paper rate and the Fed Funds rate would meet the definition of benchmark interest rate, allowing more than one or two benchmark rates to define interest rate risk was unnecessary and would make the resulting financial statements more difficult to understand. Therefore, they should not be used.

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

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

Hedging Recognized Foreign-Currency-Denominated Debt Instruments

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

19. The Board decided to make an exception to the general principle to permit both fair value hedges and cash flow hedges of foreign-currency-denominated debt instruments. The exception is applicable to foreign-currency-denominated debt instruments that are either held (assets) or owed (liabilities) and includes instruments such as bonds, loans, receivables, and payables. Designated hedging instruments and hedged items qualify for fair value hedge accounting and cash flow hedge accounting under this Statement only if all of the criteria in Statement 133 are met for fair value hedge accounting and cash flow hedge accounting. Remeasurement of the foreign-currency-denominated debt instruments will continue to be based on the guidance in Statement 52, which requires remeasurement based on spot exchange rates.

20. The Board concluded that in the situations in which fair value hedges would be used, remeasurement of the foreign-currency-denominated debt instrument based on the spot exchange rate would result in the same functional currency value that would result if the instrument was remeasured based on the forward exchange rate. For fair value hedges of only foreign exchange risk, the net amount recognized currently in earnings related to the "spot-forward difference" attributable to independently measuring the hedging instrument at fair value and the hedged item for changes in exchange rates would be the same regardless of the measurement method used for the hedged item. Permitting fair value hedges of foreign-currency-denominated debt instruments allows an entity to use a compound derivative to hedge both interest rate risk and foreign exchange rate risk, a

situation that is currently permitted under Statement 133 through the use of two derivatives. Permitting the use of a compound derivative in a fair value hedge of interest rate risk and foreign exchange rate risk would result in the value of the foreign currency debt instrument being adjusted for changes in fair value attributable to changes in foreign interest rates before remeasurement at the spot exchange rate. The ability to adjust the foreign currency debt instrument for changes in foreign interest rates effectively eliminates any spot-forward difference recognized currently in earnings.

21. The Board concluded that the use of cash flow hedges in certain situations would mitigate the effects on earnings related to the spot-forward difference resulting from the use of different measurement criteria for the hedged item (remeasured based on spot exchange rates) and the hedging instrument (measured at fair value based on forward exchange rates). The Board believes that is consistent with the principal purpose of providing special hedge accounting to mitigate the effects on earnings of different existing measurement attributes.

Hedging with Intercompany Derivatives

22. Paragraph 36 of Statement 133 permits a derivative instrument entered into with another member of the consolidated group to qualify as a foreign currency hedging instrument in the consolidated financial statements only if the member of the consolidated group has entered into an individual offsetting derivative contract with an unrelated third party. Constituents requested that Statement 133 be amended to permit derivative instruments entered into with a member of the consolidated group to qualify as hedging instruments in the consolidated financial statements if those internal derivatives are offset by unrelated third-party contracts on a net basis.

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

nancial statements, provided that the internal derivative was offset on a one-to-one basis with a third party. Constituents said that while paragraph 36 of Statement 133 permits both the designation of internal derivatives as hedges of foreign exchange risk and the use of a treasury center, the requirement to individually offset each internal derivative with a third-party contract negates the efficiency and cost savings provided by a treasury center.

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

25. In addition, the Board concluded that applying hedge accounting in the consolidated financial statements under Statement 133 to internal derivatives that are offset on a net basis by third-party contracts would conflict with basic consolidation procedures required by paragraph 6 of ARB No. 51, *Consolidated Financial Statements*. The Board determined that such a conflict exists because certain effects related to intercompany balances arising from the application of hedge accounting to internal derivative contracts would not be eliminated in consolidation. To illustrate, for fair value hedges, the adjustment to the carrying amount of the hedged item, as determined by the change in fair value of the hedged item attributable to the hedged risk, results from applying hedge accounting to internal derivatives and would not be eliminated in consolidation. For cash flow hedges, amounts recorded in other comprehensive income, and the timing of reclassification of those amounts into earnings, similarly result from applying hedge accounting to internal derivatives and would not be eliminated in consolidation. For those reasons, the Board determined that, as a general rule, derivatives entered into with a member of the consolidated group should not qualify as hedging instruments in the consolidated financial statements if those internal derivatives are not offset by unrelated third-party contracts on an individual basis.

26. Notwithstanding, the Board decided to permit a limited exception for internal derivatives designated as foreign currency cash flow hedges of forecasted borrowings, purchases, or sales denominated in foreign currency or unrecognized firm commitments, sub-

ject to meeting certain criteria. For foreign currency cash flow hedges of those items, the Board decided to permit internal derivatives designated as hedging instruments to be offset on a net basis, rather than individually, by third-party derivative contracts. The Board believes that exception for those foreign currency cash flow hedges is not sufficiently different from the accounting for certain foreign currency items provided for in existing accounting literature. The Board determined that permitting multiple internal derivative contracts designated as cash flow hedges of certain foreign currency transactions to be offset on a net basis by third-party derivative contracts does not create a net effect on consolidated other comprehensive income during the period of the hedge that is sufficiently different from an anomaly that already exists under Statement 52 related to certain foreign currency transactions. The Board reasoned that Statement 52 currently results in the effects of certain intercompany transactions not being fully eliminated in the consolidated statement of income or comprehensive income. In issuing Statement 52, the Board did not determine that it was necessary to amend ARB 51 to provide for that result.

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

28. The Board also decided not to permit internal derivative contracts to be designated as hedging instruments in the consolidated financial statements in fair value or cash flow hedges of interest rate risk, credit risk, or the risk of changes in overall fair value or cash flows. The Board observed that the requirement that the operating unit that has exposure to risk be a party to the hedging instrument exists only for hedges of foreign exchange risk but not for hedges of risks other than foreign exchange risk. Further, even if internal derivative contracts were permitted to be designated as hedging instruments in the consolidated financial statements in a hedge of interest rate risk, credit risk, or the risk of changes in overall fair value or cash flows, permitting those internal derivatives to be offset on a net basis by a third-party derivative would create a new anomaly with respect to the application of consolidation procedures. However, in hedging interest rate risk,

credit risk, or the risk of changes in overall fair value or cash flows, an entity may use internal derivatives as a mechanism for centralizing exposure or as hedging instruments in separate company financial statements.

Alternative View

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

30. The Board also observed in Statement 133 that its vision is that all financial instruments ultimately be measured at fair value. If all financial instruments were measured at fair value with changes in fair value recorded currently in earnings, the need for hedge accounting for the risks inherent in existing financial instruments would be eliminated because both the hedging instrument and the hedged item would be measured at fair value. Recognizing and measuring the changes in fair value of all financial instruments using the same criteria and measurement attributes would leave no anomalies related to financial instruments. Consequently, the Board has tentatively concluded in its project on measuring all financial instruments at fair value that all changes in fair value be reflected in earnings. Statement 133 is a step forward in recognizing currently in earnings the amounts for which a hedging instrument is ineffective in offsetting the changes in the fair value of the hedged item or the variability of cash flows of the hedged transaction.

The same Board member believes the amendments to Statement 133 referred to in paragraph 29 represent steps backward from achieving the Board's vision of reporting all financial instruments at fair value because the result of those amendments is to report the effects of hedging instruments that are not fully effective in offsetting the changes in fair value attributable to the risk being hedged as if they were. Accordingly, he believes this Statement does not represent an improvement in financial reporting.

Appendix B

AMENDED PARAGRAPHS OF STATEMENT 133 MARKED TO SHOW CHANGES THAT WOULD BE MADE BY THIS PROPOSED STATEMENT

31. This appendix contains paragraphs of Statement 133 marked to integrate changes from this amendment.

> 10b. *Normal purchases and normal sales.* Normal purchases and normal sales are contracts that provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. However, contracts that have a price based on an underlying unrelated to the asset being sold or purchased (such as the S&P index) or that are denominated in a foreign currency that does not meet the criteria in paragraphs 15(a) and 15(b) shall not be considered normal purchases and normal sales. Contracts that contain net settlement provisions as described in paragraphs 9(a) and 9(b) may qualify for the normal purchases and normal sales exception if it is probable that the contracts will not settle net and will result in physical delivery. Net settlement of similar contracts should be rare and would call into question the classification of such contracts as normal purchases or normal sales. Contracts that require cash settlements or otherwise settle gains or losses on a periodic basis do not qualify for this exception. For contracts that qualify for the normal purchases and normal sales exception, the entity must document the basis for concluding that it is probable that the contract will result in physical delivery.~~with no net settlement provision and no market mechanism to facilitate net settlement (as described in paragraphs 9(a) and 9(b)). They provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business.~~

> 12. Contracts that do not in their entirety meet the definition of a derivative instrument (refer to paragraphs 6–9), such as bonds, insurance policies, and leases, may contain "embedded" derivative instruments—implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument. The effect of embedding a derivative instrument in another type of contract ("the host contract") is that some or all of the cash flows or other exchanges that otherwise would be required by the host contract, whether unconditional or contingent upon the occurrence of a speci-

fied event, will be modified based on one or more underlyings. An embedded derivative instrument shall be separated from the host contract and accounted for as a derivative instrument pursuant to this Statement if and only if all of the following criteria are met:

a. The economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract. Additional guidance on applying this criterion to various contracts containing embedded derivative instruments is included in Appendix A of this Statement.
b. The contract ("the hybrid instrument") that embodies both the embedded derivative instrument and the host contract is not remeasured at fair value under otherwise applicable generally accepted accounting principles with changes in fair value reported in earnings as they occur.
c. A separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6–11, be a derivative instrument subject to the requirements of this Statement. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

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

21(d). If the hedged item is all or a portion of a debt security (or a portfolio of similar debt securities) that is classified as held-to-maturity in accordance with FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* the designated risk being hedged is (1) the risk of changes in its fair value attributable to credit risk, foreign exchange risk, or both or (2) if the hedged item is an option component of a held-to-maturity security that permits its prepayment, the designated risk being hedged is the risk of changes in the entire fair value of that option component.~~the~~

~~risk of changes in its fair value attributable to changes in the obligor's creditworthiness or if the hedged item is an option component of a held-to-maturity security that permits its prepayment, the designated risk being hedged is the risk of changes in the entire fair value of that option component.~~ (The designated hedged risk for a held-to-maturity security may not be the risk of changes in its fair value attributable to changes in ~~market~~ interest rates ~~or foreign exchange rates~~. If the hedged item is other than an option component that permits its prepayment, the designated hedged risk also may not be the risk of changes in its overall fair value.)

21(f). If the hedged item is a financial asset or liability, a recognized loan servicing right, or a nonfinancial firm commitment with financial components, the designated risk being hedged is (1) the risk of changes in the overall fair value of the entire hedged item, (2) the risk of changes in its fair value attributable to changes in the benchmark interest rate (referred to as interest rate risk)~~market interest rates~~, (3) the risk of changes in its fair value attributable to changes in the related foreign currency exchange rates (referred to as foreign exchange risk) (refer to paragraphs 37 and 38), or (4) the risk of changes in its fair value attributable to both changes in the obligor's creditworthiness and changes in the spread over the benchmark interest rate with respect to the hedged item's credit sector at inception of the hedge (referred to as credit risk)~~the obligor's creditworthiness~~. If the risk designated as being hedged is not the risk in paragraph 21(f)(1) above, two or more of the other risks (~~market~~ interest rate risk, foreign currency exchange risk, and credit risk) may simultaneously be designated as being hedged. The benchmark interest rate being hedged in a hedge of interest rate risk must be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Ordinarily, an entity should designate the same benchmark interest rate as the risk being hedged for similar hedges, consistent with paragraph 62; use of different interest rates for similar hedges should be rare and must be justified. The benchmark interest rate being hedged in a hedge of interest rate risk should not reflect greater credit risk than is inherent in the hedged item. For example, in the United States, if a U.S. government or AAA-rated financial instrument is the hedged item, the LIBOR swap rate cannot be the designated benchmark interest rate in a hedge of interest rate risk because the LIBOR swap rate reflects greater credit risk than the rate for U.S. government or AAA-rated financial instruments. However, the risk designated as being hedged could potentially be the risk of changes in the overall fair value of the entire hedged item if an entity wanted to designate a fair value hedging relationship involving a LIBOR-based swap and a U.S. government or AAA-rated financial instrument, provided that the other criteria for a fair value

hedge have been met. An entity may not simply designate prepayment risk as the risk being hedged for a financial asset. However, it can designate the option component of a prepayable instrument as the hedged item in a fair value hedge of the entity's exposure to changes in the overall fair value of that "prepayment" option, perhaps thereby achieving the objective of its desire to hedge prepayment risk. The effect of an embedded derivative of the same risk class must be considered in designating a hedge of an individual risk. For example, the effect of an embedded prepayment option must be considered in designating a hedge of ~~market~~ interest rate risk.

29(d). The forecasted transaction is not the acquisition of an asset or incurrence of a liability that will subsequently be remeasured with changes in fair value attributable to the hedged risk reported currently in earnings ~~(for example, if foreign exchange risk is hedged, the forecasted acquisition of a foreign-currency-denominated asset for which a foreign currency transaction gain or loss will be recognized in earnings)~~. However, forecasted sales on credit and the forecasted accrual of royalties on probable future sales by third-party licensees are not considered the forecasted acquisition of a receivable. If the forecasted transaction relates to a recognized asset or liability, the asset or liability is not remeasured with changes in fair value attributable to the hedged risk reported currently in earnings.

29(e). If the variable cash flows of the forecasted transaction relate to a debt security that is classified as held-to-maturity under Statement 115, the risk being hedged is the risk of changes in its cash flows attributable to credit risk, foreign exchange risk, or both~~default or changes in the obligor's creditworthiness~~. For those variable cash flows, the risk being hedged cannot be the risk of changes in its cash flows attributable to ~~changes in market interest rates~~interest rate risk.

29(h). If the hedged transaction is the forecasted purchase or sale of a financial asset or liability or the variable cash inflow or outflow of an existing financial asset or liability, the designated risk being hedged is (1) the risk of changes in the cash flows of the entire asset or liability, such as those relating to all changes in the purchase price or sales price (regardless of whether that price and the related cash flows are stated in the entity's functional currency or a foreign currency), (2) the risk of changes in its cash flows attributable to changes in the benchmark interest rate (referred to as interest rate risk)~~market interest rates~~, (3) the risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates (referred to as foreign exchange risk) (refer to paragraph 40), or (4) the risk of changes in its cash flows attributable to

default, changes in the obligor's creditworthiness, and changes in the spread over the benchmark interest rate with respect to the hedged item's credit sector at inception of the hedge (referred to as credit risk)~~default or changes in the obligor's creditworthiness~~. Two or more of the above risks may be designated simultaneously as being hedged. The benchmark interest rate being hedged in a hedge of interest rate risk must be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Ordinarily, an entity should designate the same benchmark interest rate as the risk being hedged for similar hedges, consistent with paragraph 62; use of different interest rates for similar hedges should be rare and must be justified. The benchmark interest rate being hedged in a hedge of interest rate risk should not reflect greater credit risk than is inherent in the hedged transactions. For example, in the United States, if the hedged transaction is the forecasted purchase or sale of a AAA-rated financial instrument, the LIBOR swap rate cannot be the designated benchmark interest rate in a hedge of interest rate risk because the LIBOR swap rate reflects greater credit risk than the rate for AAA-rated financial instruments. In a cash flow hedge of the variable cash inflow or outflow of an existing financial asset or liability, the designated risk being hedged cannot be the risk of changes in its cash flows attributable to changes in the benchmark interest rate if the cash flows of the hedged item are explicitly based on a different index. For example, if the interest payments on a recognized floating-rate financial instrument indexed to the prime rate are the hedged transactions, base Treasury rates cannot be the benchmark interest rate designated as the hedged risk. An entity may not designate prepayment risk as the risk being hedged (refer to paragraph 21(f)).

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

exception described in the preceding sentence, that derivative gain or loss reported in accumulated other comprehensive income should be reclassified into earnings immediately.~~If a cash flow hedge is discontinued because it is probable that the original forecasted transaction will not occur, the net gain or loss in accumulated other comprehensive income shall be immediately reclassified into earnings.~~

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

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

The criterion in paragraph 21(c)(1) requiring that the hedged item not be an asset or liability that is remeasured with the changes in fair value attributable to the hedged risk reported currently in earnings does not apply to foreign-currency-denominated debt instruments that require remeasurement of the carrying value at spot exchange rates based on paragraph 15 of Statement 52.~~requires that a recognized asset or liability that may give rise to a foreign currency transaction gain or loss under Statement 52 (such as a foreign-currency-denominated receivable or payable) not be the hedged item in a foreign currency fair value or cash flow hedge because it is remeasured with the changes in the carrying amount attributable to what would be the hedged risk (an exchange rate change) reported currently in earnings.~~ Similarly, the criterion in the first sentence of paragraph 29(d) requiring that the forecasted transaction not be the acquisition of an asset or the incurrence of a liability that will subsequently be remeasured with changes in fair value attributable to the hedged risk reported currently in earnings does not apply to the forecasted acquisition or incurrence of foreign-currency-denominated debt instruments that will require remeasurement of the carrying value at spot exchange rates based on paragraph 15 of Statement 52.~~paragraph 29(d) requires that the forecasted acquisition of an asset or the incurrence of a liability that may give rise to a foreign currency transaction gain or loss under Statement 52 not be the hedged item in a foreign currency cash flow hedge because, subsequent to acquisition or incurrence, the asset or liability will be remeasured with changes in the carrying amount attributable to what would be the hedged risk reported currently in earnings.~~ A foreign currency derivative instrument that has been entered into with another member

of a consolidated group can be a hedging instrument in a fair value hedge or in a cash flow hedge of an existing foreign-currency-denominated debt instrument in the consolidated financial statements only if that other member has entered into an offsetting contract with an unrelated third party to hedge the exposure it acquired from issuing the derivative instrument to the affiliate that initiated the hedge.

37. *Unrecognized firm commitment*. A derivative instrument or a nonderivative financial instrument[11] that may give rise to a foreign currency transaction gain or loss under Statement 52 can be designated as hedging changes in the fair value of an unrecognized firm commitment, or a specific portion thereof, attributable to foreign currency exchange rates. The designated hedging relationship qualifies for the accounting specified in paragraphs 22–27 if all the fair value hedge criteria in paragraphs 20 and 21 and the conditions in paragraphs 40(a) and 40(b) are met.

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

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

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

40. A nonderivative financial instrument shall not be designated as a hedging instrument in a foreign currency cash flow hedge. A derivative instrument designated as hedging the foreign currency exposure to variability in the functional-currency-equivalent cash flows associated with a recognized foreign-currency-

denominated debt instrument, a firm commitment, either a forecasted foreign-currency-denominated transaction (for example, a forecasted export sale to an unaffiliated entity with the price to be denominated in a foreign currency), or a forecasted intercompany foreign-currency-denominated transaction (for example, a forecasted sale to a foreign subsidiary or a forecasted royalty from a foreign subsidiary) qualifies for hedge accounting if all of the following criteria are met:

a. For consolidated financial statements, either (1) the operating unit that has the foreign currency exposure is a party to the hedging instrument or (2) another member of the consolidated group that has the same functional currency as that operating unit (subject to the restrictions in this subparagraph and related footnote) is a party to the hedging instrument. To qualify for applying the guidance in (2) above, there may be no intervening subsidiary with a different functional currency.* (Refer to paragraphs 40A and 40B for conditions for which an intercompany foreign currency derivative can be the hedging instrument in a cash flow hedge of foreign exchange risk.)The operating unit that has the foreign currency exposure is a party to the hedging instrument (which can be an instrument between a parent company and its subsidiary—refer to paragraph 36).
b. The hedged transaction is denominated in a currency other than that the hedging unit's functional currency.
c. All of the criteria in paragraphs 28 and 29 are met, except for the criterion in paragraph 29(c) that requires that the forecasted transaction be with a party external to the reporting entity.
d. If the hedged transaction is a group of individual forecasted foreign-currency-denominated transactions, a forecasted inflow of a foreign currency and a forecasted outflow of the foreign currency cannot both be included in the same group.

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

40A. A foreign currency derivative instrument that has been entered into with another member of a consolidated group (such as a treasury center) can be a hedging instrument in a foreign currency cash flow hedge of a forecasted borrowing, purchase, or sale or an unrecognized firm commitment in the consolidated financial

statements only if the following two conditions are satisfied. (That foreign currency derivative instrument is hereafter in this section referred to as an *internal derivative.*)

a. From the perspective of the member of the consolidated group using the derivative as a hedging instrument (hereafter in this section referred to as the *hedging affiliate*), the criteria for foreign currency cash flow hedge accounting in paragraph 40 must be satisfied.
b. The member of the consolidated group not using the derivative as a hedging instrument (hereafter in this section referred to as the *issuing affiliate*) must either (1) enter into a derivative contract with an unrelated third party to offset the exposure that results from that internal derivative or (2) enter into derivative contracts with unrelated third parties that would offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivative contracts. Hedge accounting may not be applied in consolidated financial statements if an internal derivative is not offset by a third-party derivative either individually or on a net basis.

40B. If a member of a consolidated group chooses to offset exposure arising from multiple internal derivative contracts on an aggregate or net basis, the derivatives issued to hedging affiliates may qualify as foreign currency cash flow hedges of a forecasted borrowing, purchase, or sale or an unrecognized firm commitment in the consolidated financial statements only if all of the following conditions are satisfied:

a. The issuing affiliate enters into a derivative instrument with an unrelated third party to offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivative contracts and the derivative contract with the unrelated third party generates equal or closely approximating gains and losses when compared with the aggregate or net losses and gains generated by the derivative contracts issued to affiliates.
b. Internal derivatives that are not designated as hedging instruments and all nonderivative contracts are excluded from the determination of the foreign currency exposure on a net basis that is offset by the third-party derivative.
c. Foreign currency exposure that is offset by a single net third-party contract arises from internal derivative contracts that involve the same currency and that mature within the same 31-day period. The offsetting net third-party derivative related to that group of contracts must offset the aggregate or net exposure to that currency, must mature within the same 31-day period, and must be entered into within 3 business days after the designation of the internal derivatives as hedging instruments.

d. The issuing affiliate tracks the exposure that it acquires from each hedging affiliate and maintains documentation supporting linkage of each derivative contract and the offsetting aggregate or net derivative contract with an unrelated third party.
e. The issuing affiliate does not alter or terminate the offsetting derivative with an unrelated third party unless the hedging affiliate initiates that action. If the issuing affiliate does alter or terminate the offsetting third-party derivative (which should be rare), the hedging affiliate must prospectively cease hedge accounting for the internal derivatives that are offset by that third-party derivative.
f. If an internal derivative that is included in determining the foreign currency exposure on a net basis is modified or dedesignated as a hedging instrument, compliance with this paragraph must be reassessed.

40C. A member of a consolidated group is not permitted to offset exposure arising from multiple internal derivative contracts on an aggregate or net basis for foreign currency cash flow exposure related to recognized foreign-currency-denominated debt instruments.

42. A derivative instrument or a nonderivative financial instrument that may give rise to a foreign currency transaction gain or loss under Statement 52 can be designated as hedging the foreign currency exposure of a net investment in a foreign operation provided the conditions in paragraphs 40(a) and 40(b) are met. The gain or loss on a hedging derivative instrument (or the foreign currency transaction gain or loss on the nonderivative hedging instrument) that is designated as, and is effective as, an economic hedge of the net investment in a foreign operation shall be reported in the same manner as a translation adjustment to the extent it is effective as a hedge. The hedged net investment shall be accounted for consistent with Statement 52; the provisions of this Statement for recognizing the gain or loss on assets designated as being hedged in a fair value hedge do not apply to the hedge of a net investment in a foreign operation.

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

Cash flow hedges

b. For derivative instruments that have been designated and have qualified as cash flow hedging instruments and for the related hedged transactions:
   (1) The net gain or loss recognized in earnings during the reporting period representing (a) the amount of the hedges' ineffectiveness and (b) the component of the derivative instruments' gain or loss, if any, excluded from the assessment of hedge effectiveness, and a description of where the net gain

or loss is reported in the statement of income or other statement of financial performance

(2) A description of the transactions or other events that will result in the reclassification into earnings of gains and losses that are reported in accumulated other comprehensive income, and the estimated net amount of the existing gains or losses at the reporting date that is expected to be reclassified into earnings within the next 12 months

(3) The maximum length of time over which the entity is hedging its exposure to the variability in future cash flows for forecasted transactions excluding those forecasted transactions related to the payment of variable interest on existing financial instruments

(4) The amount of gains and losses reclassified into earnings as a result of the discontinuance of cash flow hedges because it is probable that the original forecasted transactions will not occur by the end of the originally specified time period or within the additional period of time discussed in paragraph 33.

54. At the date of initial application, an entity may transfer any held-to-maturity security into the available-for-sale category or the trading category. An entity will then be able in the future to designate a security transferred into the available-for-sale category as the hedged item, or its variable interest payments as the cash flow hedged transactions, in a hedge of the exposure to changes in the benchmark interest rate~~market interest rates, changes in foreign currency exchange rates,~~ or changes in its overall fair value. (Paragraph 21(d) precludes a held-to-maturity security from being designated as the hedged item in a fair value hedge of ~~market~~ interest rate risk or the risk of changes in its overall fair value. Paragraph 29(e) similarly precludes the variable cash flows of a held-to-maturity security from being designated as the hedged transaction in a cash flow hedge of ~~market~~ interest rate risk.) The unrealized holding gain or loss on a held-to-maturity security transferred to another category at the date of initial application shall be reported in net income or accumulated other comprehensive income consistent with the requirements of paragraphs 15(b) and 15(c) of Statement 115 and reported with the other transition adjustments discussed in paragraph 52 of this Statement. Such transfers from

the held-to-maturity category at the date of initial adoption shall not call into question an entity's intent to hold other debt securities to maturity in the future.[14]

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

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

a. *"Regular-way" security trades*. The exception in paragraph 10(a) applies only to a contract that requires delivery of securities that are readily convertible to cash.[16] To qualify, a contract must require delivery of such a security within the period of time after the trade date that is customary in the market in which the trade takes place. For example, a contract to purchase or sell a publicly traded equity security in the United States customarily requires settlement within three business days. If a contract for purchase of that type of security requires settlement in three business days, the regular-way exception applies, but if the contract requires settlement in five days, the regular-way exception does not apply. This Statement does not change whether an entity recognizes regular-way security trades on the trade date or the settlement date. However, trades that do not qualify for the regular-way exception are subject to the requirements of this Statement regardless of the method an entity uses to report its security trades.
b. *Normal purchases and normal sales.* The exception in paragraph 10(b) applies only to a contract that ~~requires~~ involves future delivery of assets (other than financial instruments or derivative instruments)~~ that are readily convertible to cash[17] and only if there is no market mechanism to facilitate net settlement outside the contract~~. To qualify for the exception, a contract's terms also must be consistent with the terms of an entity's normal purchases or normal sales, that is, the quantity purchased or sold must be reasonable in relation to the entity's business needs. Determining whether or not the terms are consistent will require judgment. In making those judgments, an entity should consider all relevant factors, such as (1) the quantities provided under the contract and the entity's need for the related assets, (2) the locations to which delivery of the items will be made, (3) the period of time between entering into the contract

and delivery, and (4) the entity's prior practices with regard to such contracts. Evidence such as past trends, expected future demand, other contracts for delivery of similar items, an entity's and industry's customs for acquiring and storing the related commodities, and an entity's operating locations should help in identifying contracts that qualify as normal purchases or normal sales. Also, in order for a contract that meets the net settlement provisions of paragraphs 9(a) and 57(c)(1) and the market mechanism provisions of paragraphs 9(b) and 57(c)(2) to qualify for the exception, net settlement of similar contracts must be rare.

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 an 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.

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

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

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

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

68(b). The fair value of the swap at ~~its inception~~the inception of the hedging relationship is zero.

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

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

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

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

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

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

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

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

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

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

155. Because Swap 1 meets all of the conditions discussed in paragraph 68, MNO is permitted to assume that there will be no ineffectiveness in the hedging relationship and to use the shortcut method illustrated in ~~Example 2~~Example 5.

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

graph 31).~~ Because the two swaps in combination meet the conditions discussed in paragraph 68, MNO is permitted to assume no ineffectiveness and use the short-cut method illustrated in Example 5.~~

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

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

> *Scope Application:* Paragraph 10(b) excludes contracts that require future delivery of commodities that are readily convertible to cash from the accounting for derivatives if the commodities will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. However, that paragraph also states that contracts that are denominated in a foreign currency that does not meet the criteria in paragraphs 15(a) and 15(b) shall not be considered normal purchases and normal sales.~~the corn purchase contract must be examined to determine whether it contains an embedded derivative that warrants separate accounting.~~ Because the Japanese yen is not the functional currency of either party to the contract and the purchase of corn is transacted internationally in many different currencies, the contract does not qualify for the normal purchases and normal sales exception. The contract is a compound

derivative comprising~~The corn purchase contract can be viewed as~~ a U.S. dollar-denominated forward contract for the purchase of corn and an embedded foreign currency swap from the purchaser's functional currency (the U.S. dollar) to yen. Consistent with the last sentence of footnote 13 to paragraph 49, the compound derivative cannot be separated into its components (representing the foreign currency derivative and the forward commodity contract) and accounted for separately under Statement 133.~~Because the yen is the functional currency of neither party to the transaction and the purchase of corn is transacted internationally in many different currencies, the contract does not qualify for the exception in paragraph 15 that precludes separating the embedded foreign currency derivative from the host contract. The embedded foreign currency swap should be separated from the host contract and accounted for as a derivative for purposes of this Statement because a separate instrument with the same terms would meet the definition of a derivative instrument in paragraphs 6–11.~~

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

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

- *Death benefit component.* Paragraph 10(c)(1) excludes a death benefit from the scope of this Statement because the payment of the death benefit is the result of an identifiable insurable event instead of changes in an underlying. The death benefit in this example is limited to the floor guarantee of the investment account, calculated as the premiums paid into the investment account plus a guaranteed rate of return, less the account mar-

ket value. Statement 60 remains the applicable guidance for the insurance-related liability accounting.

- *Investment component.* The policyholder directs certain premium investments in the investment account that includes equities, bonds, or both, which are held in separate accounts that are ~~owned by the policyholder and~~ separate from the insurer's general account assets. ~~This component is viewed as a direct investment because the policyholder directs and owns these investments.~~ This component is not considered a derivative because of the unique attributes of traditional variable annuity contracts issued by insurance companies~~the policyholder has invested the premiums in acquiring those investments~~. Furthermore, any embedded derivatives within those investments should not be separated from the host contract by the insurer because the separate account assets are already marked-to-market under Statement 60. In contrast, if the product were an equity-index-based interest annuity (rather than a variable annuity), the investment component would contain an embedded derivative (the equity index-based derivative) that meets all the requirements of paragraph 12 of Statement 133 for separate accounting. ~~not be viewed as a direct investment because the policyholder does not own those investments, which are assets recorded in the general account of the insurance company~~The economic characteristics and risks of the embedded derivative would not be clearly and closely related to the economic characteristics and risks of the host contract (that is, the host contract is a debt instrument and the embedded option is equity-indexed), the hybrid instrument would not be remeasured at fair value with changes in fair value reported in earnings as they occur under GAAP, and a separate instrument with the same terms as the embedded derivative instrument would be a derivative instrument pursuant to paragraphs 6–11 of Statement 133. ~~As a result, the host contract would be a debt instrument, and the equity-index-based derivative should be separated and accounted for as a derivative instrument.~~
- *Investment account surrender right at market value.* Because this right is exercised only at the fund market value (without the insurer's floor guarantee) and relates to a traditional variable annuity contract issued by an insurance company~~an investment owned by the insured~~, this right is not within the scope of this Statement.
- *Payment alternatives at the end of the accumulation period.* Payment alternatives are options subject to the requirements of this Statement if interest rates or other underlying variables affect the value.

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