MAY 1, 2002

Financial Accounting Series

EXPOSURE DRAFT

Proposed Statement of Financial Accounting Standards

Amendment of Statement 133 on Derivative Instruments and Hedging Activities

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 Technical Projects and Technical Activities
File Reference No. 1100-163

Comment Deadline: July 1, 2002

Financial Accounting Standards Board
of the Financial Accounting Foundation

Responses from interested parties wishing to comment on the Exposure Draft must be *received* in writing by July 1, 2002. Reponses received after that date will be distributed to Board members but will *not* be considered in the staff's analysis of comments that will be the basis for the Board's redeliberations. Interested parties should submit their comments by email to director@fasb.org, File Reference 1100-163. Respondents submitting comments by electronic mail should clearly identify themselves and the organization they represent. Those without electronic mail may send their comments to the "MP&T Director—File Reference 1100-163" at the address at the bottom of this page. Responses should *not* be sent by fax.

Any individual or organization may obtain one copy of this Exposure Draft without charge until July 1, 2002, on written request only. *Please ask for our Product Code No. E164.* For information on applicable prices for additional copies and copies requested after July 1, 2002, contact:

Order Department
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Financial Accounting Standards Board
of the Financial Accounting Foundation
401 Merritt 7, P.O. Box 5116, Norwalk, Connecticut 06856-5116

Summary

This proposed Statement would amend the definition of a derivative in paragraph 6(b) of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. This proposed Statement also would amend Statement 133 for various decisions made as part of the Derivatives Implementation Group process. This proposed Statement resolves issues raised in connection with Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets." That resolution would require that beneficial interests that do not qualify for the exception in paragraph 14 of Statement 133 (as amended) be evaluated to determine if those beneficial interests meet the amended definition of a derivative in paragraph 6 of Statement 133.

Reasons for Issuing This Proposed Statement

The Board concluded that certain of the changes proposed in implementation issues developed to address the questions raised in Implementation Issue D1 are in conflict with Statement 133. In particular, Statement 133 Implementation Issue No. A20, "Application of Paragraph 6(b) regarding Initial Net Investment," provides proposed guidance that conflicts with the definition of a derivative in that Statement. After considering alternatives for resolving this conflict, the Board decided to amend Statement 133.

How the Changes in This Proposed Statement Would Improve Financial Reporting

The changes required by this proposed Statement would improve financial reporting by requiring that contracts with comparable characteristics be accounted for similarly. In particular, this proposed Statement would clarify under what circumstances a contract

(either an option-based contract or a non-option-based contract) with an initial net investment would meet the characteristic of a derivative discussed in paragraph 6(b) of Statement 133. That change would result in more consistent reporting of contracts as either derivatives or hybrid instruments.

The Effective Date of This Proposed Statement

This proposed Statement would be effective as of the first day of the first fiscal quarter beginning after November 15, 2002, except for certain provisions. Those paragraphs relating to the amended definition of a derivative, the amended scope exception in paragraph 14 of Statement 133, and the separate reporting of embedded derivative instruments (paragraphs 4, 5, 8, and 10 of this proposed Statement) would be effective upon issuance of the final Statement for both the transferor and the holders of beneficial interests in a qualifying special-purpose entity (SPE) that fails to meet the requirements in paragraph 42 of this proposed Statement. Paragraphs 4, 5, 8, and 10 would not be effective upon issuance of the final Statement for both the transferor and the beneficial interest holders in a formerly qualifying SPE that meets the requirements in paragraph 42 of this proposed Statement. Upon issuance of this proposed Statement, the transferor to a formerly qualifying SPE that meets the requirements in paragraph 42 would disclose in its financial statements the amount of assets and liabilities that are currently off-balance-sheet in existing structures.

Earlier application as of the first day of an earlier fiscal period in which financial statements have not been issued would be permitted provided that the entity did not have any embedded derivative previously separated and designated as a hedging instruments in a cash flow hedge that would not be separated under this proposed Statement for any part of that earlier fiscal quarter.

The provisions in this proposed Statement that relate to Statement 133 Implementation Issues that have been effective for fiscal quarters that began prior to November 15, 2002, would continue to be applied in accordance with their respective effective dates.

Proposed Statement of Financial Accounting Standards

Amendment of Statement 133 on Derivative Instruments and Hedging Activities

May 1, 2002

CONTENTS

Paragraph Numbers

Proposed Statement of Financial Accounting Standards

Amendment of Statement 133 on Derivative Instruments and Hedging Activities

May 1, 2002

INTRODUCTION

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

2. This Statement amends Statement 133 to incorporate guidance from Statement 133 Implementation Issues that were posted to the FASB website in October 2001. Statement 133 Implementation Issues No. A20, "Application of Paragraph 6(b) regarding Initial Net Investment," No. C17, "Application of the Exception in Paragraph 14 to Beneficial Interests That Arise in a Securitization," and No. D2, "Applying Statement 133 to Beneficial Interests in Securitized Financial Assets (a Resolution of the Issues Raised in Implementation Issue D1)," include guidance that conflicts with the definition of a derivative in paragraph 6(b) and the scope exception in paragraph 14 of Statement 133. This Statement resolves those conflicts.

3. This Statement also amends Statement 133 for certain decisions made by the Board as part of the Derivatives Implementation Group (DIG) process. For those amendments that relate to Statement 133 implementation guidance, the specific Statement 133

Implementation Issue necessitating the amendment is identified. If the amendment relates to a cleared issue, the date of clearance also is noted.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Amendments to Statement 133

4. Paragraph 6(b) is replaced by the following paragraph and related footnotes:

> If it is an option-based contract,* it has an initial net investment equal to the fair value of the option component. If it is not an option-based contract (hereafter referred to as a non-option-based contract), it requires an initial net investment that is less than 5 percent of the fully prepaid amount.†
>
> *An option-based contract is a contract that either is a freestanding option or has an embedded option. A contract that contains an embedded option for which the strike price is fair value at the time of exercise should be considered non-option-based for purposes of applying this paragraph.
>
> † For non-option-based contracts, judgment of whether an initial net investment is less than 5 percent of the fully prepaid amount should be made based on comparison of the initial net investment to the amount of investment that would result in the contract becoming fully prepaid. Non-option-based contracts are fully prepaid if one party invests the fair value of all its future cash outflows under the contract and no longer has to sacrifice additional assets to settle the contract.

[Implementation Issue A20]

5. In the second sentence of paragraph 8, *at-the-money* is added before *option* in the first parenthetical phrase and *where that premium is less than 5 percent of the fully prepaid amount of the contract* is added after *forward price* in the second parenthetical phrase.

[Implementation Issue A20]

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

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

7. Paragraph 10 is amended as follows:

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

"Regular-way" security trades. Regular-way security trades are contracts that provide for delivery of a security within the time generally established by regulations or conventions in the marketplace or exchange in which the transaction is being executed. However, a contract for an existing security does not qualify for the regular-way security trades exception if it requires or permits net settlement (as discussed in paragraphs 9(a) and 57(c)(1)), or if a market mechanism to facilitate net settlement of that contract (as discussed in paragraphs 9(b) and 57(c)(2)) exists. Application of the regular-way security trades exception to a contract for the purchase and sale of securities that are referred to as *when-, as-,* or *if-issued,* or *to-be-announced* is addressed in paragraph 59(a).

b. Subparagraph (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. In addition to this condition, the guidance in paragraph 10(b)(1)–(4) should be considered in determining whether a specific type of contract may be considered normal purchases and normal sales. However, contracts that have a price based on an underlying that is not clearly and closely related to the asset being sold or purchased (such as a price in a contract for the sale of a grain commodity based in part on changes in the S&P index) or that are denominated in a foreign currency that meets none of the criteria in paragraphs 15(a)–15(d) shall not be considered normal purchases and normal sales.

(1) *Forward contracts (non-option-based contracts)*. Forward contracts with no net settlement provision and no market mechanism to facilitate net settlement (as described in paragraphs 9(a) and 9(b)) are eligible to qualify for the normal purchases and normal sales exception. Forward contracts that contain net settlement provisions as described in paragraphs 9(a) and 9(b) are not eligible for the normal purchases and normal sales exception unless it is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery. Net settlement (as described in paragraphs 9(a) and 9(b)) of contracts in a group of contracts similarly designated as normal purchases and normal sales would call into question the classification of all such contracts as normal purchases or normal sales. Contracts that require cash settlements of gains or losses or are otherwise settled net on a periodic basis, including individual contracts that are part of a series of sequential contracts intended to accomplish ultimate acquisition or sale of a commodity, do not qualify for this exception.

(2) *Freestanding option contracts*. Option contracts that would require delivery of the related asset at an established price under the contract only if exercised are not eligible to qualify for the normal purchases and normal sales exception, except as indicated in paragraph 10(b)(4) below.
(3) *Forward contracts that contain optionality features.* Forward contracts that contain optionality features that do not modify the quantity of the asset to be delivered under the contract are eligible to qualify for the normal purchases and normal sales exception. Except for power purchase or sales agreements addressed in paragraph 10(b)(4), if an option component permits modification of the quantity of the assets to be delivered, the contract is not eligible for the normal purchases and normal sales exception, except if the option component permits the holder only to purchase additional quantities at the market price at the date of delivery. In order for forward contracts that contain optionality features to qualify for the normal purchases and normal sales exception, the criteria discussed in paragraph 10(b)(1) must be met.
(4) *Power purchase or sales agreements.* A power purchase or sales agreement (whether a forward contract, option contract, or a combination of both) may also qualify for the normal purchases and normal sales exception if it meets the criteria in paragraph 58(b).

For contracts that qualify for the normal purchases and normal sales exception, the entity shall document the designation of the contract as a normal purchase or normal sale. For contracts that qualify for the normal purchases and normal sales exception under paragraph 10(b)(1), the entity shall document the basis for concluding that it is probable that the contract will result in physical delivery. For contracts that qualify for the normal purchases and normal sales exception under paragraph 10(b)(4), the entity shall document the basis for concluding that the agreement is a **capacity contract.** The documentation requirements can be applied either to groups of similarly designated contracts or to each individual contract.

[Statement 133 Implementation Issue No. C10, "Can Option Contracts and Forward Contracts with Optionality Features Qualify for the Normal Purchases and Normal Sales Exception," cleared March 21, 2001, revised June 27, 2001; Statement 133 Implementation Issue No. C15, "Normal Purchases and Normal Sales Exception for Certain Option-Type Contracts and Forward Contracts in Electricity," cleared June 27, 2001, revised December 19, 2001; and Statement 133 Implementation Issue No. C16, "Applying the Normal Purchases and Normal Sales Exception to Contracts That Combine a Forward Contract and a Purchased Option Contract," cleared September 19, 2001, revised December 19, 2001]

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

Certain financial guarantee contracts. Financial guarantee contracts are not subject to this Statement if they provide for payments to be made only to reimburse the guaranteed party for failure of the debtor to satisfy its required payment obligations, either at pre-specified payment dates or because an event of default occurred, as defined in the financial obligation covered by the guarantee contract, and payments were accelerated automatically or by means of notice to the debtor. The guaranteed party must be exposed to the risk of nonpayment both at inception of the financial guarantee contract and throughout its term. In contrast, financial guarantee contracts are subject to this Statement if, for example, they provide for payments to be made in response to changes in an underlying such as a decrease in a specified debtor's creditworthiness.

d. The following are added at the end of paragraph 10:

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

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

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

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

i. *Loan commitments.* Loan commitments that relate to the origination or acquisition of mortgage loans that will be held for investment purposes, as discussed in paragraph 6 of FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* (as amended), are not subject to this Statement. In addition, loan commitments that relate to the origination of other types of loans (that is, other than mortgage loans) are not subject to the requirements of this Statement. Loan commitments that relate to the origination or acquisition of mortgage loans that will be held for sale, as discussed in paragraph 4 of Statement 65, shall be accounted for as derivative instruments by the issuer of the loan commitment (that is, the potential lender). However, the holder of that type of loan commitment (that is, the potential borrower) is not subject to the requirements of this Statement.

[Statement 133 Implementation Issue No. C13, "When a Loan Commitment Is Included in the Scope of Statement 133," cleared March 13, 2002]

8. The following is added at the end of paragraph 12:

> A contract that, in its entirety, meets the definition of a derivative but is a non-option-based contract that requires an initial net investment that is less than 5 percent of the fully prepaid amount (as discussed in paragraph 6(b)) may be accounted for as either (1) a derivative in its entirety or (2) a hybrid instrument that must be bifurcated into a debt host and a derivative with a fair value of zero at acquisition of the hybrid instrument.

[Implementation Issue A20]

9. Paragraph 13(b) is replaced by the following:

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

[Statement 133 Implementation Issue No. B9, "Clearly and Closely Related Criteria for Market Adjusted Value Prepayment Options," cleared December 6, 2000]

10. In the first sentence of paragraph 14, *interest-only strips and principal-only strips* is replaced by *beneficial interests that arise in a securitization.*

[Implementation Issue C17]

11. Paragraph 15 is amended as follows:

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

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

> , (c) the local currency of any substantial party to the contract, or (d) the currency used by a substantial party to the contract as if it were the functional currency because the primary economic environment in which the party operates is highly

inflationary (as discussed in paragraph 11 of Statement 52). If similar transactions for a certain product or service are routinely denominated in international commerce in various different currencies, the transaction does not qualify for the exception in (b) above. The evaluation of whether a contract qualifies for the exception in this paragraph should be performed only at inception of the contract.

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

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

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

13. Paragraph 19 is deleted.

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

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

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

b. The following is added at the end:

> A supply contract for which the contract price is fixed only in certain circumstances (such as when the selling price is above an embedded price cap or below an embedded price floor) meets the definition of a firm commitment for purposes of designating the hedged item in a fair value hedge. Provided the embedded price cap or floor is considered clearly and closely related to the host contract and therefore is not accounted for separately under paragraph 12, either party to the supply contract can hedge the fair value exposure arising from the cap or floor.

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

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

[Implementation Issue F10]

17. In paragraphs 27, 34, 64, 65(c), 94–97, 99, and 143, the following footnote is added after *expected cash flows*:

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

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

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

> If a non-option-based contract (such as a forward contract) is the hedging instrument in a cash flow hedge of the variability of the functional-currency-equivalent cash flows for a recognized foreign-currency-denominated asset or liability that is remeasured at spot exchange rates under paragraph 15 of Statement 52, an amount that will offset the related transaction gain or loss arising from the remeasurement and that will adjust earnings for the cost to the purchaser (income to the seller) of the hedging instrument shall be reclassified each period from other comprehensive income to earnings. If an option contract is used as the hedging instrument to provide only one-sided offset against the hedged foreign exchange risk, an amount shall be reclassified each period to or from other comprehensive income with respect to the changes in the underlying that result in a change in the hedging option's intrinsic value and, if the assessment of effectiveness and measurement of ineffectiveness is also based on total changes in the option's cash flows, an amount that adjusts earnings for the amortization of the cost of the option on a rational basis shall be reclassified each period to or from other comprehensive income to earnings. (In determining the accounting for other seemingly similar hedging relationships, one should not analogize to the accounting prescribed in this guidance due to the unique attributes of foreign currency hedging relationships and the fact that this accounting guidance is viewed as an exception for foreign currency hedging relationships.)

[Statement 133 Implementation Issue No. G20, "Assessing and Measuring the Effectiveness of a Purchased Option Used in a Cash Flow Hedge," cleared June 27, 2001]

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

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

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

21. Paragraph 57(b) is amended as follows:

a. The first sentence is replaced by *An option-based contract is a derivative if it has an initial net investment equal to the fair value of the option component. A non-option-based contract is a derivative if it requires an initial net investment that is less than 5 percent of the fully prepaid amount (as discussed in paragraph 6(b))*.

b. In the third sentence, *initial* is inserted between *no* and *net*.

c. In the sixth sentence, *option* is replaced by *option-based contract*.

[Implementation Issue A20]

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

a. The following parenthetical sentence is added after the first sentence:

> (The notion of *readily convertible to cash* shall be applied to a contract throughout its life, not only at its inception.)

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

> Shares of stock to be received upon the exercise of a stock purchase warrant do not meet the characteristic of being readily convertible to cash if both of the

following conditions exist: (a) the stock purchase warrant is issued by an entity for only its own stock and (b) the sale or transfer of the issued shares is restricted for a period of 32 days or more from the date the stock purchase warrant is exercised. In contrast, restrictions imposed by a stock purchase warrant on the sale or transfer of shares of stock that are received from the exercise of that warrant issued by an entity for *other* than its own stock (whether those restrictions are for more or less than 32 days) do not impact the determination of whether those shares are readily convertible to cash.

[Statement 133 Implementation Issue No. A14, "Derivative Treatment of Stock Purchase Warrants Issued by a Company for Its Own Shares of Stock, Where the Subsequent Sale or Transfer Is Restricted," cleared December 6, 2000, and revised April 9, 2002]

23. Paragraph 58 is amended as follows:

a. In the first sentence, *paragraph 10* is replaced by *paragraphs 10 and 14*.

b. Subparagraph (a) is amended as follows:

(1) At the end of the first sentence before the reference to footnote 16, *except as provided in paragraph 59(a) for a contract for the purchase and sale of a security referred to as when-, as-,* or *if-issued,* or *to-be-announced* is added.

(2) In the fourth and sixth sentences, *regular-way exception* is replaced by *regular-way security trades exception*.

(3) Footnote 16 is amended as follows:

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

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

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

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

(1) For both parties to the contract:

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

(b) The power purchase or sales agreement is a capacity contract. Differentiating between a capacity contract and a traditional option contract (that is, a financial option on electricity) is a matter of judgment that depends on the facts and circumstances. The characteristics of a capacity contract, which are set forth in paragraph 540, should be considered in that evaluation; however, other characteristics not listed may also be relevant in that evaluation.

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

(3) For the buyer of electricity:

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

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

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

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

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

d. The following subparagraph is added at the end of paragraph 58:

d. *Beneficial interests issued in securitization transactions*. Beneficial interests issued in securitization transactions are eligible for the scope exception in paragraph 14 only if both criteria in that paragraph are satisfied. Paragraph 14(a) is satisfied if the securitized financial assets do not themselves contain any embedded derivatives that, under the requirements of paragraph 12, would require separate accounting and the securitization vehicle does not contain any freestanding derivatives that were entered into or transferred to the structure. Beneficial interests arising from securitization transactions that distribute noncontractual cash flows to beneficial interest holders do not satisfy the criterion in paragraph 14(a). Paragraph 14(b) is satisfied if the beneficial interests in the securitized assets receive cash flows that arise solely from the particular assets that were securitized.

[Implementation Issue C17]

24. Paragraph 59 is amended as follows:

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

Forward purchases or sales of to-be-announced securities or securities when-issued, as-issued, or if-issued. Contracts for the purchase and sale of securities referred to as when-, as-, or if-issued, or to-be-announced are excluded from the requirements of this Statement as a regular-way security trade only if (1) there is no other way to purchase or sell that security, (2) delivery of that security and settlement will occur within the shortest period possible for that type of security, and (3) it is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery of a security when it is issued. A contract for the purchase and sale of a security when-, as-, or if-issued, or to-be-announced is eligible to qualify for the regular-way security trades exception even though that contract permits net settlement (as discussed in paragraphs 9(a) and 57(c)(1)) or a market mechanism to facilitate net settlement of that contract (as discussed in paragraphs 9(b) and 57(c)(2)) exists. The entity shall document the basis for concluding that it is probable that the contract will result in physical delivery.

b. Subparagraph (c)(3) is replaced by *the contract requires an initial net investment that is less than 5 percent of the fully prepaid amount (as discussed in paragraph 6(b))*.

[Implementation Issue A20]

c. In subparagraph (d), the fifth sentence after the list of five activities is replaced by:

However, the other characteristic, an initial net investment that is less than 5 percent of the fully prepaid amount (as discussed in paragraph 6(b)), is not present.

[Implementation Issue A20]

d. The following subparagraph is added at the end of paragraph 59:

f. *Beneficial interests that arise in a securitization*. Beneficial interests that arise in a securitization that are either purchased by third-party investors or held by transferors should first be evaluated to determine if they qualify for the scope exception in paragraph 14, as discussed in paragraph 58(d). A beneficial interest that does not meet the scope exception in paragraph 14 should be evaluated under paragraph 6. Generally, beneficial interests meet the characteristics in paragraph 6(a) that require that the contract has one or more underlyings and one or more notional amounts or payment provisions or both. Beneficial interests that are option-based contracts (that is, either freestanding options or instruments with embedded options, other than an option for which the strike price is the fair value of the underlying at the time of exercise) meet the characteristic in paragraph 6(b) if the initial net investment is equal to the fair value of the option component. Beneficial interests that are non-option-based contracts meet the characteristic in paragraph 6(b) if the initial net investment is less than 5 percent of the amount necessary to fully prepay the contract. For purposes of applying paragraph 6(b), the initial net investment in a beneficial interest held by a third-party investor is the amount of consideration required to invest in the instrument. The initial net investment in a beneficial interest held by a transferor (for example, a retained interest) is the fair value at the date of transfer of the interest retained. Beneficial interests generally meet the characteristics in paragraph 6(c) because, as discussed in paragraph 9(a), neither party is required to deliver an asset associated with the underlying or with a principal amount equal to the notional amount. In some cases, depending upon the nature of the beneficial interest, a market mechanism as discussed in paragraph 9(b) may be present. If a beneficial interest does not meet the definition of a derivative in paragraph 6, it should be evaluated under paragraphs 12–16 to determine if it contains an embedded derivative that should be bifurcated.

[Implementation Issue D2]

25. Paragraph 61 is amended as follows:

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

[Implementation Issue B9]

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

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

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

d. The following subparagraph is added at the end of paragraph 61:

m. *Beneficial interests issued by qualifying special-purpose entities*. Beneficial interests issued by qualifying special-purpose entities, as defined by FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* should be considered to have debt host contracts. A beneficial interest holder must determine whether its interest contains an embedded derivative that is not clearly and closely related to the debt host contract. For example, as discussed in paragraph 61(a), an embedded interest rate derivative that could under any circumstance result in the hybrid instrument being settled in such a way that the holder does not recover substantially all of its initial recorded investment would be considered to be not clearly and closely related to the host contract even though the possibility that such a circumstance would occur is remote.

[Statement 133 Implementation Issue No. B12, "Beneficial Interests Issued by Qualifying Special-Purpose Entities"]

26. Paragraph 68 is amended as follows:

a. The phrase *being hedged* is added at the end of the sentence in subparagraph (a).

[Statement 133 Implementation Issue No. E10, "Application of the Shortcut Method to Hedges of a Portion of an Interest-Bearing Asset or Liability (or Its Related Interest) or a Portfolio of Similar Interest-Bearing Assets or Liabilities," cleared June 28, 2000 and revised September 25, 2000]

b. The following is added at the end of paragraph 68(b):

except for an interest rate swap containing an embedded mirror-image call or put option as discussed in paragraph 68(d), in which case the fair value of the interest rate swap containing an embedded mirror-image call or put at the inception of the hedging relationship is equal to the time value of the embedded call or put option.

27. In paragraph 95, the first sentence is replaced by the following:

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

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

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

29. The following definitions are added to paragraph 540:

Beneficial interests

Rights to receive all or portions of specified cash inflows to a trust or other entity, including senior and subordinated shares of interest, principal, or other cash inflows to be "passed-through" or "paid-through," premiums due to guarantors, commercial paper obligations, and residual interests, whether in the form of debt or equity.

Capacity contract

An agreement by an owner of capacity to sell the right to that capacity to another party to satisfy its obligations. A capacity contract for power has characteristics that include, but are not limited to, the following:

a. The contract usually specifies the power plant or group of power plants providing the electricity.
b. The strike price (paid upon exercise) includes pricing terms to compensate the plant operator for variable operations and maintenance costs expected during the specified production periods.
c. The specified quantity is based on individual needs of parties to the agreement.
d. The title transfer point is usually at one or a group of specified physical delivery point(s), as opposed to a major market hub.
e. The contract usually specifies certain operational performance by the facility (for example, the achievement of a certain heat rate).
f. The contract sometimes incorporates requirements for interconnection facilities, physical transmission facilities, or reservations for transmission services.
g. The contract may specify jointly agreed-to plant outages (for example, for maintenance) and provide for penalties in the event of unexpected outages.
h. Damage provisions upon default are usually based on a reduction of the capacity payment (which is not market based). If default provisions specify market-liquidating damages, they usually contain some form of floor, ceiling, or both. The characteristics of the default provision are usually tied to the expected generation facility.
i. The contract's terms are usually long (one year or more).

[Implementation Issues C10, C15, and C16]

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

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

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

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

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

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

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

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

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

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

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

Amendments to Other Existing Pronouncements

35. The following sentence is added at the end of paragraph 3 of FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities:*

> In addition, this Statement does not apply to loan commitments that relate to mortgage loans to be held for sale, which are subject to the requirements of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

36. In paragraph 2(c) of FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities,* the phrase *other than loan commitments that relate to mortgage loans to be held for sale* is added before *during the reporting period.*

37. Paragraph 25 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* is replaced by the following:

> A formerly qualifying SPE that fails to meet one or more conditions for being a qualifying SPE under this Statement shall continue to be considered a qualifying SPE if it (a) maintains its qualifying status under previous accounting standards, (b) does not issue new beneficial interests after the effective date of this Statement or if the failure results from the initial application of FASB Statement No. 14X, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities,*

as of the issuance of that Statement as stated in paragraph 42 of Statement 14X, and (c) does not receive assets it was not committed to receive (through a commitment to BIHs unrelated to the transferor) before the pertinent effective date. Otherwise, the formerly qualifying SPE and assets transferred to it shall be subject to other consolidation policy standards and guidance and to all the provisions of Statement 140.

Effective Date and Transition

Effective Date

38. This Statement shall be effective as of the first day of the first fiscal quarter beginning after November 15, 2002, except as noted in paragraphs 39 and 42. Earlier application as of the first day of an earlier fiscal quarter for which financial statements have not been issued is permitted provided that the entity did not have any embedded derivative previously separated and designated as a hedging instrument in a cash flow hedge that would not be separated under this Statement for any part of that earlier fiscal quarter. With the exception of its effect on beneficial interests, which are discussed in paragraph 42, the provisions of this paragraph should be applied prospectively.

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

39. Paragraphs 6, 7(b), 7(d), 9, 11, 15, 16, 19, 20, 22, 23(c), 25(a), and 26 of this Statement, which relate to guidance in Statement 133 Implementation Issues that have been cleared by the Board and have been effective for fiscal quarters that began prior to November 15, 2002, shall continue to be applied in accordance with their respective effective dates.

Transition

40. If an entity had not accounted for a contract as a derivative in its entirety or had not bifurcated an embedded derivative but is now required to do so as a result of this Statement, the entity shall account for the effects of initially complying with this Statement prospectively for all existing contracts as of the effective date of this Statement, except for existing contracts that qualify for the grandfathering provisions of paragraph 50 of Statement 133. Those provisions exempt certain hybrid instruments from the embedded derivative provisions of Statement 133 on an all-or-none basis. (For example, if a company had elected on adoption of Statement 133 pursuant to paragraph 50 of Statement 133 to bifurcate only those hybrid instruments acquired or substantively modified after December 31, 1998, the company shall not apply newly issued implementation guidance to hybrid instruments acquired before January 1, 1999.) The effects of initially complying with this Statement as of the effective date shall be reported as a cumulative-effect-type adjustment of net income. Retroactive designation of a hedging relationship that could have been established had the interest initially been accounted for as a derivative or had an embedded derivative initially been accounted for separately is not permitted.

41. If a contract that would not be accounted for as a derivative instrument under this Statement was previously accounted for as a derivative instrument, that accounting treatment shall not be changed. That is, for those contracts, this Statement applies prospectively only to transactions after the effective date.

Statement 140 Transition for Qualifying SPEs Applying Statement 133 under This Statement

42. Paragraphs 4, 5, 8, and 10 of this Statement shall not apply to either the transferor or the beneficial interest holders in a formerly qualifying SPE that meets the requirements described in the following sentence. That is, a formerly qualifying SPE shall continue to be accounted for as a qualifying SPE under Statement 140 and be exempt from applying Statement 133 if it (a) maintains its qualifying status under previous accounting standards, (b) does not issue additional beneficial interests after the issuance of this Statement, and (c) does not receive assets that it was not committed to receive (through a commitment to beneficial interest holders unrelated to the transferor) before the issuance date of this Statement. If the formerly qualifying SPE does not meet all of those requirements, it shall be subject to the provisions of paragraphs 4, 5, 8, and 10 as of the date of issuance of this Statement and to all the provisions of Statement 140 (including paragraph 55 of Statement 140, which requires that a change in the status of the transferee as a qualifying SPE be accounted for by the transferor as a purchase of the assets from the former transferee(s) in exchange for the liabilities assumed).

43. The provisions of paragraphs 4, 5, 8, and 10 shall be effective upon issuance of this Statement for both the transferor and the holders of beneficial interests in a qualifying SPE that fail the requirements in paragraph 42 of this Statement.

Disclosures

44. A transferor to a formerly qualifying SPE that meets the requirements of paragraph 42 shall upon issuance of this Statement disclose in any financial statements issued after

the issuance of this Statement the aggregate amount of assets and liabilities in those existing structures that are currently off-balance-sheet.

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

Appendix A

BACKGROUND INFORMATION, BASIS FOR CONCLUSIONS, AND ALTERNATIVE VIEW

CONTENTS

Appendix A

BACKGROUND INFORMATION, BASIS FOR CONCLUSIONS, AND ALTERNATIVE VIEW

Introduction

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

Background Information

A2. Paragraph 6 of Statement 133 sets forth a characteristic-based definition of a derivative. For certain types of instruments, the characteristic in paragraph 6(b)—the instrument has an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors—determines whether the instrument meets the definition of a derivative in its entirety. Statement 133 Implementation Issue No. A9, "Prepaid Interest Rate Swaps," provides guidance on the application of paragraph 6(b). In addressing a specific example, that Issue concludes that a structured note with leveraged embedded terms satisfies the characteristic of paragraph 6(b). It also indicates that ". . . even a contract with a much lower leverage factor than that illustrated in the above example [an eight times leverage factor] would meet the criterion in paragraph 6(b)."

A3. Constituents indicated that the amount of initial net investment in an instrument that results in a hybrid instrument rather than a derivative in its entirety is unclear. In addition, constituents questioned the application of the guidance in Implementation Issue A9 to beneficial interests issued in securitization transactions. Subordinated beneficial interests in securitization transactions typically involve terms with varying degrees of leverage. If the other characteristics of a derivative are also satisfied, the guidance in Implementation Issue A9 results in certain subordinated beneficial interests meeting the definition of a derivative under Statement 133. Accounting for interests held by the transferor as derivatives under Statement 133 conflicts with the requirement of Statement 140 to initially measure those interests by allocating the previous carrying amount between assets sold and retained interests based on their relative fair values at the date of transfer.

A4. In light of the identified scope conflict between Statement 133 and Statement 140, the Board issued Statement 133 Implementation Issue No. D1, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets," in June 2000. That Issue provides that entities may continue to apply the guidance related to accounting for beneficial interests in paragraph 14 and paragraph 362 of Statement 140 until further guidance is issued. The scope of that interim guidance covers transactions involving both qualifying and nonqualifying SPEs.

A5. In considering various alternatives for resolving the issues identified in Implementation Issue D1, the Board initially focused on the implications of applying Statement 133 to beneficial interests. However, the Board decided that there is a need to address the broader question of how to apply paragraph 6(b) for all financial instruments.

In October 2001, the Board decided to post on the FASB website for a 35-day comment period 5 tentative Statement 133 Implementation Issues[1] that helped to resolve both the broad concerns with application of paragraph 6(b) and the issues raised in Implementation Issue D1 related to beneficial interests. The Board observed that the changes proposed in certain of those issues, particularly the fundamental change to the characteristic of a derivative in paragraph 6(b), were in conflict with Statement 133. After considering alternatives for resolving the conflict, the Board concluded that an amendment of Statement 133 was required.

A6. Accordingly, this Statement amends paragraph 6(b). It also includes amendments necessary to resolve other issues about the application of Statement 133 to beneficial interests issued in securitization transactions, and amendments of Statement 133 necessary to implement guidance in various other Statement 133 implementation issues, many of which were previously cleared by the Board.

Benefits and Costs

A7. The Board's mission statement charges the Board to determine that a proposed standard will fill a significant need and that the costs it imposes will be justified in relation to the overall benefits.

---

[1] Statement 133 Implementation Issues No. A20, "Application of Paragraph 6(b) regarding Initial Net Investment," No. B12, "Embedded Derivatives in Beneficial Interests Issued by Qualifying Special-Purpose Entities," No. C17, "Application of the Exception in Paragraph 14 to Beneficial Interests That Arise in a Securitization," No. D2, "Applying Statement 133 to Beneficial Interests in Securitized Financial Assets (a Resolution of the Issues Raised in Implementation Issue D1)," and No. E21, "Continuing the Shortcut Method after a Purchase Business Combination."

A8. Previous practice in accounting for contracts subject to Statement 133 was inconsistent because of the potential for differing interpretations of paragraph 6(b). Accordingly, contracts with similar terms and characteristics were being accounted for differently. This Statement amends paragraph 6(b) to eliminate the subjective evaluation of whether an initial net investment in an instrument is "smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors." It clarifies that the following two types of contracts meet the characteristics of a derivative in paragraph 6(b): (a) an option-based contract with an initial net investment equal to the fair value of the option component and (b) a non-option-based contract that requires an initial net investment that is less than 5 percent of the fully prepaid amount (as discussed in footnote[†] to paragraph 6(b)). The Board believes that this change will simplify the definition of a derivative and lead to more consistent application. This Statement also amends paragraph 12 to permit a contract that, in its entirety, meets the definition of a derivative but is a non-option-based contract that requires an initial net investment that is less than 5 percent of the fully prepaid amount to be accounted for either as a derivative in its entirety or as a hybrid instrument that must be bifurcated into a debt host and a derivative with a fair value of zero at acquisition of the hybrid instrument. The Board reasoned that permitting this choice decreases the burden associated with applying Statement 133 to certain contracts. The Board recognizes that the need to evaluate contracts under the new guidance in this Statement comes at a cost. However, the Board believes that the benefits of more consistent reporting of contracts will outweigh the cost of implementing this Statement.

A9. This Statement amends paragraphs 10(a) and 59(a) of Statement 133 to remove from the scope of Statement 133 contracts for the purchase and sale of securities referred to as *when-, as-,* or *if-issued,* or *to-be-announced* if the contract meets all three criteria in paragraph 59(a) of Statement 133. The Board decided to provide that scope exception to eliminate the potential burden associated with accounting for those contracts as derivatives. This Statement also adds new scope exceptions in paragraphs 10(g)−10(i) and amends paragraph 10(d) of Statement 133 to clarify which financial guarantee contracts are within the scope exception. In each case, the Board decided to provide a scope exception for practical reasons.

Amendments to Statement 133

Amendment of Paragraphs 6(b) and 12

A10. Prior to this amendment, in order to meet the characteristic of a derivative in paragraph 6(b), an instrument was required to have "an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors." The Board understood that it could be difficult to determine at what level of investment instruments in the marketplace, particularly those with structured terms, satisfy that characteristic. In addition, the use of other terminology within Statement 133 in describing the requirement of paragraph 6(b), such as the phrase *little or no initial net investment* in paragraphs 59(c) and 59(d) of that Statement, led to a concern that the definition of a derivative was being applied inconsistently. For those reasons, the Board determined that the characteristic in paragraph 6(b) of Statement 133 should be clarified.

A11. The Board considered various approaches for clarifying the language in paragraph 6(b). The first approach would have allowed an entity to apply judgment in determining whether contracts with an initial net investment meet the characteristic in paragraph 6(b). That approach would have avoided setting an arbitrary threshold. The Board rejected that approach because it would not have solved the basic problem—how to determine when an initial net investment is "small" enough to meet the requirements of paragraph 6(b).

A12. As a second approach, the Board considered establishing a bright line for determining whether a contract meets the characteristic in paragraph 6(b), as well as various possibilities for setting that threshold. The Board also considered an approach that would have resulted in non-option-based contracts with any initial net investment (that is other than zero) failing the characteristic in paragraph 6(b). The Board rejected that approach because it would have required bifurcation of all off-market swap and forward contracts into a debt host and an embedded derivative even if they were only slightly off-market. That change in practice could have potentially placed a burden on preparers of financial statements without providing significant incremental benefits to financial statement users.

A13. The Board decided to amend paragraph 6(b) to indicate that the characteristic in that paragraph is satisfied for (a) an option-based contract if the contract requires an initial net investment equal to the fair value of the option component and (b) a non-option-based contract if the contract requires an initial net investment that is less than 5 percent of the fully prepaid amount (as discussed in footnote[†] to paragraph 6(b)). The application of paragraph 6(b) to non-option-based contracts requires a comparison of the initial net investment to the amount of investment that would result in a contract becoming fully prepaid.

A14. In applying that approach, the Board decided that instruments that have embedded options with a strike price equal to the fair value of the underlying at the exercise date (for example, an interest rate swap that includes an explicit termination option with a strike price equal to the fair value of the underlying at the exercise date) should be considered non-option-based contracts for purposes of applying paragraph 6(b). The Board reasoned that those options merely increase the liquidity of the instrument and that considering those options as non-option-based contracts avoids the complexities of bifurcation (especially given that bifurcation could result in a minimal debt host contract).

A15. The Board decided to amend paragraph 12 of Statement 133 to permit contracts that, in their entirety, meet the definition of a derivative but are non-option-based and require an initial net investment that is less than 5 percent of the fully prepaid amount to be accounted for as either (a) derivatives in their entirety or (b) hybrid instruments that must be bifurcated into a debt host and an embedded derivative with a fair value of zero at acquisition of the hybrid instrument. The Board decided to provide flexibility in order to alleviate the requirement that entities bifurcate off-market swap or forward contracts that are just slightly more or less favorable than similar instruments in the market.

Application of Statement 133 to Beneficial Interests That Arise in a Securitization

The scope exception in paragraph 14

A16. Paragraph 14 of Statement 133 states that interest-only (IO) and principal-only (PO) strips are not subject to the requirements of Statement 133 if they satisfy certain criteria. Some constituents interpreted paragraph 14 to encompass certain beneficial interests other than IO and PO strips, because securitization transactions generally are viewed as a reallocation of the cash flows of the original securitized assets. Some constituents held the view that paragraph 14 applied broadly to all retained interests. Constituents questioned the placement of paragraph 14 within the guidance related to embedded derivative instruments and whether the intent of paragraph 14 was to permit IO and PO strips to avoid bifurcation or to provide a scope exception for those instruments in their entirety.

A17. The Board decided that paragraph 14 should be applied to beneficial interests more broadly, rather than be limited to IO and PO strips only, and that paragraph 14 should provide a scope exception for those instruments in their entirety. The Board acknowledges that the placement of paragraph 14 suggests the paragraph was originally drafted to permit an investor in an IO strip to avoid separate accounting for an embedded derivative that would otherwise be required to be separated under paragraph 13(a) of Statement 133 (because it is possible that the effect of prepayments could cause the investor not to recover substantially all of its initial net investment) and, similarly, to permit an investor in a PO strip to avoid separate accounting for an embedded derivative that would otherwise be required to be separated under paragraph 13(b) of Statement 133 (because it is possible that the investor's rate of return could be doubled).

A18. The Board decided that the scope exception in paragraph 14 should be applied more broadly to beneficial interests, including retained interests, for several reasons. First, the Board determined that application of the scope exception should be based on common characteristics, and not limited to a designated class of interests. The Board understands that the majority of beneficial interests eligible for that exception would be "pass-through" securities, which pass the cash flows arising from those securitized assets to beneficial interests holders without changing the basic nature of those cash flows.

A19. Second, the Board also determined that beneficial interests that reflect only the prepayment or credit risk of the particular securitized assets qualify for the scope exception, *even if* those risks are not proportionally allocated among classes of beneficial interests. The Board believes that the reallocation of risk is a characteristic of all securitization transactions and that IO and PO strips, which were always considered eligible for the exception in paragraph 14, often have greater concentrations of prepayment risk than other classes of beneficial interests.

Application of the definition of a derivative and embedded derivative provisions

A20. The Board concluded that beneficial interests that do not meet the scope exception in paragraph 14 are within the scope of Statement 133 and should be evaluated under the definition of a derivative in paragraph 6. The Board understands that, for many beneficial interests issued in securitization transactions, the characteristic of a derivative in paragraph 6(b) will be the determining factor for whether the definition of a derivative is met. The Board believes that the provisions of paragraph 6(b) will not be satisfied for many beneficial interests held by third-party investors because the initial net investment will either be greater than 5 percent of the fully prepaid amount for non-option-based beneficial interests or will be an amount other than the fair value of the option component for option-based beneficial interests. Similarly, the Board believes that paragraph 6(b) will not be satisfied for many beneficial interests held by transferors (for example, a retained interest) because the initial net investment in a beneficial interest held by a transferor is the fair value at the date of transfer of the interest retained.

Amendment of Paragraph 10

A21. As a result of issues addressed as part of the DIG process and various other Statement 133 Implementation Issues raised by constituents, the Board made certain decisions that result in proposed amendments of paragraph 10 of Statement 133.

Securities Referred to as When-, As-, or If-Issued, or To-Be-Announced

A22. The Board concluded in paragraph 276 of Statement 133 that the regular-way security trades exception in paragraph 10(a) should be extended to securities referred to as *when-, as-,* or *if-issued,* or *to-be-announced* "only if (a) there is no other way to purchase or sell the security and (b) the trade will settle within the shortest period permitted for the security." Paragraph 10(a) indicates that contracts are eligible for that exception only if they have no net settlement provision and there is no market mechanism to facilitate net settlement. Paragraph 59(a) of Statement 133 discusses the application of that scope exception to securities referred to as *when-, as-,* or *if-issued,* or *to-be-announced*. Constituents questioned whether that exception was applicable to securities referred to as *when-, as-,* or *if-issued,* or *to-be-announced* securities if a market mechanism exists, which is the case for GNMA to-be-announced forward contracts. If that exception is not applicable when a market mechanism exists, constituents asked that a special exception be made for securities referred to as *when-, as-,* or *if-issued,* or *to-be-announced* securities.

A23. The Board considered constituents' comments and decided that the regular-way security trade exception in paragraph 10(a) should apply to securities referred to as *when-, as-,* or *if-issued,* or *to-be-announced* that have net settlement provisions or for which a market mechanism exists if it is probable at inception and throughout the term that the contract will not settle net and will result in physical delivery. The Board's decision was based on a concern about potentially burdensome requirements if those transactions were required to be accounted for as derivatives. Accordingly, this Statement amends paragraphs 10(a) and 59(a) to indicate that the regular-way security trade exception may be applied to securities referred to as *when-, as-,* or *if-issued,* or *to-be-announced* even though a market mechanism exists. Paragraph 59(a) is amended also to include the additional requirement that it be probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery of a security when it is issued.

Power Purchase or Sales Agreements

A24. This Statement amends Statement 133 to permit a scope exception for a power purchase or sales agreement if specific criteria are met. Pursuant to Statement 133 Implementation Issue No. C10, "Can Option Contracts and Forward Contracts with Optionality Features Qualify for the Normal Purchases and Normal Sales Exception," option and forward contracts that contain optionality features that can modify the quantity of the asset to be delivered under the contract do not qualify for the normal purchases and normal sales exception in paragraph 10(b). Companies in the electric industry enter into contracts that permit one party to purchase electricity (also referred to as "power"), and that frequently provide optionality about the quantity to be delivered.

A25. The Board decided that certain unique characteristics of the utility industry justified extending the scope exception in paragraph 10(b) to certain power purchase or sales agreements. The Board understood that deregulation has influenced the way contracts to buy and sell power are structured. A unique characteristic of the industry is that electricity cannot be readily stored in significant quantities. Additionally, many suppliers are statutorily or contractually obligated to maintain a specified level of electricity supply to meet demand. Therefore, suppliers must maintain access to an additional supply of electricity (through generation or purchase) to meet varying demand. As a result, some contracts to buy and sell electricity permit the buyer some flexibility in determining when to take electricity and in what quantities in order to match power to fluctuating demand.

A26. The Board understood that another important characteristic of the industry is that fixed costs are a very high percentage of the total cost of producing power. To provide for recovery of fixed costs, power contracts typically include a specified charge (sometimes referred to as the capacity or demand charge) to provide for recovery of the cost of the plant (or, in some cases, recovery of the market-based value of the plant) and related financing. A contract also will include a variable charge to recover, among other things, the variable cost of producing power (the energy charge). In a regulated electric industry, regulators set rates in order to recover plant fixed costs and variable costs plus a reasonable return. Tariffs are established that generally separate the capacity charge and the energy charge, among other charges. With the introduction of independent power plants, some contracts to buy and sell power also include capacity charges and energy charges, which, in the past, were generally established by regulators. The intent to physically deliver power at rates that will recover the cost of plant and energy while giving the buyer the ability to have some control over when and in what quantity power is delivered is a consistent characteristic of these contracts.

A27. The Board decided to permit the normal purchases and normal sales exception to be applied to a power purchase or sales agreement if certain criteria are met, regardless of whether the agreement includes optionality features that can modify the quantity of the asset to be delivered. Those criteria are outlined in paragraph 58(b) of Statement 133 as amended by this Statement.

Financial Guarantee Contracts

A28. This Statement amends Statement 133 to clarify the types of financial guarantee contracts that are included in that scope exception in paragraph 10(d). Constituents questioned whether this scope exception was intended to encompass financial guarantee contracts acquired by entities to obtain protection against events of default that are stipulated in the legal documents used to execute a credit agreement. Financial guarantee contracts typically provide for payment upon several default events (as specified in the underlying credit agreement) and not just the single triggering event described in paragraph 10(d)—that is, failure to pay when payment is due. Credit agreements typically contain events of default that are "payment-based" (for example, payment of principal or interest when due) and "non-payment-based" (for example, violation of a covenant or a change in control). Constituents questioned whether a guarantee contract that mirrors exactly the events of default covered by the original loan agreement and permits the guaranteed party to deliver the loan to the guarantor upon the occurrence of a non-payment-based event of default (such as a change in control of the debtor or a violation of a covenant) would qualify for the scope exception. Under that scenario, the guaranteed party would receive payment under the contract even though the debtor did not literally fail to pay when payment was due.

A29. In considering this issue, the Board discussed two possible alternatives: (a) amend paragraph 10(d) to permit financial guarantee contracts that provide protection to a guaranteed party in any event of default to qualify for the scope exception or (b) to clarify paragraph 10(d) to emphasize the need for the guaranteed party to demand payment and attempt collection prior to collecting any payment from the guarantor in order for a guarantee contract to be eligible for the scope exception. Both alternatives contemplate that, as part of the financial guarantee arrangement, the guarantor receives delivery of the defaulted receivable upon an event of default and obtains the right under the financial obligation to pursue collection of amounts for which the guaranteed party is reimbursed.

A30. The Board selected the second alternative, because it is more consistent with the Board's original intent when Statement 133 was being developed. The Board noted that the exception for financial guarantee contracts was intended to be similar to the exception for insurance contracts. The Board reasoned that the guarantees eligible for the scope exception are similar to insurance contracts in that they entitle the holder to compensation only if, as a result of an insurable event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk. The Board concluded that the intent of the scope exception for guarantee contracts in paragraph 10(d) of Statement 133 was to more closely align that exception with the scope exception for traditional insurance contracts addressed in paragraph 10(c). Accordingly, the Board determined that, in order for a financial guarantee contract to qualify for the scope exception in paragraph 10(d), the guaranteed party must demand payment from the debtor and, once it is determined that the required obligation is not satisfied by the debtor, the guaranteed party must relinquish rights of subrogation to the guarantor in order to receive payment by the guarantor. The Board also concluded that the language in paragraph 10(d) should be clarified to eliminate use of the term *loss that would be incurred* and instead focus on amounts due to the guaranteed party but not paid by the debtor.

A31. In addition, the Board decided that the concepts in Statement 133 Implementation Issue No. C7, "Certain Financial Guarantee Contracts," are critical to differentiating guarantee contracts covered by the scope exception in paragraph 10(d) from credit derivatives that provide payments in response to a change in credit rating or credit spreads of a reference credit. The amended language in paragraph 7(f) of this Statement was written to include financial guarantees with all of the following characteristics: (a) the guaranteed party's direct exposure on the referenced asset must be present both at the inception of the contract and throughout its life; (b) the guaranteed party has an amount that is due from the debtor (either at a pre-specified payment date or because an event of default occurred, as defined in the financial obligation covered by the guarantee contract, and payments were accelerated by means of notice to the debtor) and that amount is past due; and (c) the compensation paid to the guaranteed party under the contract does not exceed the direct exposure of the guaranteed party relating to the referenced asset either from owning the referenced asset or from other contractual commitments (for example, back-to-back arrangements).

Investments in Life Insurance

A32. Paragraph 12(b) of Statement 133 permits hybrid contracts to avoid bifurcation if they are remeasured at fair value with changes in value recorded in the income statement. Certain life insurance policies (for example, corporate-owned life insurance, business-owned life insurance, or key-man insurance subject to FASB Technical Bulletin No. 85-4, *Accounting for Purchases of Life Insurance*) that contain embedded derivatives do not satisfy the criterion in paragraph 12(b). While Technical Bulletin 85-4 requires that those contracts be measured at cash surrender value or contract value with changes in value recognized in the income statement during the contract period, contract value may not equal the fair value of the insurance policy. In those instances, policyholders would be required to follow paragraph 16 of Statement 133 and account for the host contract under generally accepted accounting principles. However, because the policyholder would not have a table of cash surrender values that relate only to the host contract, application of existing guidance in Technical Bulletin 85-4 for only the host contract is not feasible. For that reason, the Board decided that the policyholder should continue to account for those products in accordance with Technical Bulletin 85-4.

Contracts Held by Benefit Plans

A33. Constituents identified conflicts between the requirements of Statement 133 and both FASB Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts,* (which amended FASB Statement No. 35, *Accounting and*

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

Loan Commitments

A34. Paragraph 291 of Statement 133 addresses loan commitments. That paragraph states that a loan commitment would be excluded from the scope of Statement 133 "if it (a) requires the holder to deliver a promissory note that would not be readily convertible to cash and (b) cannot readily be settled net." Constituents questioned whether any loan commitments are subject to Statement 133 and, if so, which types of loan commitments meet the definition of a derivative. Constituents noted that if a loan commitment is subject to Statement 133, an overlap exists between a requirement to account for that arrangement as a derivative and the existing accounting guidance for commitment fees and costs in FASB Statements No. 65, *Accounting for Certain Mortgage Banking Activities,* and No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases,* as amended. Statements 65 and 91 were not amended by Statement 133.

A35. As reflected in paragraph 291, the Board believed that the characteristic of net settlement in paragraph 6(c) determines whether a loan commitment meets the definition of a derivative and that loan commitments generally meet the characteristics of a derivative described in paragraphs 6(a) and 6(b) of Statement 133. That is, a loan commitment contains an underlying (the specified interest rate on the undrawn borrowing) and a notional amount (the maximum amount of the borrowing), and the initial net investment in the contract is similar to a premium on other option-type contracts. In considering the net settlement characteristic, the Board understood that most loan commitments were not contractually required or permitted to be net settled as discussed in paragraph 9(a) of Statement 133. However, the Board acknowledged that a loan commitment may meet the characteristic of net settlement either because there is a market mechanism that facilitates net settlement (under paragraph 9(b)) or because the underlying asset that will be delivered under the contract (the loan) is readily convertible to cash (under paragraph 9(c)). During the development of Statement 133, the Board's perception was that most loan commitments did not meet the net settlement characteristic. Later, the Board became aware that certain types of loan commitments meet the net settlement characteristic and, therefore, meet the definition of a derivative.

A36. In an effort to resolve the scope overlap of Statement 133 and Statements 65 and 91, in December 2000, the FASB issued tentative guidance on the application of Statement 133 to loan commitments in Statement 133 Implementation Issue No. C13, "When a Loan Commitment Is Included in the Scope of Statement 133." That tentative guidance provided that only loan commitments that relate to the origination or acquisition of mortgage loans held for resale under Statement 65 would be accounted for as derivatives under Statement 133. However, Statement 65 would continue to apply to loan commitments that relate to the origination or acquisition of mortgage loans held for investment. Also, Statement 91 would continue to apply to all commitments that relate to the origination of loans that are not mortgage loans (for example, loan commitments issued to commercial and industrial enterprises). The Board recognized that the approach in Implementation Issue C13 could include in the scope of Statement 133 certain loan commitments that technically do not meet the definition of a derivative. For example, commitments that relate to mortgage loans classified as held for sale under Statement 65 would be considered derivatives under that guidance, even if the underlying loans did not meet the definition of *readily convertible to cash* under paragraph 9(c) of Statement 133.

A37. Because of concerns about the possible outcomes under Implementation Issue C13, the Board studied several alternatives for accounting for loan commitments. Those alternatives included (a) requiring the characteristic-based definition of a derivative to be applied to loan commitments and (b) providing a scope exception for some or all loan commitments. The Board consulted with members of the DIG and other constituents. Constituents highlighted the unique considerations surrounding the application of the definition of a derivative to different types of loan commitments. Many constituents indicated that additional guidance would be needed to assist practice in the application of the net settlement characteristic, including determining whether a market mechanism exists for commercial loan commitments and when a loan is considered readily convertible to cash. Constituents highlighted the operational burden of applying the characteristic-based definition of a derivative to various types of loan commitments.

A38. The Board decided to finalize the guidance in Implementation Issue C13. The Board observed that requiring an evaluation of loan commitments under the characteristic-based definition of a derivative in Statement 133 would impose a significant operational burden on entities, for example, by requiring an evaluation of some types of loan commitments on a contract-by-contract basis. In addition, the Board was persuaded by constituents that there would be significant disagreement as to whether a given loan had a market mechanism or was readily convertible to cash. Consequently, the Board was concerned that requiring entities to determine whether either of those requirements was met would result both in diversity of practice and ongoing requests for implementation guidance. Because of those concerns, the Board believes that if that requirement was imposed, entities could incur significant costs without providing a significant incremental improvement to financial reporting for banks' lending activities. The Board also observed that the approach in Implementation Issue C13 would limit the need for ongoing implementation guidance because many entities had already developed procedures for its implementation.

A39. The Board decided to add a new scope exception to paragraph 10 of Statement 133 for lenders who enter into loan commitments that relate to the origination or acquisition of mortgage loans held for investment and loans other than mortgages. With respect to loan commitments that relate to the origination or acquisition of mortgage loans held for resale under Statement 65, the Board concluded, as a practical exception, that the holder of the commitment (that is, the potential borrower under the arrangement) is not required to account for the contract as a derivative. Therefore, paragraph 7(i) of this Statement also provides a scope exception for holders of loan commitments that are required to be accounted for as derivatives. Paragraph 35 of this Statement amends Statement 65 to exclude from the scope of that Statement any loan commitments that are required to be accounted for as derivatives by the issuer (that is, the potential lender) under Statement 133. In addition, paragraph 36 of this Statement amends FASB Statement No. 126, *Exemption from Certain Required Disclosures about Financial Instruments for Certain Nonpublic Entities,* to indicate that certain disclosures about the fair value of financial instruments would continue to be optional for an entity that holds loan commitments to originate mortgage loans to be held for sale that are considered derivatives under Statement 133.

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

A40. Paragraph 61(f) of Statement 133 states that interest rate caps that are at or above the current market price (or rate) and interest rate floors that are at or below the current market price (or rate) at issuance of an instrument are considered to be clearly and closely related. The last sentence of that paragraph references paragraph 13(b) of Statement 133 and states that the derivative embedded in a variable-rate debt instrument that has a floor on the interest rate would not be separated from the host contract and accounted for separately even though, in a falling interest rate environment, the debt instrument may have a return to the investor that is a significant amount above the market return of a debt instrument without a floor provision. Constituents' views differed on the application of paragraph 61(f). Some constituents said that any embedded floor or cap that is in-the-money must be accounted for separately. Other constituents said that an embedded floor would never be accounted for separately.

A41. As a result of constituent concerns, the Board decided that paragraph 61(f) should indicate that interest rate floors and caps are typically considered clearly and closely related to a debt host. However, determining whether any floor or cap is considered clearly and closely related depends on the analysis required in paragraph 13 for embedded derivative instruments in which the underlying is an interest rate or interest rate index that alters net interest payments that otherwise would be paid or received on an interest-bearing host contract.

A42. Constituents' views differed on the application of paragraph 13(b) in the context of an interest rate cap or an interest rate floor. Prior to this amendment, paragraph 13(b) indicated that if an embedded derivative could at least double the investor's initial rate of return on the host contract *and* could also result in a rate of return that is at least twice what otherwise would be the *market return* for a contract that has the same terms as the host contract and that involves a debtor with a similar credit quality, the embedded derivative would not be clearly and closely related to the host contract. Some constituents interpreted paragraph 13(b) to indicate that the two conditions in that paragraph were identical.

A43. As a result of constituent concerns, the Board decided that paragraph 13(b) should indicate that if an embedded derivative could at least double the investor's initial rate of return on the host contract and at the same time result in a rate of return that is at least twice what otherwise would be the *then-current market return* for a contract that has the same terms as the host contract and that involves a debtor with a similar credit quality at the date of issuance, the embedded derivative is not clearly and closely related to the debt host contract. In other words, application of paragraph 13(b) requires first that the embedded derivative could, with any possibility, at least double the investor's initial rate of return on a contract that did not contain the embedded derivative. When that condition is met, the embedded derivative is not considered clearly and closely related if, for any of those possibilities in which the investor's initial rate of return is at least doubled, the rate of return the investor will obtain in the future on the host contract is at least twice the then-current market return for that contract.

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

A44. The Board concluded that it was necessary to add footnotes to the term *expected cash flows* in Statements 15, 35, 60, 87, 106, and 133 because the use of that term in those Statements is not consistent with the definition of *expected cash flows* in the glossary to Concepts Statement 7. In addition to the footnotes added to Statement 133, paragraphs 30–34 of this Statement amend other pronouncements to reflect the fact that because those pronouncements were issued prior to Concepts Statement 7, the term *expected cash flows* does not necessarily have the same meaning as it does in Concepts Statement 7.

Effective Date and Transition

A45. The Board decided that this Statement should be effective as of the first day of the first fiscal quarter beginning after November 15, 2002, for all paragraphs in this Statement except as noted in paragraph A46 and paragraph A47 (relating to the accounting by the transferor and the beneficial interest holder of a qualifying SPE). The Board decided to permit earlier application as of the first day of the first fiscal quarter for which financial statements have not been issued, provided that the entity did not have any embedded derivatives previously separated and designated as a hedging instrument in a cash flow hedge that would not be separated under this Statement for any part of that earlier fiscal quarter. The Board chose not to allow retroactive application of the provisions of this Statement because it would not be consistent with prior transition guidance in Statement 133 and if retroactive application were permitted, entities also would request the ability to retroactively designate a hedging relationship, which is prohibited under paragraph 51(c) of Statement 133.

A46. The Board chose not to readdress the effective dates of the Statement 133 Implementation Issues referenced in the provisions of paragraphs 6, 7(b), 7(d), 9, 11, 15, 16, 19, 20, 22, 23(c), 25(a), and 26 of this Statement. It concluded that those effective dates should remain unchanged from those noted in the respective Statement 133 Implementation Issues that were cleared by the Board.

A47. The Board decided that the provisions in paragraphs 4, 5, 8, and 10 of this Statement should be effective upon issuance of this Statement for the transferor and beneficial interest holders in a qualifying SPE that does not meet the requirements in paragraph 42 of this Statement to continue to be accounted for as a qualifying SPE. The Board concluded that, while it did not want to penalize those who applied the interim guidance in Implementation Issue D1, it also did not wish to allow entities to use a qualifying SPE to avoid the accounting in Statement 133 for transactions occurring beyond the earliest date that guidance amending Statement 133 was finalized—the date this Statement is issued.

Transition Provisions for the Revised Guidance Related to a Derivative and Embedded Derivatives

A48. The Board concluded that the provisions of this Statement that relate to the revised definition of a derivative (paragraph 4) or the bifurcation of embedded derivatives (paragraph 8) should be applied prospectively to all existing and future contracts. The Board decided that retroactive application could impair comparability of financial statements and result in constituents' desire to retroactively designate a hedging relationship.

A49. The Board also concluded that if an entity had not accounted for a contract as a derivative in its entirety or had not bifurcated an embedded derivative but is required to do so under this Statement, the effects of initially complying with this Statement should be reported as a cumulative-effect-type adjustment of net income. If an entity had been accounting for a contract as a derivative under Statement 133 but would no longer be able to do so under the revised implementation guidance, the Board concluded that those contracts should be grandfathered and the entity should apply the revised guidance prospectively for future contracts only.

Statement 140 Transition for Qualifying SPEs Applying Statement 133 under This Statement

A50. A number of constituents expressed concern that after applying paragraphs 4 and 8 of this Statement to beneficial interests, certain qualifying SPEs would lose their qualifying status because the beneficial interests would violate paragraph 35(c)(2) of Statement 140 (as discussed further in paragraph 40 of that Statement). Under paragraphs 35(c)(2) and 40, to be qualifying an SPE may hold only "passive derivative financial instruments that pertain to beneficial interests *(other than another derivative financial instrument)* issued or sold to parties other than the transferor, its affiliates, or its agents" (emphasis added). Loss of that status would result in the transferor being required under paragraph 55 of Statement 140 to account for the securitized assets as purchased from the former transferee(s) in exchange for the liabilities assumed.

A51. In considering transition for qualifying SPEs, the Board first considered amending paragraphs 35(c)(2) and 40 of Statement 140 to delete the parenthetical phrase *other than another derivative financial instrument,* thereby allowing qualifying SPE status for existing and future SPEs that enter into derivatives that pertain only to other embedded or freestanding derivatives of that SPE. The Board decided not to amend those paragraphs. The requirements in those paragraphs were put in place for two reasons: (1) so that the requirements of Statement 133 could not be circumvented by executing transactions through qualifying SPEs and (2) because a qualifying SPE is not permitted to engage in transactions that give it discretion. The Board believes that the guidance in Implementation Issue D2 and related issues addresses its first concern: that entities would be able to circumvent Statement 133. However, the Board remained concerned that an amendment of Statement 140 would result in unintended consequences and open up the possibility for transfers of pools of derivatives into qualifying SPEs.

A52. The Board considered three alternatives to provide transition relief to structures that were qualifying SPEs under Statement 140 prior to the effective date of this Statement. The Board considered providing a delayed effective date so that entities could adapt to the new guidance. Under that alternative, both existing and new structures would be required to apply Statements 140 and 133, as amended, upon that specified effective date. The second alternative considered by the Board was to grandfather existing structures. Under that alternative, only new issuances of beneficial interests would be accounted for under Statement 133. The third alternative discussed by the Board was to grandfather existing structures that do not meet the requirements to be a qualifying SPE after applying the guidance in this Statement. Under that alternative, a transferor that holds a beneficial interest in an SPE would assess the beneficial interests in the SPE to determine if it was still a qualifying SPE after applying the amended definition of a derivative. If, as a result of that assessment, it was determined that the SPE no longer met the requirements of a qualifying SPE, that holder of the beneficial interest would be required to disclose in financial statements issued after the issuance of the amendment to Statement 133, the amount of assets and liabilities that are currently off-balance-sheet in existing structures that would not meet the requirements for a qualifying SPE if both Statements 133 and 140 were applied.

A53. The Board selected the last alternative—to grandfather, subject to certain restrictions, existing structures that would not meet the requirements to be a qualifying SPE if they were to apply this Statement. The Board reasoned that while transferors and beneficial interest holders should be required to account for beneficial interests in accordance with Statement 133, applying Statement 133 to qualifying SPEs that were established under interim guidance should not result in existing structures losing their qualifying status because they hold *derivative instruments that pertain to beneficial interests that are derivatives,* even though holding those instruments is prohibited by paragraphs 35(c)(2) and 40 of Statement 140. That transition allows some entities to continue to account for those structures as qualifying SPEs, but it limits the period in which those structures can continue to issue additional beneficial interests.

A54. The Board chose to limit the provision in paragraph 42 of this Statement to a previously qualifying SPE that (a) maintains its qualifying status under previous accounting standards, (b) does not issue additional beneficial interests after the issuance of the amendment to Statement 133, and (c) does not receive assets it was not committed to receive before that date. The Board chose the issuance date of this Statement in order to prohibit new structures from being grandfathered after the amended provisions relating to the definition of a derivative and bifurcation of hybrid instruments are finalized. The Board considered requiring earlier application; however, it decided not to require the application of the provisions in this Statement until they are finalized and issued.

Alternative View

A55. One Board member believes that the principal reason this Statement proposes to amend the current definition of a derivative in Statement 133 is that there is a conflict between the measurement provisions of Statement 133 and Statement 140. Many of the interests held by a transferor that result from a securitization transaction meet the current definition of a derivative in Statement 133. As derivatives, they should be measured at fair value under Statement 133. However, under Statement 140, those interests are not generally measured, either initially or subsequently, at fair value. That Board member believes that amending the definition of a derivative in Statement 133 to resolve that conflict is suboptimal. He believes that a better approach would be to amend Statement 140 and rescind paragraph 14 of Statement 133 such that all of the interests in a qualifying SPE that are held by a transferor of assets to that qualifying SPE are recognized and measured, both initially and subsequently, at fair value in the statement of financial position. Those interests held by a transferor after a securitization that meet the definition of a derivative would be eligible to be designated as hedging instruments.

A56. The Board member believes the approach taken in this Statement is a case of the tail wagging the dog. The amendment to the definition of a derivative in Statement 133 has far more consequence than just resolving the conflict between Statement 133 and Statement 140. The amended definition will be applied to all financial instruments—not just beneficial interests that arise from securitizations. Accordingly, in order to contain the collateral effects of the amended definition, other provisions of Statement 133 are also being amended. The Board member believes the overall effect of the amendments is to weaken the scope and application of Statement 133. In particular, a number of financial instruments that currently meet the definition of a derivative will not be accounted for as derivatives under the amended definition. Consequently, many financial instruments that the Board member believes should be accounted for as derivatives will no longer be measured at fair value. The Board member acknowledges that many, if not most, of those financial instruments will contain embedded derivatives that must be separated from the host contract and accounted for as derivatives. However, if it is designated as a hedging instrument, the bifurcated derivative generally will result in much less ineffectiveness to be recognized because its terms will likely more closely match the terms of a hedged exposure. The effect of the bifurcation will be to mask the ineffectiveness caused by the portion of the financial instrument that is deemed to be the host contract. That Board member believes that effect of reducing reported volatility when volatility exists is a step backward—not an improvement—in financial reporting. Furthermore, reducing the number of financial instruments accounted for at fair value is another step away from achieving the Board's stated vision of carrying all financial instruments at fair value in the statement of financial position.

A57. One benefit of the approach favored by the Board member is the elimination of different accounting treatments for retained interests and proceeds from a securitization. Under Statement 140, interests held by a transferor after a securitization that are deemed to be proceeds are initially measured and usually subsequently measured at fair value, while interests that are considered retained interests generally are carried at allocated cost. Because the distinction between what is considered proceeds and what is considered retained interests is arbitrary, the Board member believes that measuring, both initially and subsequently, all interests that are held by a transferor that arose from a transfer of assets to a qualifying SPE at fair value would result in financial reporting that is more representationally faithful. More important, it would eliminate the existing conflict between Statement 133 and Statement 140 while improving financial reporting, because all interests, including derivatives, held by a transferor after a securitization would be carried at fair value.

A58. That Board member has some concerns that his preferred approach might result in certain instruments with identical characteristics being accounted for differently, depending on whether they arose from a securitization and are held by the transferor or from some other source. While that is troubling, the Board member believes that if the definition of a derivative in Statement 133 was not changed, that situation would be sufficiently infrequent to override the benefits of having all interests held by a transferor in the assets transferred to a qualifying SPE accounted for at fair value.

A59. That Board member also believes certain transition provisions are inappropriate. He understands and is sympathetic to the Board's belief that formerly qualifying SPEs that no longer meet the requirements for qualification as a result of a changed interpretation of accounting standards should be accorded special transition provisions that enable them to continue as qualifying SPEs in certain circumstances. However, he sees no justification for extending that relief such that derivatives or hybrid instruments held by the transferor of assets to formerly qualifying SPEs as a result of transfers to those SPEs are exempt from the accounting standards set forth in Statement 133. If those assets are derivatives or contain embedded derivatives, they should be accounted for accordingly.

Appendix B

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

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

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Derivative Instruments

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

a. It has (1) one or more **underlyings** and (2) one or more **notional amounts**[3] or payment provisions or both. Those terms determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required.[4]
b. If it is an option-based contract,[*] it has an initial net investment equal to the fair value of the option component. If it is not an option-based contract (hereafter referred to as a non-option-based contract), it requires an initial net investment that is less than 5 percent of the fully prepaid amount.[†]~~It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.~~

---

[3]Sometimes other names are used. For example, the notional amount is called a face amount in some contracts.
[4]The terms *underlying, notional amount, payment provision,* and *settlement* are intended to include the plural forms in the remainder of this Statement. Including both the singular and plural forms used in this paragraph is more accurate but much more awkward and impairs the readability.
[*]An option-based contract is a contract that either is a freestanding option or has an embedded option. A contract that contains an embedded option for which the strike price is fair value at the time of exercise should be considered non-option-based for purposes of applying this paragraph.
[†]For non-option-based contracts, judgment of whether an initial net investment is less than 5 percent of the fully prepaid amount should be made based on comparison of the initial net investment to the amount of investment that would result in the contract becoming fully prepaid. Non-option-based contracts are fully prepaid if one party invests the fair value of all its future cash outflows under the contract and no longer has to sacrifice additional assets to settle the contract.

c. Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

8. *Initial net investment*. Many derivative instruments require no initial net investment. Some require an initial net investment as compensation for time value (for example, a premium on an <u>at-the-money </u>option) or for terms that are more or less favorable than market conditions (for example, a premium on a forward purchase contract with a price less than the current forward price<u> where that premium is less than 5 percent of the fully prepaid amount of the contract</u>). Others require a mutual exchange of currencies or other assets at inception, in which case the net investment is the difference in the fair values of the assets exchanged. A derivative instrument does not require an initial net investment in the contract that is equal to the notional amount (or the notional amount plus a premium or minus a discount) or that is determined by applying the notional amount to the underlying.

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

a. Neither party is required to deliver an asset that is associated with the underlying ~~or~~ <u>and</u> that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (or the notional amount plus a premium or minus a discount). For example, most interest rate swaps do not require that either party deliver interest-bearing assets with a principal amount equal to the notional amount of the contract.
b. One of the parties is required to deliver an asset of the type described in paragraph 9(a), but there is a market mechanism that facilitates net settlement, for example, an exchange that offers a ready opportunity to sell the contract or to enter into an offsetting contract.

c. One of the parties is required to deliver an asset of the type described in paragraph 9(a), but that asset is readily convertible to cash[5] or is itself a derivative instrument. An example of that type of contract is a forward contract that requires delivery of an exchange-traded equity security. Even though the number of shares to be delivered is the same as the notional amount of the contract and the price of the shares is the underlying, an exchange-traded security is readily convertible to cash. Another example is a swaption—an option to require delivery of a swap contract, which is a derivative.

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

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

a. *"Regular-way" security trades.* Regular-way security trades are contracts ~~with no net settlement provision and no market mechanism to facilitate net settlement (as described in paragraphs 9(a) and 9(b)). They~~that provide for delivery of a security within the time generally established by regulations or conventions in the marketplace or exchange in which the transaction is being executed. However, a contract for an existing security does not qualify for the regular-way security trades exception if it requires or permits net settlement (as discussed in paragraphs 9(a) and 57(c)(1)), or if a market mechanism to facilitate net settlement of that contract (as discussed in paragraphs 9(b) and 57(c)(2)) exists. Application of the regular-way security trades exception to a contract for the purchase and sale of securities that are referred to as *when-, as-,* or *if-issued,* or *to-be-announced* is addressed in paragraph 59(a).
b. *Normal purchases and normal sales*. Normal purchases and normal sales are contracts that provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business. In addition to this condition, the guidance in paragraph 10(b)(1)–(4) should be considered in determining whether a specific type of contract may be considered normal purchases and normal sales. However, contracts that have a price based on an underlying that is not clearly and closely related to the asset being sold or purchased (such as a price in a contract for the sale of a grain commodity based in part on changes in the S&P index) or that are denominated in a foreign currency that meets none~~neither~~ of the criteria in paragraphs 15(a)–15(d)~~and 15(b)~~ shall not be considered normal purchases and normal sales.

---

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

(1) *Forward contracts (non-option-based contracts).* Forward contracts with no net settlement provision and no market mechanism to facilitate net settlement (as described in paragraphs 9(a) and 9(b)) are eligible to qualify for the normal purchases and normal sales exception. Forward ~~C~~contracts that contain net settlement provisions as described in paragraphs 9(a) and 9(b) are not eligible ~~may qualify~~ for the normal purchases and normal sales exception unless~~if~~ it is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery. Net settlement (as described in paragraphs 9(a) and 9(b)) of contracts in a group of contracts similarly designated as normal purchases and normal sales would call into question the classification of all such contracts as normal purchases or normal sales. Contracts that require cash settlements of gains or losses or are otherwise settled net on a periodic basis, including individual contracts that are part of a series of sequential contracts intended to accomplish ultimate acquisition or sale of a commodity, do not qualify for this exception.

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

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

(4) *Power purchase or sales agreements.* A power purchase or sales agreement (whether a forward contract, option contract, or a combination of both) may also qualify for the normal purchases and normal sales exception if it meets the criteria in paragraph 58(b).

For contracts that qualify for the normal purchases and normal sales exception, the entity shall document the designation of the contract as a normal purchase or normal sale. For contracts that qualify for the normal purchases and normal sales exception under paragraph 10(b)(1), the entity shall document the basis for concluding that it is probable that the contract will result in physical delivery. For contracts that qualify for the normal purchases and normal sales exception under paragraph 10(b)(4), the entity shall document the basis for concluding that the agreement is a **capacity contract.** The documentation requirements can be applied either to groups of similarly designated contracts or to each individual contract.

c. *Certain insurance contracts*. Generally, contracts of the type that are within the scope of FASB Statements No. 60, *Accounting and Reporting by Insurance Enterprises,* No. 97, *Accounting and Reporting by Insurance Enterprises for Certain*

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

(1) *Traditional life insurance contracts.* The payment of death benefits is the result of an identifiable insurable event (death of the insured) instead of changes in a variable.

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

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

d. *Certain financial guarantee contracts.* Financial guarantee contracts are not subject to this Statement if they provide for payments to be made only to reimburse the guaranteed party for failure of the debtor to satisfy its required payment obligations, either at pre-specified payment dates or because an event of default occurred, as defined in the financial obligation covered by the guarantee contract, and payments were accelerated automatically or by means of notice to the debtor. The guaranteed party must be exposed to the risk of nonpayment both at inception of the financial guarantee contract and throughout its term.~~a loss incurred because the debtor fails to pay when payment is due, which is an identifiable insurable event.~~ In contrast, financial guarantee contracts are subject to this Statement if, for example, they provide for payments to be made in response to changes in an underlying ~~(for example,~~such as a decrease in a specified debtor's creditworthiness~~)~~.

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

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

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

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

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

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

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

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

i. *Loan commitments.* Loan commitments that relate to the origination or acquisition of mortgage loans that will be held for investment purposes, as discussed in paragraph 6 of FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities* (as amended), are not subject to this Statement. In addition, loan commitments that relate to the origination of other types of loans (that is, other than mortgage loans) are not subject to the requirements of this Statement. Loan commitments that relate to the origination or acquisition of mortgage loans that will be held for sale, as discussed in paragraph 4 of Statement 65, shall be accounted for as derivative instruments by the issuer of the loan commitment (that is, the potential lender). However, the holder of that type of loan commitment (that is, the potential borrower) is not subject to the requirements of this Statement.

12. Contracts that do not in their entirety meet the definition of a derivative instrument (refer to paragraphs 6–9), such as bonds, insurance policies, and leases, may contain

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

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

<u>A contract that, in its entirety, meets the definition of a derivative but is a non-option-based contract that requires an initial net investment that is less than 5 percent of the fully prepaid amount (as discussed in paragraph 6(b)) may be accounted for either as (1) a derivative in its entirety or (2) a hybrid instrument that must be bifurcated into a debt host and a derivative with a fair value of zero at acquisition of the hybrid instrument.</u>

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

a. The hybrid instrument can contractually be settled in a such a way that the investor (holder) would not recover *substantially all* of its initial recorded investment.
b. The embedded derivative meets both of the following conditions:
   (1) There is a possible future interest rate scenario (that may be currently remote) under which the embedded derivative would ~~could~~ at least double the investor's initial rate of return on the host contract
   (2) For any of the possible interest rate scenarios under which the investor's initial rate of return on the host contract would be doubled (as discussed under paragraph 13(b)(i)) the embedded derivative would at the same time~~and could also~~ result in a rate of return that is at least twice what otherwise would be the then-current market return (under each future interest rate scenario) for a contract that has the same terms as the host contract and that involves a debtor with a similar credit quality.

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

---

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

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

15. An embedded foreign currency derivative instrument shall *not* be separated from the host contract and considered a derivative instrument under paragraph 12 if the host contract is not a financial instrument and it requires payment(s) denominated in (a) the functional currency of ~~the primary economic environment in which~~any substantial party to that contract, ~~operates (that is, its functional currency) or~~ (b) the currency in which the price of the related good or service that is acquired or delivered is routinely denominated in international commerce (for example, the U.S. dollar for crude oil transactions), (c) the local currency of any substantial party to the contract, or (d) the currency used by a substantial party to the contract as if it were the functional currency because the primary economic environment in which the party operates is highly inflationary (as discussed in paragraph 11 of Statement 52). If similar transactions for a certain product or service are routinely denominated in international commerce in various different currencies, the transaction does not qualify for the exception in (b) above. The evaluation of whether a contract qualifies for the exception in this paragraph should be performed only at inception of the contract. Unsettled foreign currency transactions, including financial instruments, that are monetary items and have their principal payments, interest payments,

or both denominated in a foreign currency are subject to the requirement in Statement 52 to recognize any foreign currency transaction gain or loss in earnings and shall not be considered to contain embedded foreign currency derivative instruments under this Statement. The same proscription applies to available-for-sale or trading securities that have cash flows denominated in a foreign currency.

Recognition of Derivatives and Measurement of Derivatives and Hedged Items

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

~~19. In this Statement, the *change in the fair value* of an entire financial asset or liability for a period refers to the difference between its fair value at the beginning of the period (or~~

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

~~acquisition date) and the end of the period adjusted to exclude (a) changes in fair value due to the passage of time and (b) changes in fair value related to any payments received or made, such as in partially recovering the asset or partially settling the liability.~~

Fair Value Hedges

General

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

a. At inception of the hedge, there is formal documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value attributable to the hedged risk will be assessed. There must be a reasonable basis for how the entity plans to assess the hedging instrument's effectiveness.
   (1) For a fair value hedge of a firm commitment, the entity's formal documentation at the inception of the hedge must include a reasonable method for recognizing in earnings the asset or liability representing the gain or loss on the hedged firm commitment.
   (2) An entity's defined risk management strategy for a particular hedging relationship may exclude certain components of a specific hedging derivative's change in fair value, such as time value, from the assessment of hedge effectiveness, as discussed in paragraph 63 in Section 2 of Appendix A.
b. Both at inception of the hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. If the hedging instrument (such as an at-the-money option contract) provides only one-sided offset of the hedged risk, the increases (or decreases) in the fair value of the hedging instrument must be expected to be highly effective in offsetting the decreases (or increases) in the fair value of the hedged item. All assessments of effectiveness shall be consistent with the risk management strategy documented for that particular hedging relationship (in accordance with paragraph 20(a) above).

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

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

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

The Hedged Item

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

a. The hedged item is specifically identified as either all or a specific portion of a recognized asset or liability or of an unrecognized firm commitment.[8] The hedged item is a single asset or liability (or a specific portion thereof) or is a portfolio of similar assets or a portfolio of similar liabilities (or a specific portion thereof).
   (1) If similar assets or similar liabilities are aggregated and hedged as a portfolio, the individual assets or individual liabilities must share the risk exposure for which they are designated as being hedged. The change in fair value attributable to the hedged risk for each individual item in a hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk. That is, if the change in fair value of a hedged portfolio attributable to the hedged risk was 10 percent during a reporting period, the change in the fair values attributable to the hedged risk for each item constituting the portfolio should be expected to be within a fairly narrow range, such as 9 percent to 11 percent. In contrast, an expectation that the change in fair value attributable to the hedged risk for individual items in the portfolio would range from 7 percent to 13 percent would be inconsistent with this provision. In aggregating loans in a portfolio to be hedged, an entity may choose to consider some of the following characteristics, as appropriate: loan type, loan size, nature and location of collateral, interest rate type (fixed or variable) and the coupon

---

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

interest rate (if fixed), scheduled maturity, prepayment history of the loans (if seasoned), and expected prepayment performance in varying interest rate scenarios.[9]

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

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

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

(c) A put option~~,~~ or ~~a~~ call option~~,~~ (including an interest rate or price cap~~,~~ or an interest rate or price floor) embedded in an existing asset or liability that is not an embedded derivative accounted for separately pursuant to paragraph 12 of this Statement

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

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

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

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

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

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

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

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

f. If the hedged item is a financial asset or liability, a recognized loan servicing right, or a nonfinancial firm commitment with financial components, the designated risk being hedged is:

(1) The risk of changes in the overall fair value of the entire hedged item,

(2) The risk of changes in its fair value attributable to changes in the **designated benchmark interest rate** (referred to as interest rate risk),

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

(4) The risk of changes in its fair value attributable to both changes in the obligor's creditworthiness and changes in the spread over the benchmark interest rate with respect to the hedged item's credit sector at inception of the hedge (referred to as credit risk).

If the risk designated as being hedged is not the risk in paragraph 21(f)(1) above, two or more of the other risks (interest rate risk, foreign currency exchange risk, and credit risk) may simultaneously be designated as being hedged. The benchmark interest rate being hedged in a hedge of interest rate risk must be specifically identified as part of the designation and documentation at the inception of the hedging relationship. Ordinarily, an entity should designate the same benchmark interest rate as the risk being hedged for similar hedges, consistent with paragraph 62; the use of different benchmark interest rates for similar hedges should be rare and must be justified. In calculating the change in the hedged item's fair value attributable to changes in the benchmark interest rate, the estimated cash flows used in calculating fair value must be based on all of the contractual cash flows of the entire hedged item. Excluding some of the hedged item's contractual cash flows (for example, the portion of the interest coupon in excess of the benchmark interest rate) from the calculation is not permitted.[*] An entity may not simply designate

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

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 interest rate risk.

Impairment

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

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

Cash Flow Hedges

General

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

a. At inception of the hedge, there is formal documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged transaction, the nature of the risk being hedged, and how the hedging instrument's effectiveness in hedging the exposure to the hedged transaction's variability in cash flows attributable to the hedged risk will be assessed. There must be a reasonable basis for how the entity plans to assess the hedging instrument's effectiveness.
   (1) An entity's defined risk management strategy for a particular hedging relationship may exclude certain components of a specific hedging derivative's change in fair value from the assessment of hedge effectiveness, as discussed in paragraph 63 in Section 2 of Appendix A.
   (2) Documentation shall include all relevant details, including the date on or period within which the forecasted transaction is expected to occur, the specific nature of asset or liability involved (if any), and the expected currency amount or quantity of the forecasted transaction.
      (a) The phrase *expected currency amount* refers to hedges of foreign currency exchange risk and requires specification of the exact amount of foreign currency being hedged.
      (b) The phrase *expected . . . quantity* refers to hedges of other risks and requires specification of the physical quantity (that is, the number of items or units of measure) encompassed by the hedged forecasted transaction. If a forecasted sale or purchase is being hedged for price risk, the hedged transaction cannot be specified solely in terms of expected currency amounts, nor can it be specified as a percentage of sales or purchases

---

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

during a period. The current price of a forecasted transaction also should be identified to satisfy the criterion in paragraph 28(b) for offsetting cash flows.

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

b. Both at inception of the hedge and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge, except as indicated in paragraph 28(d) below. An assessment of effectiveness is required whenever financial statements or earnings are reported, and at least every three months. If the hedging instrument, such as an at-the-money option contract, provides only one-sided offset against the hedged risk, the cash inflows (outflows) from the hedging instrument must be expected to be highly effective in offsetting the corresponding change in the cash outflows or inflows of the hedged transaction. All assessments of effectiveness shall be consistent with the originally documented risk management strategy for that particular hedging relationship.

c. If a written option is designated as hedging the variability in cash flows for a recognized asset or liability<u> or an unrecognized firm commitment</u>, the combination of the hedged item and the written option provides at least as much potential for favorable cash flows as exposure to unfavorable cash flows. That test is met if all possible percentage favorable changes in the underlying (from zero percent to 100 percent) would provide at least as much favorable cash flows as the unfavorable cash flows that would be incurred from an unfavorable change in the underlying of the same percentage. (Refer to paragraph 20(c)(1).)

d. If a hedging instrument is used to modify the interest receipts or payments associated with a recognized financial asset or liability from one variable rate to another variable rate, the hedging instrument must be a link between an existing designated asset (or group of similar assets) with variable cash flows and an existing designated liability (or group of similar liabilities) with variable cash flows and be highly effective at achieving offsetting cash flows. A link exists if the basis (that is, the rate index on which the interest rate is based) of one leg of an interest rate swap is the same as the basis of the interest receipts for the designated asset and the basis of the other leg of the swap is the same as the basis of the interest payments for the designated liability. In this situation, the criterion in the first sentence in paragraph 29(a) is applied separately to the designated asset and the designated liability.

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

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

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

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

the seller) of the hedging instrument shall be reclassified each period from other comprehensive income to earnings. If an option contract is used as the hedging instrument to provide only one-sided offset against the hedged foreign exchange risk, an amount shall be reclassified each period to or from other comprehensive income with respect to the changes in the underlying that result in a change in the hedging option's intrinsic value and, if the assessment of effectiveness and measurement of ineffectiveness is also based on total changes in the option's cash flows, an amount that adjusts earnings for the amortization of the cost of the option on a rational basis shall be reclassified each period to or from other comprehensive income to earnings. (In determining the accounting for other seemingly similar hedging relationships, one should not analogize to the accounting prescribed in this guidance due to the unique attributes of foreign currency hedging relationships and the fact that this accounting guidance is viewed as an exception for foreign currency hedging relationships.)

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

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

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

Effective Date and Transition

49. At the date of initial application, an entity shall recognize all freestanding derivative instruments (that is, derivative instruments other than embedded derivative instruments) in the statement of financial position as either assets or liabilities and measure them at fair value, pursuant to paragraph 17.[13] The difference between a derivative's previous carrying amount and its fair value shall be reported as a transition adjustment, as discussed in paragraph 52. The entity also shall recognize offsetting gains and losses on hedged assets, liabilities, and firm commitments by adjusting their carrying amounts at that date, as discussed in paragraph 52(b). Any gains or losses on derivative instruments that are reported independently as deferred gains or losses (that is, liabilities or assets) in the statement of financial position at the date of initial application shall be derecognized from that statement; that derecognition also shall be reported as transition adjustments as indicated in paragraph 52. Any gains or losses on derivative instruments reported in other comprehensive income at the date of initial application because the derivative instruments were hedging the fair value exposure of available-for-sale securities also shall be reported as transition adjustments; the offsetting losses and gains on the securities shall be accounted for pursuant to paragraph 52(b). Any gain or loss on a derivative instrument reported in accumulated other comprehensive income at the date of initial application

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

because the derivative instrument was hedging the *variable cash flow exposure* of a forecasted (anticipated) transaction related to an available-for-sale security shall remain in accumulated other comprehensive income and shall *not* be reported as a transition adjustment. The accounting for any gains and losses on derivative instruments that arose prior to the initial application of the Statement and that were previously added to the carrying amount of recognized hedged assets or liabilities is not affected by this Statement. Those gains and losses shall not be included in the transition adjustment.*

IMPLEMENTATION GUIDANCE

Section 1: Scope and Definition

Application of Paragraphs 6–11

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

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

---

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

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

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

b. *Initial net investment.* ~~A derivative requires no initial net investment or a smaller initial net investment than other types of contracts that have a similar response to changes in market factors.~~An option-based contract is a derivative if it has an initial net investment equal to the fair value of the option component. A non-option-based contract is a derivative if it requires an initial net investment that is less than 5 percent of the fully prepaid amount (as discussed in paragraph 6(b)). For example, entering into a commodity futures contract generally requires no initial net investment, while purchasing the same commodity requires an initial net investment equal to its market price. However, both contracts reflect changes in the price of the commodity in the same way (that is, similar gains or losses will be incurred). A swap or forward contract also generally does not require an initial net investment unless the terms favor one party over the other. An option-based contract generally requires that one party make an initial net investment (a premium) because that party has the rights under the contract and the other party has the obligations. The phrase *initial net investment* is stated from the perspective of only one party to the contract, but it determines the application of the Statement for both parties.[15]

c. *Net settlement.* A contract that meets any one of the following criteria has the characteristic described as net settlement:
   (1) Its terms implicitly or explicitly require or permit net settlement. For example, a penalty for nonperformance in a purchase order is a net settlement provision if the amount of the penalty is based on changes in the price of the items that are the subject of the contract. Net settlement may be made in cash or by delivery of any other asset, whether or not it is readily convertible to cash. A fixed penalty for nonperformance is not a net settlement provision.
   (2) There is an established market mechanism that facilitates net settlement outside the contract. The term *market mechanism* is to be interpreted broadly. Any institutional arrangement or other agreement that enables either party to be relieved of all rights and obligations under the contract and to liquidate its net position without incurring a significant transaction cost is considered net settlement.

---

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

(3) It requires delivery of an asset that is readily convertible to cash. (The notion of *readily convertible to cash* shall be applied to a contract throughout its life, not only at its inception.) The definition of *readily convertible to cash* in FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises,* includes, for example, a security or commodity traded in an active market and a unit of foreign currency that is readily convertible into the functional currency of the reporting entity. A security that is publicly traded but for which the market is not very active is readily convertible to cash if the number of shares or other units of the security to be exchanged is small relative to the daily transaction volume. That same security would not be readily convertible if the number of shares to be exchanged is large relative to the daily transaction volume. The ability to use a security that is not publicly traded or an agricultural or mineral product without an active market as collateral in a borrowing does not, in and of itself, mean that the security or the commodity is readily convertible to cash. Shares of stock to be received upon the exercise of a stock purchase warrant do not meet the characteristic of being readily convertible to cash if both of the following conditions exist: (a) the stock purchase warrant is issued by an entity for only its own stock and (b) the sale or transfer of the issued shares is restricted for a period of 32 days or more from the date the stock purchase warrant is exercised. In contrast, restrictions imposed by a stock purchase warrant on the sale or transfer of shares of stock that are received from the exercise of that warrant issued by an entity for *other* than its own stock (whether those restrictions are for more or less than 32 days) do not impact the determination of whether those shares are readily convertible to cash.

58. The following discussion further explains some of the exceptions discussed in paragraphs 10 and 14.

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 except as provided in paragraph 59(a) for a contract for the purchase and sale of a security referred to as when-, as-, or if-issued, or to-be-announced.[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 security trades exception applies, but if the contract requires settlement in five days, the regular-way security trades exception does not apply. This Statement does not change whether an entity recognizes regular-way security trades

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

on the trade date or the settlement date. However, trades that do not qualify for the regular-way security trades exception are subject to the requirements of this Statement regardless of the method an entity uses to report its security trades.

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

(1) For both parties to the contract:

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

  (b) The power purchase or sales agreement is a capacity contract. Differentiating between a capacity contract and a traditional option contract (that is, a financial option on electricity) is a matter of judgment that depends on the facts and circumstances. The characteristics of a capacity contract, which are set forth in paragraph 540, should be considered in that evaluation; however, other characteristics not listed may also be relevant in that evaluation.

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

(3) For the buyer of electricity:

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

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

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

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

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

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

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

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

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

d. *Beneficial interests issued in securitization transactions*. Beneficial interests issued in securitization transactions are eligible for the scope exception in paragraph 14 only if both criteria in that paragraph are satisfied. Paragraph 14(a) is satisfied if the securitized financial assets do not themselves contain any embedded derivatives that, under the requirements of paragraph 12, would require separate accounting and the securitization vehicle does not contain any freestanding derivatives that were entered into or transferred to the structure. Beneficial interests arising from securitization transactions that distribute noncontractual cash flows to beneficial interest holders do not satisfy the criterion in paragraph 14(a). Paragraph 14(b) is satisfied if the beneficial interests in the securitized assets receive cash flows that arise solely from the particular assets that were securitized.

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

a. *Forward purchases or sales of to-be-announced securities or securities when-issued, as-issued, or if-issued.* ~~A contract for the purchase and sale of a security when, as, or if issued or to be announced is excluded from the requirements of this Statement as a regular-way security trade if~~Contracts for the purchase and sale of securities referred to as when-, as-, or if-issued, or to-be-announced are excluded from the requirements of this Statement as a regular-way security trade only if (1) there is no other way to purchase or sell that security, ~~and~~ (2) delivery of that security and settlement will occur within the shortest period possible for that type of security, and (3) it is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery of a security when it is issued. A contract for the purchase and sale of a security when-, as-, or if-issued, or to-be-announced is eligible to qualify for the regular-way security trades exception even though that contract permits net settlement (as discussed in paragraphs 9(a) and 57(c)(1)) or a market mechanism to facilitate net settlement of that contract (as discussed in paragraphs 9(b) and 57(c)(2)) exists. The entity shall document the basis for concluding that it is probable that the contract will result in physical delivery.
b. *Credit-indexed contracts (often referred to as credit derivatives).* Many different types of contracts are indexed to the creditworthiness of a specified entity or group of entities, but not all of them are derivative instruments. Credit-indexed contracts that have certain characteristics described in paragraph 10(d) are guarantees and are not subject to the requirements of this Statement. Credit-indexed contracts that do not have the characteristics necessary to qualify for the exception in paragraph 10(d) are subject to the requirements of this Statement. One example of the latter is a credit-indexed contract that requires a payment due to changes in the creditworthiness of a specified entity even if neither party incurs a loss due to the change (other than a loss caused by the payment under the credit-indexed contract).
c. *Take-or-pay contracts.* Under a take-or-pay contract, an entity agrees to pay a specified price for a specified quantity of a product whether or not it takes delivery. Whether a take-or-pay contract is subject to this Statement depends on its terms. For example, if the product to be delivered is not readily convertible to cash and there is no net settlement option, the contract fails to meet the criterion in paragraph 6(c) and is not subject to the requirements of this Statement. However, a contract that meets all of the following conditions is subject to the requirements of this Statement: (1) the product to be delivered is readily convertible to cash, (2) the contract does not qualify for the normal purchases and normal sales exception in paragraph 10(b), and (3) ~~little or no initial net investment in the contract is required~~the contract requires

an initial net investment that is less than 5 percent of the fully prepaid amount (as discussed in paragraph 6(b)).

d. *Short sales (sales of borrowed securities)*.[18] Short sales typically involve the following activities:

(1) Selling a security (by the short seller to the purchaser)
(2) Borrowing a security (by the short seller from the lender)
(3) Delivering the borrowed security (by the short seller to the purchaser)
(4) Purchasing a security (by the short seller from the market)
(5) Delivering the purchased security (by the short seller to the lender).

Those five activities involve three separate contracts. A contract that distinguishes a short sale involves activities (2) and (5), borrowing a security and replacing it by delivering an identical security. Such a contract has two of the three characteristics of a derivative instrument. The settlement is based on an underlying (the price of the security) and a notional amount (the face amount of the security or the number of shares), and the settlement is made by delivery of a security that is readily convertible to cash. ~~However, the other characteristic, little or no initial net investment, is not present.~~ However, the other characteristic, an initial net investment that is less than 5 percent of the fully prepaid amount (as discussed in paragraph 6(b)), is not present. The borrowed security is the lender's initial net investment in the contract. Consequently, the contract relating to activities (2) and (5) is not a derivative instrument. The other two contracts (one for activities (1) and (3) and the other for activity (4)) are routine and do not generally involve derivative instruments. However, if a forward purchase or sale is involved, and the contract does not qualify for the exception in paragraph 10(a), it is subject to the requirements of this Statement.

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

f. *Beneficial interests that arise in a securitization*. Beneficial interests that arise in a securitization that are either purchased by third-party investors or held by transferors should first be evaluated to determine if they qualify for the scope exception in paragraph 14, as discussed in paragraph 58(d). A beneficial interest that does not

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

meet the scope exception in paragraph 14 should be evaluated under paragraph 6. Generally, beneficial interests meet the characteristics in paragraph 6(a) that require that the contract has one or more underlyings and one or more notional amounts or payment provisions or both. Beneficial interests that are option-based contracts (that is, either freestanding options or instruments with embedded options, other than an option for which the strike price is the fair value of the underlying at the time of exercise) meet the characteristic in paragraph 6(b) if the initial net investment is equal to the fair value of the option component. Beneficial interests that are non-option-based contracts meet the characteristic in paragraph 6(b) if the initial net investment is less than 5 percent of the amount necessary to fully prepay the contract. For purposes of applying paragraph 6(b), the initial net investment in a beneficial interest held by a third-party investor is the amount of consideration required to invest in the instrument. The initial net investment in a beneficial interest held by a transferor (for example, a retained interest) is the fair value at the date of transfer of the interest retained. Beneficial interests generally meet the characteristics in paragraph 6(c) because, as discussed in paragraph 9(a), neither party is required to deliver an asset associated with the underlying or with a principal amount equal to the notional amount. In some cases, depending upon the nature of the beneficial interest, a market mechanism as discussed in paragraph 9(b) may be present. If a beneficial interest does not meet the definition of a derivative in paragraph 6, it should be evaluated under paragraphs 12–16 to determine if it contains an embedded derivative that should be bifurcated.

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

a. *Interest rate indexes.* An embedded derivative in which the underlying is an interest rate or interest rate index and a host contract that is considered a debt instrument are considered to be clearly and closely related unless, as discussed in paragraph 13, the embedded derivative contains a provision that (1) permits any possibility whatsoever that the investor's (or creditor's) undiscounted net cash inflows over the life of the instrument would not recover substantially all of its initial recorded investment in the hybrid instrument under its contractual terms or (2) could under any possibility whatsoever at least double the investor's initial rate of return on the host contract and ~~also~~at the same time result in a rate of return that is at least twice what otherwise would be the then-current market return for a contract that has the same terms as the host contract and that involves a debtor with a similar credit quality. The requirement to separate the embedded derivative from the host contract applies to *both parties* to the hybrid instrument even though the above tests focus on the investor's net cash inflows. Plain-vanilla servicing rights, which involve an obligation to perform servicing and the right to receive fees for performing that servicing, do not contain an embedded derivative that would be separated from those servicing rights and accounted for as a derivative.

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

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

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

e. *Calls and puts on equity instruments.* A put option that enables the holder to require the issuer of an equity instrument to reacquire that equity instrument for cash or other assets is *not* clearly and closely related to that equity instrument. Thus, such a put option embedded in a publicly traded equity instrument to which it relates should be separated from the host contract by the holder of the equity instrument. 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.

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

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

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

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

j. *Indexed rentals:*

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

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

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

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

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

m. *Beneficial interests issued by qualifying special-purpose entities.* Beneficial interests issued by qualifying special-purpose entities, as defined by FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* should be considered to have debt host contracts. A beneficial interest holder must determine whether its interest contains an embedded derivative that is not clearly and closely related to the debt host contract. For example, as discussed in paragraph 61(a), an embedded interest rate derivative that could under any circumstance result in the hybrid instrument being settled in such a way that the holder does not recover substantially all of its initial recorded investment would be considered to be not clearly and closely related to the host contract even though the possibility that such a circumstance would occur is remote.

Section 2: Assessment of Hedge Effectiveness

Hedge Effectiveness Requirements of This Statement

64. In assessing the effectiveness of a cash flow hedge, an entity generally will need to consider the time value of money if significant in the circumstances. Considering the

effect of the time value of money is especially important if the hedging instrument involves periodic cash settlements. An example of a situation in which an entity likely would reflect the time value of money is a tailing strategy with futures contracts. When using a tailing strategy, an entity adjusts the size or contract amount of futures contracts used in a hedge so that earnings (or expense) from reinvestment (or funding) of daily settlement gains (or losses) on the futures do not distort the results of the hedge. To assess offset of expected cash flows[‡] when a tailing strategy has been used, an entity could reflect the time value of money, perhaps by comparing the present value of the hedged forecasted cash flow with the results of the hedging instrument.

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

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

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

paragraph 63 or the change in expected cash flows[‡] on the forecasted transaction is based on the forward price for the commodity.

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

Conditions applicable to both fair value hedges and cash flow hedges

a. The notional amount of the swap matches the principal amount of the interest-bearing asset or liability being hedged.
b. The fair value of the swap at the inception of the hedging relationship is zero except for an interest rate swap containing an embedded mirror-image call or put option as discussed in paragraph 68(d), in which case the fair value of the interest rate swap containing an embedded mirror-image call or put at the inception of the hedging relationship is equal to the time value of the embedded call or put option.
c. The formula for computing net settlements under the interest rate swap is the same for each net settlement. (That is, the fixed rate is the same throughout the term, and the variable rate is based on the same index and includes the same constant adjustment or no adjustment.)
d. The interest-bearing asset or liability is not prepayable (that is, able to be settled by either party prior to its scheduled maturity), except as indicated in the following sentences. This criterion does not apply to an interest-bearing asset or liability that is prepayable solely due to an embedded call option provided that the hedging interest rate swap contains an embedded mirror-image call option. The call option embedded in the swap is considered a mirror image of the call option embedded in the hedged item if (1) the terms of the two call options match (including matching maturities, strike price, related notional amounts, timing and frequency of payments, and dates on which the instruments may be called) and (2) the entity is the writer of one call option and the holder (or purchaser) of the other call option. Similarly, this criterion does not apply to an interest-bearing asset or liability that is prepayable solely due to an embedded put option provided that the hedging interest rate swap contains an embedded mirror-image put option.

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

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

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

Conditions applicable to fair value hedges only

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

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

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

Conditions applicable to cash flow hedges only

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

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

k. The repricing dates match those of the variable-rate asset or liability.

---

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

Assessing the hedge's expected effectiveness and measuring ineffectiveness

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

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

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

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

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

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

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

Assessing the hedge's expected effectiveness and measuring ineffectiveness

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

---

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

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

EXAMPLES ILLUSTRATING APPLICATION OF THIS STATEMENT

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

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

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

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

Background

154. MNO Company enters into an interest rate swap (Swap 1) and designates it as a hedge of the variable quarterly interest payments on the company's 5-year $5 million borrowing program, initially expected to be accomplished by a series of $5 million notes with 90-day terms. MNO plans to continue issuing new 90-day notes over the next 5 years as each outstanding note matures. The interest on each note will be determined based on LIBOR at the time each note is issued. Swap 1 requires a settlement every 90 days, and the variable interest rate is reset immediately following each payment. MNO pays a fixed rate of interest (6.5 percent) and receives interest at LIBOR. MNO neither

---

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

pays nor receives a premium at the inception of Swap 1. The notional amount of the contract is $5 million, and it expires in 5 years.

GLOSSARY

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

Benchmark interest rate

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

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

Beneficial interests

Rights to receive all or portions of specified cash inflows to a trust or other entity, including senior and subordinated shares of interest, principal, or other cash inflows to be "passed-through" or "paid-through," premiums due to guarantors, commercial paper obligations, and residual interests, whether in the form of debt or equity.

Capacity contract

An agreement by an owner of capacity to sell the right to that capacity to another party to satisfy its obligations. A capacity contract for power has characteristics that include, but are not limited to, the following:

a. The contract usually specifies the power plant or group of power plants providing the electricity.
b. The strike price (paid upon exercise) includes pricing terms to compensate the plant operator for variable operations and maintenance costs expected during the specified production periods.
c. The specified quantity is based on individual needs of parties to the agreement.
d. The title transfer point is usually at one or a group of specified physical delivery point(s), as opposed to a major market hub.
e. The contract usually specifies certain operational performance by the facility (for example, the achievement of a certain heat rate).
f. The contract sometimes incorporates requirements for interconnection facilities, physical transmission facilities, or reservations for transmission services.
g. The contract may specify jointly-agreed to plant outages (for example, for maintenance) and provide for penalties in the event of unexpected outages.
h. Damage provisions upon default are usually based on a reduction of the capacity payment (which is not market based). If default provisions specify market-liquidating damages, they usually contain some form of floor, ceiling, or both. The characteristics of the default provision are usually tied to the expected generation facility.
i. The contract's terms are usually long (one year or more).

Comprehensive income

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

Derivative instrument

Refer to paragraphs 6–9.

Fair value

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

Financial instrument

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

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

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

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

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

Firm commitment

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

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

b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable.

Forecasted transaction

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

LIBOR swap rate

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

Notional amount

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

Underlying

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