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# A guide to derivatives and hedge accounting

June 2026

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# 1 Overview

This guide provides an overview of derivatives and hedging, including the related financial reporting considerations, which are primarily based on the authoritative guidance within ASC 815. This guide contains interpretive guidance and illustrative examples to explain common derivative instruments and hedging strategies, as well as clarify the application of the financial reporting requirements of ASC 815.

The subject of derivatives and hedging may overlap with other topics in U.S. generally accepted accounting principles (GAAP). As a result, this guide refers to some of our companion accounting guides, including:

- A guide to accounting for debt and equity instruments in financing transactions. Among other provisions:
  - Chapter 2 and Chapter 3 address the accounting for debt with conversion options and other embedded derivatives.
  - Chapter 4 addresses the accounting for preferred and similar stock (including embedded derivatives within these instruments).
  - Chapter 5 addresses the accounting for warrants and other equity-linked instruments and includes an in-depth analysis of ASC 815-40 and the requirements for the derivative scope exception for contracts in an entity's own equity.
- A guide to accounting for investments, loans and other receivables. Among other provisions, this guide addresses the accounting for contracts that are not derivative instruments and are within the scope of the Certain Contract on Debt and Equity Securities subsection of ASC 815-10.

## 1.1 Overview of ASC 815

ASC 815 sets forth accounting guidance for derivative instruments and qualifying hedging transactions. The accounting guidance in ASC 815 is based on the following cornerstones:

- Derivative instruments represent rights or obligations that meet the definitions of assets or liabilities and should be reported on the balance sheet.
- Fair value is the most relevant measure for financial instruments and the only relevant measure for derivative instruments. Derivative instruments should be measured at fair value (with the exception that reporting at settlement value may be elected when an entity uses the simplified hedge accounting approach), and adjustments to the carrying amount of hedged items should reflect changes in their fair value (i.e., unrealized gains or losses) that arise while the hedge is in effect and are attributable to the risk being hedged.
- Special accounting should be provided for items that qualify for hedge accounting if, among other things, there is an expectation that changes in fair values or cash flows will be effectively offset during the term of the hedge for the risk being hedged.

## 1.2 Scope of ASC 815 and determining what constitutes a derivative instrument

ASC 815 applies to all entities, including those that otherwise report substantially all assets and liabilities at fair value (e.g., investment companies), although the effect on these entities may be less significant. ASC 815 also applies to all financial instruments and other contracts that meet the definition of a derivative instrument in ASC 815 and do not qualify for one of the many scope exceptions discussed in Section 3.3.

ASC 815 defines a derivative instrument broadly as a financial instrument or other contract that has all of the following characteristics:

- **An underlying.** An underlying is a variable (e.g., a price, rate or index associated with an asset or liability), but it is not the asset or liability itself. For example, the price of a commodity is an underlying, but the commodity itself is not. Other common underlyings include interest rate index; security price; foreign exchange rate; or the occurrence or nonoccurrence of a specified event, such as a scheduled contractual payment.
- **A notional amount, payment provision or both.** A notional amount is a number of currency units, shares, bushels, pounds or other units specified in the contract. Other names, such as face amount, may be used to describe a notional amount in some contracts. A payment provision specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner. For example, a derivative instrument might require a specified payment if a referenced interest rate increases by 300 basis points.
- **No initial net investment, or an initial net investment that is smaller than would be required for other types of contracts that are expected to have a similar response to changes in market factors.** That is, the parties do not have to invest in or own the notional amount at the inception of the contract.
- **Requirement or permissibility of net settlement.** The contract can readily be settled net by a means outside the contract (e.g., futures contracts), or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

Section 3.2.1 describes these key characteristics of derivative instruments in more detail.

**RSM COMMENTARY:** The term “derivative instrument” is broadly defined in ASC 815 to ensure that contracts that should be accounted for as derivative instruments are accounted for as such. Contracts that may not intuitively be thought of as derivative instruments (e.g., certain lease arrangements) may meet the definition of a derivative instrument. However, in an attempt to prevent certain contracts and features from being treated as derivative instruments, ASC 815 provides many scope exceptions to that definition (including one for leases). Refer to Section 3.3 for more about the scope exceptions.

## 1.3 Embedded derivatives

ASC 815 also addresses derivatives embedded in other contracts. These embedded derivatives may need to be separated from their host contract and accounted for as derivative instruments if certain conditions are met. Refer to Chapter 4, which addresses the complexities of analyzing contracts that contain embedded derivatives and the resulting accounting ramifications.

## 1.4 Hedge accounting

As mentioned earlier in this chapter, derivative instruments are typically reported at fair value on the balance sheet, with changes in fair value reported in earnings unless cash flow hedge or net investment hedge accounting is applied. As a result, if an entity were to use a derivative instrument as an economic hedge, but did not designate it as a hedging instrument, the changes in the fair value of the derivative instrument reported on the income statement often would not be offset by the accounting for the hedged item or forecasted transaction. This is because hedged forecasted transactions are not reported on the balance sheet until they occur (e.g., forecasted purchase or sale of a commodity) and some recognized assets or liabilities that are hedged (sometimes referred to as hedged items) may not be accounted for at fair value through earnings (e.g., an issuer’s debt accounted for at amortized cost).

Hedge accounting formally designates a derivative hedging instrument together with either a hedged item or forecasted transaction and aligns the accounting for the derivative instrument with the accounting for

the hedged item or forecasted transaction. In doing so, it mitigates or eliminates the accounting mismatch that would occur if the derivative had not been designated as a hedging instrument.

### 1.4.1 Hedgeable risks

Hedge accounting is only allowed when hedging certain types of risk. The risks that an entity is permitted to designate as the hedged risk for hedge accounting purposes varies based on whether the entity is hedging a financial or nonfinancial exposure.

For financial exposures, the risks permitted to be designated as hedged risks are:

- Interest rate risk
- Foreign currency risk
- Market price risk
- Credit risk

Interest rate risk and foreign currency risk are the most common hedged risks. Credit risk is often not designated as a hedged risk for hedge accounting purposes because of the practical difficulty of distinguishing changes in fair value of a financial instrument that are attributable to credit risk from changes in fair value of that instrument that are attributable to liquidity risk.

For nonfinancial exposures, the risks permitted to be designated as hedged risks are:

- Market price risk of the entire item
- Foreign currency risk
- A contractually specified price component (for cash flow hedges only)

### 1.4.2 Hedge accounting models

When hedging the risks discussed in Section 1.4.1, ASC 815 provides for three different types of hedge accounting models:

- **Fair value hedge.** A fair value hedge is defined as a hedge of the exposure to changes in the fair value of a recognized asset or liability, or of an unrecognized firm commitment, that are attributable to a particular risk.
- **Cash flow hedges.** A cash flow hedge is defined as a hedge of the exposure to variability in the cash flows of a recognized asset or liability, or of a forecasted transaction, that is attributable to a particular risk.
- **Net investment hedge.** A net investment hedge is a hedge of the foreign currency exposure of a net investment in a foreign operation.

Fair value hedges and cash flow hedges are the most common types of hedges.

A common example of a fair value hedge is the hedge of fixed-rate debt issued with an interest rate swap whereby the reporting entity receives a fixed rate and pays a variable rate. The fixed rate that the reporting entity receives on the swap offsets the fixed rate it pays on its debt. The reporting entity will also pay a variable rate on the swap. When the debt and swap are viewed together, to the extent that the fixed rates offset, the reporting entity has essentially converted the fixed-rate interest payments into variable-rate interest payments. As a result, the reporting entity will benefit if interest rates decrease.

A common example of a cash flow hedge is the hedge of variable-rate debt issued with an interest rate swap whereby the reporting entity receives a variable rate and pays a fixed rate. The variable rate that the reporting entity receives on the swap offsets the variable rate it pays on its debt. The reporting entity will also pay a fixed rate on the swap. When the debt and swap are viewed together, to the extent that the variable rates offset, the reporting entity has essentially converted the variable-rate interest payments into

fixed-rate interest payments. As a result, the reporting entity will not be affected, or will be affected less, by the variability in interest rates.

Cash flow hedges can also be used to hedge forecasted transactions (e.g., a forecasted purchase of a commodity), where the terms of the transaction are still subject to market fluctuations (in contrast to a firm commitment, which has fixed terms). An entity can use a cash flow hedge to eliminate the cash flow variability from market fluctuations that would otherwise affect it.

### 1.4.3 Hedge accounting conditions

Although hedge accounting provides an intuitive mitigation or elimination of the reporting of the change in fair value of a hedging instrument in earnings, hedge accounting can be challenging to achieve and maintain. Two conditions that must be met to achieve hedge accounting, but often place hedge accounting in jeopardy, are:

- Hedge documentation
- Hedge effectiveness

#### 1.4.3.1 Hedge documentation

At the inception of the hedging relationship, an entity must formally document the hedging relationship and its risk management objective and strategy for undertaking the hedge, including identification of all of the following:

- The hedging instrument
- The hedged item
- The nature of the risk being hedged
- The means of assessing the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value or cash flows attributable to the hedged risk

In addition, there are requirements related to the timing in which the hedge documentation must be completed.

#### 1.4.3.2 Hedge effectiveness

At the inception of the hedging transaction and on an ongoing basis, the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value (for fair value hedges) or cash flows (for cash flow hedges) during the period that the hedge is designated. For a cash flow hedge of a forecasted transaction to satisfy this condition, the forecasted transaction must be probable of occurring, both at inception and throughout the life of the hedging relationship.

## 1.5 Accounting treatment of derivative instruments and embedded derivatives

Derivative instruments and embedded derivatives are typically carried at fair value on the balance sheet. If the derivative instrument or embedded derivative is not designated as a hedging instrument, the change in its fair value is reported in earnings.

However, if the derivative instrument is designated as a hedging instrument, the type of hedge accounting model used will determine where the change in fair value of the derivative instrument is reported. The accounting treatment for each hedge accounting model is summarized in the table below.

| Hedge accounting model | Accounting treatment |
|---|---|
| Fair value hedge | The change in fair value of the derivative hedging instrument that is included in the assessment of hedge effectiveness is reported in earnings. This is offset by the change in value of the hedged item attributable to the hedged risk, which is also reported in earnings. |
| Cash flow hedge (not using the simplified approach) | The change in fair value of the derivative hedging instrument that is included in the assessment of hedge effectiveness is reported in other comprehensive income (OCI). This amount is reclassified into earnings in the same periods during which the hedged forecasted transaction affects earnings. |
| Cash flow hedge (using the simplified approach) | The change in fair value (or settlement value, if elected) of the derivative hedging instrument is reported in OCI. This amount is reclassified into earnings in the same periods during which the hedged forecasted transaction affects earnings. |
| Net investment hedge | The change in fair value of the derivative hedging instrument that is included in the assessment of hedge effectiveness is reported in cumulative translation adjustment (CTA). This amount remains there unless and until the hedged net investment is sold or liquidated, at which time it is reclassified to earnings. |

The preceding table refers to the change in fair value of the derivative hedging instrument that is included in the assessment of hedge effectiveness. Assume the derivative hedging instrument is an option and the entity elects to only include the change in fair value of the option attributable to its intrinsic value in the assessment of hedge effectiveness. This means that the change in fair value of the option that is not attributable to its intrinsic value (i.e., the time value of the option) is not included in the assessment of hedge effectiveness. In this case, the time value would be considered an excluded component.

Unless the entity makes an accounting policy election to immediately recognize the change in the fair value of any excluded components in earnings, the entity would recognize in earnings (through an amortization approach) any amounts it excluded from the assessment of hedge effectiveness for the three main types of hedges (i.e., fair value hedge, cash flow hedge and net investment hedge).

## 1.6 Disclosure

ASC 815 requires extensive quantitative and qualitative disclosures to allow the users of an entity's financial statements to understand how and why the entity uses derivative instruments; how it accounts for derivative instruments and related hedged items; and how these instruments affect the entity's financial position, results of operations and cash flows. These disclosures are required for derivative instruments designated as hedging instruments, undesignated derivative instruments and embedded derivatives that are accounted for separately as derivative instruments.

These disclosures provide information regarding an entity's objectives and strategies for using derivative instruments, its level of derivative activity separated by the type of underlying risk exposure (e.g., interest rate, foreign exchange rate) and the accounting designation (i.e., derivative instruments designated in fair value hedges, cash flow hedges or net investment hedges, or not designated in a hedging relationship).

**Looking forward: FASB research projects**

The FASB continues to revisit the guidance on derivatives and hedge accounting. The related research projects are:

- **Accounting for derivatives.** This project will consider potential refinements to ASC 815 to address stakeholder feedback on the accounting for derivative contract modifications, the conditions to require bifurcation of embedded derivatives and other related areas.
- **Hedge Accounting.** This project will consider broader changes to the hedge accounting model. The staff will perform research that may result in the issuance of a Preliminary Views document for public comment.

For further information on the latest developments on these projects, refer to the FASB's Current Projects site.

# 2 Introduction to derivative instruments and the related accounting

## 2.1 What is a derivative instrument?

A derivative instrument is a contract whose value is based on an underlying variable. That is, a derivative instrument derives its value from the fluctuation of a particular price (e.g., commodity price), index (e.g., interest rate index) or the occurrence or nonoccurrence of an event (e.g., a hurricane). Derivative instruments come in various forms and are designed to do various things. Certain derivative instruments may be designed to lock in the future price of a commodity, such as steel. Other derivative instruments may be designed to speculate on future stock price movements to attempt to make a profit. Still others may be used to create a certain type of financing. For example, an interest rate swap can effectively convert a variable interest rate to a fixed interest rate.

As explained in ASC 815-10-15-83, a derivative instrument is a financial instrument or other contract that has all of the following:

- One or more underlyings
- One or more notional amounts, payment provisions or both
- An initial net investment
- An ability to be settled net

Each of these traits is described below and more fully discussed in Chapter 3.

**Underlying**

A variable that, along with either a notional amount or a payment provision, determines the settlement of a derivative instrument

For example, a commodity price, interest rate, exchange rate or the occurrence of a specified event (e.g., initial public offering (IPO), change in control)

**Notional amount**

For example, a face amount, number of units or currency

- or -

**Payment provision**

A fixed or determinable settlement to be made if the underlying behaves in a specified manner (e.g., payment of $50M if a commodity index reaches a specified level)

**Initial net investment**

The contract requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors

**Net settlement**

May exist contractually, through a market mechanism or delivery of a derivative instrument or an asset that is readily convertible to cash (e.g., an exchange traded commodity or security)

## 2.2 Common types of derivative instruments

The following table lists some types of contracts that are accounted for as derivative instruments if all the characteristics of a derivative instrument are met.

| Type of contract | Description | Example |
|---|---|---|
| Forward contract | A contract where one party agrees to sell a financial instrument, commodity or other asset to another party at a future date, with a selling price that is fixed or determinable at the inception of the contract. | A contract to sell 1,000 bushels of corn at $5 per bushel 90 days after inception of the contract. |
| Futures contract | A forward contract that is traded on an exchange. Futures contracts are standardized and executed through a clearinghouse. | A futures contract to buy 10 million BTUs of natural gas on the New York Mercantile Exchange at $2.50 per million BTU, to be delivered to a standardized delivery point on the last day of the month. |
| Interest rate swap | An arrangement between two counterparties whereby each party agrees to be obligated to make a series of interest-based payments to the other party, in exchange for the right to receive a different series of interest-based payments from the other party. Most commonly, one party agrees to pay a fixed rate in exchange for the receipt of a floating rate or vice versa, which are commonly referred to as a fixed-to-floating or a floating-to-fixed interest rate swap. Swaps can also be structured to have payments exchanged based on two different floating rates (e.g., Secured Overnight Financing Rate (SOFR), Prime), which is commonly referred to as a basis swap. The payments are made on a net basis on contractual settlement dates. | Party A agrees to pay Party B an interest rate of 1% per annum applied to a notional amount of $1 million, and Party B agrees to pay Party A a variable interest rate of one-month SOFR, also applied to a notional amount of $1 million. Payments on the swap are due on the last business day of every month during its term. On the monthly payment date, if one-month SOFR is less than 1%, Party A will pay Party B the difference between 1% and one-month SOFR multiplied by $1 million multiplied by 30/360. If, however, one-month SOFR is greater than 1%, Party B will pay Party A the difference between one-month SOFR and 1% multiplied by $1 million multiplied by 30/360. |
| Currency swap | Two parties exchange an equal amount of money in different currencies. Essentially, each party lends their counterparty money in a given currency and will repay that counterparty at a specified exchange rate on a specified date. At the end of the agreement, the parties will exchange currencies again to close out the contract at either the original exchange rate or a predetermined rate. | On Day 1, Party A pays USD 100,000 to Party B, and Party B pays CAD 127,590 to Party A. The contract is scheduled to settle in 90 days. Ninety days after inception, the exchange rate has changed. Upon settlement, Party A pays CAD 127,590 (which it received on day one) to Party B, and Party B pays USD 98,123 to Party A. Essentially, Party A lost USD 1,877, less the time value of money. That is, while the amount of CAD that Party A received at inception and paid at settlement was |

| Type of contract | Description | Example |
|---|---|---|
| | | the same (127,590), the amount of USD that Party A received at settlement was 1,877 (100,000 – 98,123) less than the amount it paid upon inception. |
| Commodity swap | Each party agrees to make a payment to the other party that is based on a commodity price or index applied to an agreed-upon quantity or notional amount. Most commonly, one party agrees to pay a fixed price and the other party agrees to pay a variable price. However, some commodity swaps involve the exchange of variable payments that are based on one index for variable payments based on another index. On pre-defined settlement dates, a payment exchanges hands on a net basis. | Party A agrees to pay Party B $2.70 per million BTU for natural gas, and Party B agrees to pay Party A the current Henry Hub rate for natural gas per million BTU. The swap settles upon the last business day of every month for a quantity of 10,000. On the settlement date, if the Henry Hub rate for natural gas is less than $2.70, Party A will pay Party B the difference between $2.70 and the Henry Hub rate for natural gas per million BTU multiplied by 10,000. If, however, the Henry Hub rate for natural gas per million BTU is greater than $2.70, Party B will pay Party A the difference between the Henry Hub rate for natural gas and $2.70 per million BTU multiplied by 10,000. |
| Call option | A contract whereby the holder of the contract has the right, but not the obligation, to purchase an asset from the call option writer at an agreed upon price, referred to as the strike price. The strike price is typically fixed at the inception of the contract. Depending on how the option is structured, the holder may exercise its call option at any time during the term of the option or only upon a specified date or dates.<br>The holder of the call option is also referred to as the purchaser. The writer of the call option is referred to as the seller.<br>The option contract is referred to as a purchased call from the perspective of the holder and a written call from the perspective of the writer. | Entity XYZ purchased a call option from Entity ABC for $5. The call option gives Entity XYZ the right, but not the obligation, to buy equity shares of Entity ABC from Entity ABC for $60. The option expires in three years. Equity shares of Entity ABC were trading at $50 per share upon the inception of the call option.<br>In this example, Entity XYZ is considered the call purchaser or holder, and Entity ABC is considered the call writer or seller.<br>From Entity XYZ's perspective, the call option is considered a purchased call; from Entity ABC's perspective, the call option is considered a written call. |
| Put option | A contract whereby the holder of the contract has the right, but not the obligation, to sell an asset to the put option writer at an agreed upon price, referred to as the strike price. The strike price is typically fixed at the inception of the contract. Depending on how the option is structured, the holder may | Entity XYZ purchased a put option from Entity ABC for $5. The put option gives Entity XYZ the right, but not the obligation, to sell equity shares of Entity ABC to Entity ABC for $50. The option expires in three years. Equity shares of Entity ABC were trading at $60 per |

| Type of contract | Description | Example |
|---|---|---|
| | exercise its put option at any time during the term of the option or only upon a specified date or dates.<br>The holder of the put option is also referred to as the purchaser. The writer of the put option is referred to as the seller.<br>The option contract is referred to as a purchased put from the perspective of the holder and a written put from the perspective of the writer. | share upon the inception of the put option.<br>In this example, Entity XYZ is considered the put purchaser or holder, and Entity ABC is considered the put writer or seller.<br>From Entity XYZ's perspective, the put option is considered a purchased put; from Entity ABC's perspective, the put option is considered a written put. |
| Collar | A combination of a put option and call option. | Entity XYZ purchases equity shares of Entity MNO for $50 per share and enters into a collar such that it will only be exposed to price changes between $45 and $55 per share.<br>Specifically, Entity XYZ writes a call option to Entity ABC whereby Entity ABC can call equity shares of Entity MNO from Entity XYZ for $55 per share.<br>Simultaneously, Entity XYZ purchases a put option from Entity ABC whereby Entity XYZ can put equity shares of Entity MNO to Entity ABC for $45 per share.<br>If the price of Entity MNO's equity shares increases above $55 per share, Entity XYZ's written call will be in a loss position to Entity XYZ to the degree to which the price of the shares exceeds $55 per share. This loss will offset the gain position Entity XYZ experiences due to the price increase on the shares of Entity MNO it holds that were purchased at $50 per share.<br>Alternatively, if the price of Entity MNO equity shares decreases below $45 per share, Entity XYZ's purchased put option will be in a gain position to Entity XYZ to the degree to which the price of the shares is below $45 per share. This will offset the loss Entity XYZ incurs due to the price decrease on the shares of Entity MNO it holds that were purchased at $50 per share. As a result, Entity XYZ is only exposed to price changes between $45 and $55, which forms the "collar." |

## 2.3 Use of derivative instruments

An entity can typically enter into a derivative contract with little or no money upfront and yet be exposed to similar gains or losses as though it purchased the underlying asset at its market price. Consider the following example, which demonstrates this concept.

Investor A is interested in investing in shares of XYZ Company stock. It can purchase a share for $10, or for $4 it can purchase an option contract that gives it the right to buy a share of XYZ at a price of $10 (i.e., the strike price) over the next five years. (In this example, the option is said to be issued “at-the-money” because its strike price is the same as the price of the underlying shares at the inception of the option). If the share price increases in value by $5 during this five-year period, the option contract would experience a similar increase in value even though its $4 purchase price was substantially less than the $10 price Investor A would have incurred to purchase a share.

It is this characteristic that makes derivative instruments popular trading instruments. Interestingly, it is also what makes derivative instruments valuable risk management tools. That is, an entity can take a trading position or mitigate certain risks by entering into a derivative instrument with little or no upfront money.

### 2.3.1 Derivative instruments used for leveraged trading purposes

Trading is defined in the ASC Master Glossary as “An activity involving securities sold in the near term and held for only a short period of time. The term trading contemplates a holding period generally measured in hours and days rather than months or years.” Because derivative instruments can change in fair value relatively quickly, these instruments lend themselves to use for trading or speculative purposes. For example, an entity may enter into a gold futures contract to purchase gold at a fixed price with the hope that the price of gold will increase before the contract settles.

Derivative instruments can provide investors and traders a leveraged return. This means that even small changes in the value of the underlying asset might result in disproportionately larger changes in value for the derivative instrument. That is, when an entity enters into a derivative instrument, it is doing so in contemplation that slight fluctuations in the derivative instrument’s underlying will be amplified to produce a large return on investment. This is illustrated through a continuation of the preceding example involving Investor A. Assume Investor A had $100 to invest and is considering either a direct investment in shares of XYZ or buying a five-year option to purchase the same shares at $10 per share. The following comparison demonstrates how Investor A would be affected by both a $5 increase in share price and $5 decrease in share price had it invested $100 to purchase 10 shares in XYZ at a price of $10 per share, or $100 to purchase 25 options at a price per option of $4.

| | Share | Derivative option |
|---|---|---|
| Purchase price | $10 per share | $4 per option |
| Gain if share price increases to $15 before the options expire | $50 ($5 x 10 shares) | $125 ($5 x 25 options) |
| Loss if share price decreases to $5 and the options expire unexercised | ($50) (-$5 x 10 shares) | ($100) ($4 purchase price x 25 options) |

Because the options had a strike price of $10 per share and were purchased when the underlying shares had a fair value of $10 per share, the options were “at the money” at the time of purchase. This means that the options had no intrinsic value. In the case where the share price increased by $5 to $15 per share, the options’ fair value also increased by $5 per share. In the case where the share price decreased by $5 to $5 per share, the options expired unexercised and the loss on the options was limited to the purchase price of $4 per option.

### 2.3.2 Derivative instruments used for risk management purposes

An entity may enter into a derivative transaction for risk management purposes. The following table further explains three common risk management strategies whereby:

- Entity A hedges the variability of cash flows attributable to interest rate risk associated with the floating-rate debt that it issued.
- Entity B hedges the change in fair value attributable to interest rate risk associated with the fixed-rate debt in which it invested.
- Entity C hedges the variability of cash flows attributable to foreign currency risk associated with the forecasted purchase of foreign-currency-denominated inventory.

| Risk management situation | Derivative instrument used to manage risk | Risk management result |
|---|---|---|
| Entity A issued floating-rate debt whereby it pays an interest rate equal to prime plus 2%. Entity A then decides that it no longer wants to be subject to the potential variability attributable to fluctuations in the prime rate. | Entity A entered into an interest rate swap with a notional amount that equals the amount of its variable-rate debt whereby it receives payments based on prime and pays a fixed interest rate of 3%, applied to the notional amount of the swap. | Under the swap agreement, Entity A receives interest payments based on the prime rate and pays interest at a fixed rate of 3%. When viewed in combination with its debt, the prime-based portion of the interest payment that Entity A makes on the debt is offset by the prime-based payment that it receives on the receive “leg” of the swap. In the aggregate, Entity A pays interest at 5% (the 2% spread above prime on the debt plus the 3% interest payment on the fixed leg of the swap). From an economic perspective, when the swap and debt are viewed together, the swap has effectively converted the variable rate of interest on the debt into a fixed rate. By implementing this risk management strategy, Entity A has eliminated the variability in its cash flows attributable to changes in the prime rate. |
| Entity B invested in a fixed-rate debt security that receives an interest rate of 5%. Entity B realizes that if interest rates increase, its investment would lose value because the market would view the investment less favorably than a higher interest-paying investment. | Entity B entered into an interest rate swap with a notional amount that equals the amount of the debt security whereby it receives payments based on a Treasury rate plus 4% and pays a fixed rate of 5%, with both rates applied to the notional amount of the swap. | Under the swap agreement, Entity B receives interest based on a Treasury rate and pays interest at a fixed rate of 5%. When viewed in combination with the debt security, the 5% interest payment that Entity B receives on its debt security is offset by the 5% interest it pays on the pay “leg” of the swap. As interest rates (specifically Treasury) rise and fall, the interest rate Entity B receives on the Treasury “leg” of the swap adjusts accordingly. From an economic perspective, when the swap and debt security are viewed together, the swap has effectively converted the fixed rate of interest on the debt into a variable rate. By implementing this risk management strategy, Entity B has protected itself against the change in fair value of its debt security that |

| Risk management situation | Derivative instrument used to manage risk | Risk management result |
|---|---|---|
| | | would otherwise be attributable to changes in the Treasury rate. |
| Entity C, a U.S. dollar (USD) functional currency entity forecasts a purchase of inventory that will be denominated in Canadian dollars (CAD) three months from today. The forecasted purchase price is CAD 125,000. Entity C is concerned that the CAD may become more expensive relative to the USD over the next three months. | Entity C entered into a forward purchase contract to purchase CAD 125,000 in three months at a price of USD 100,000 agreed upon today. | Regardless of how the USD moves compared to the CAD, three months from today, Entity C will exchange CAD 125,000 for USD 100,000. By implementing this risk management strategy, Entity C has protected itself against the change in the USD/CAD exchange rate. |

## 2.4 Use of derivative instruments

In many cases, reporting entities do not seek to enter into a derivative contract but rather are faced with a requirement to account for what may have appeared to be an ordinary contract or embedded feature as a derivative instrument.

A common example of an ordinary contract that may require derivative accounting is an option contract that an entity enters into with its fuel supplier that enables it to buy stated quantities of fuel at a stated price on future dates.

A common example of an ordinary embedded derivative that may require derivative accounting is a provision within a debt agreement that requires immediate repayment of the amount borrowed plus a premium in the event the obligor goes into default.

Chapter 3 explains in more detail what derivative instruments are and when they require derivative accounting treatment. Similarly, Chapter 4 explains in detail what embedded derivatives are and when they require separate accounting as a derivative instrument.

## 2.5 Transacting in derivative instruments

Broadly speaking, derivative instruments are either traded through mechanisms referred to as exchanges and clearinghouses or “over the counter.” Instruments that are traded on an exchange have standardized terms and conditions set by the exchange. Alternatively, instruments that are traded over the counter have contractual terms that are customized to meet the needs and risk preferences of the transacting parties.

| Exchange-traded | Over the counter (OTC) |
|---|---|
| These derivative instruments are traded through mechanisms referred to as exchanges and clearinghouses. Exchange-traded derivative instruments are standardized, which makes them more liquid and makes trading them more efficient.<br>When a derivative instrument is traded on an exchange, a clearinghouse stands between the two derivative counterparties. The clearinghouse becomes the counterparty to each side of the trade. That is, rather than each party transacting directly with each other, each party transacts with the clearinghouse in a mirror trade. Exchange-traded contracts generally require daily posting of collateral to a margin account by the party that is in a loss position to the contract on a given day.<br>A futures contract is an example of an exchange-traded derivative instrument. | OTC derivative instrument trades are negotiated and executed between counterparties according to their individual risk preferences. These private trades go through derivative instrument dealers, who then trade amongst themselves. Because these transactions take place without a clearinghouse standing between the two counterparties (as is the case in exchange-traded derivative instrument markets), each counterparty is directly exposed to the credit risk of the other counterparty. OTC derivative instrument trades may or may not be subject to collateral requirements that, when present, typically apply only to the end user and not to the dealer.<br>OTC derivative instruments make up a greater portion of the derivative instruments market.<br>A forward contract is an example of an OTC derivative. |

## 2.6 Summary of accounting for derivative instruments

### 2.6.1 Balance sheet presentation

ASC 815 generally requires derivative instruments within its scope to be recognized at fair value on the balance sheet. An exception exists under the simplified hedge accounting approach, discussed in ASC 815-20-25-133 through 25-142, whereby certain private companies can elect to recognize certain interest rate swaps at their settlement value rather than fair value. Refer to Section "Simplified hedge accounting approach for a cash flow hedge of a variable-rate borrowing with a receive-variable, pay-fixed interest rate swap" for additional information.

### 2.6.2 Presentation of the change in fair value of a derivative

The change in the fair value of a derivative instrument that is not designated as a hedging instrument is reported in earnings.

However, if the derivative instrument is designated as a hedging instrument, the type of hedge accounting model used will determine where the change in fair value of the derivative instrument is reported. The accounting treatment for each hedge accounting model is summarized below.

| Hedge accounting model | Accounting treatment |
|---|---|
| Fair value hedge | The change in fair value of the derivative hedging instrument that is included in the assessment of hedge effectiveness is reported in earnings. This is offset by the change in value of the hedged item attributable to the hedged risk, which is also reported in earnings. |
| Cash flow hedge (not using the simplified approach) | The change in fair value of the derivative hedging instrument that is included in the assessment of hedge effectiveness is reported in OCI. This amount is reclassified into earnings in the same periods during which the hedged forecasted transaction affects earnings. |

| Hedge accounting model | Accounting treatment |
|---|---|
| Cash flow hedge (using the simplified approach) | The change in fair value (or settlement value, if elected) of the derivative hedging instrument is reported in OCI. This amount is reclassified into earnings in the same periods during which the hedged forecasted transaction affects earnings. |
| Net investment hedge | The change in fair value of the derivative hedging instrument that is included in the assessment of hedge effectiveness is reported in CTA. This amount remains there unless and until the hedged net investment is sold or liquidated, at which time it is reclassified to earnings. |

**RSM COMMENTARY:** The changes in fair value of embedded derivatives that require bifurcation and are accounted for separately as derivative instruments are reported in earnings. Embedded derivatives that require bifurcation may be designated as a hedging instrument. However, we rarely see this in practice.

Refer to Chapter 5 through Chapter 10 for more information on hedge accounting and the requirements that must be met to apply it. Refer to Chapter 4 for additional considerations related to the accounting for an embedded derivative that has been separately recognized as a derivative instrument.

As noted in ASC 815-10-25-2 through 25-3, a contract (or a feature embedded in a contract) can move in and out of derivative status. If a contract that does not meet the definition a derivative instrument at the time it was first recognized later meets the definition of a derivative instrument, it would be immediately recognized as a derivative asset or liability at its fair value with the initial offsetting entry, and with additional entries to continuously adjust the carrying amount to fair value recognized through the income statement. Conversely, if a contract that was accounted for as a derivative instrument ceases to meet the definition of a derivative instrument, its carrying amount at that time becomes its cost basis and it would be accounted for prospectively based on other GAAP relevant to the type of contract.

**RSM COMMENTARY** Some reasons why a contract (or feature embedded in a contract) may move in and out of derivative instrument status include:

- Changes to conclusions on whether the net settlement characteristic of a derivative instrument exists. Specifically, as noted at Section "Net settlement through a market mechanism", the evaluation of whether a market mechanism exists and whether items to be delivered under a contract are readily convertible to cash must be reassessed on an ongoing basis.
- Changes to whether a derivative instrument qualifies for a scope exception. For example:
  - To qualify for the nonfinancial asset or liability scope exception discussed in Section 3.3.5.2, the underlying asset cannot be considered readily convertible to cash. The determination of whether an asset is readily convertible to cash can change over time because of market activity changes.
  - As discussed in Section 4.4.3, a change in circumstance may cause a feature that qualified for the derivative scope exception in ASC 815-10-15-74(a) for contracts in an entity's own equity to no longer qualify or, conversely, cause a feature that initially did not qualify for the scope exception to subsequently qualify.
  - As discussed in Section 3.3.2.3, a contract that initially qualified for the normal purchases or normal sales scope exception may no longer qualify if physical delivery does not remain probable.

- As noted in Section 4.4.3, a modification to a hybrid instrument could trigger the need to reassess the conclusion as to whether an embedded derivative is clearly and closely related to the host contract. Additionally, changes to the terms may impact conclusions on whether a contract or embedded feature is a derivative instrument and, if so, whether it qualifies for a scope exception.

# 3 Scope of ASC 815 and determining what constitutes a derivative instrument

## 3.1 Scope of ASC 815

ASC 815 applies to all entities, including those that otherwise report substantially all assets and liabilities at fair value (e.g., investment companies), although the effect on these entities may be less significant. ASC 815 also applies to all financial instruments and other contracts that meet the definition of a derivative instrument in ASC 815-10-15-83 and do not qualify for one of the scope exceptions discussed in Section 3.3.

Certain entities, such as not-for-profit entities and benefit plans that do not report earnings, are not permitted to use cash flow hedge accounting (which is the focus of Chapter 10) or to elect the amortization approach for amounts excluded from the assessment of effectiveness under fair value hedge accounting. Not-for-profit, business-oriented health care entities that report a performance indicator are permitted to use cash flow hedge accounting, even though they are not required to report a separate component of equity on the balance sheet for other comprehensive income.

**Pending Change: Derivatives scope refinements**

In September 2025, the FASB issued ASU 2025-07, *Derivatives and Hedging (Topic 815) and Revenue from Contracts with Customers (Topic 606): Derivatives Scope Refinements and Scope Clarification for a Share-based Noncash Consideration from a Customer in a Revenue Contract*, to address stakeholder concerns regarding:

- The application of derivative accounting to contracts with features based on the operations or activities of one of the parties to the contract (see Section 3.3.5.4 for further information)
- Diversity in accounting for share-based payments from customers as consideration for the transfer of goods or services

**Scope clarification for share-based payment from a customer in a revenue contract**

ASU 2025-07 clarifies the applicability of ASC 606 and its interaction with ASC 815 or ASC 321, *Investments – Equity Securities*, when accounting for share-based payments received from customers as consideration in exchange for the transfer of goods or services. More specifically, the ASU clarifies that an entity should apply ASC 606, including its noncash consideration guidance, to a contract with a customer who makes a share-based payment (e.g., shares, share options or other equity instruments) as consideration for the transfer of goods or services. ASC 815 or ASC 321 should not be applied unless and until the entity's right to receive or retain the share-based noncash consideration is unconditional under ASC 606.

The amendments in ASU 2025-07 are effective for all entities for annual reporting periods beginning after December 15, 2026, and interim reporting periods within those annual reporting periods. Early adoption is permitted.

An entity is permitted to apply ASU 2025-07 either:

- Prospectively to new contracts entered into on or after the date of adoption, including modified contracts accounted for as separate contracts in accordance with ASC 606-10-25-12
- On a modified retrospective basis through a cumulative-effect adjustment to the opening balance of retained earnings as of the beginning of the annual reporting period of adoption for contracts existing as of the beginning of the annual reporting period of adoption.

### 3.1.1 Unit of account for scope purposes

ASC 815-10-15-4A through 15-9 addresses certain unit of account questions that determine how the guidance in ASC 815 should be applied. The questions addressed are whether:

- A contract should be viewed as freestanding or embedded
  - There are additional conditions in ASC 815-15-25-1 that must be met to recognize an embedded contract as a derivative instrument (refer to Chapter 4 for a summary of this analysis)
- Two or more contracts should be viewed as a single unit when applying the guidance in ASC 815-10

### 3.1.2 Freestanding or embedded

A freestanding financial instrument is defined in the ASC Master Glossary.

**Master Glossary – Freestanding Financial Instrument**

A financial instrument that meets either of the following conditions:

a. It is entered into separately and apart from any of the entity's other financial instruments or equity transactions.

b. It is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.

ASC 815-10-15-5 indicates that a feature that may be sold or traded separately from the contract in which it is embedded should be considered an attached freestanding derivative instrument, rather than an embedded derivative, by both the writer and the holder if the feature meets the definition of a derivative instrument.

As explained in ASC 815-10-15-6, if a third party attaches a put or call option to a debt instrument contemporaneously with or after its issuance, it is viewed as a separate freestanding instrument rather than embedded in the debt instrument because the option and debt have different counterparties. Pursuant to ASC 815-15-25-2, an embedded derivative refers to a feature embedded within a single contract rather than features in separate contracts between different counterparties.

As explained in ASC 815-10-15-7, if at its issuance a debt instrument includes an option feature that is explicitly transferable separate from the debt instrument and, as a result, could be exercised by a party other than the issuer or investor of the debt instrument, that option should be considered an attached freestanding derivative instrument, and not an embedded derivative, by both the option writer and the holder.

### 3.1.3 Viewing multiple contracts as a single unit

As indicated in ASC 815-10-15-8, an entity may enter two or more transactions that together would create an economic result similar to that of a single transaction that would be required to be accounted for as a derivative instrument. To prevent an entity from attempting to circumvent the derivative accounting requirements, ASC 815-10-15-9 requires two or more separate transactions to be viewed as one unit of account if all the indicators below are present:

- The transactions were entered into contemporaneously and in contemplation of one another.
- The transactions were executed with the same counterparty (or structured through an intermediary).
- The transactions relate to the same risk.
- There is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.

ASC 815 requires that the indicators be assessed in the aggregate. The following example illustrates the application of this guidance in the context of two commodities forward contracts.

**Example 3-1: Recognition—Viewing separate transactions as a unit for purposes of evaluating net settlement (ASC 815-10-55-177 through 55-178)**

**Case A: Two Forward Contracts Viewed as a Unit**

Entity A enters into a forward contract to purchase 1,500,000 units of a particular commodity in 3 months for $10 per unit. Simultaneously, Entity A enters into a forward contract to sell 1,400,000 units of the same commodity in 3 months for $10 per unit. The purchase and sale contracts are with the same counterparty. There is no market mechanism to facilitate net settlement of the contracts, and both contracts require physical delivery of the commodity at the same location in exchange for the forward price. On a gross basis, neither contract is readily convertible to cash because the market cannot rapidly absorb the specified quantities without significantly affecting the price. However, on a net basis, Entity A has a forward purchase contract for 100,000 units of the commodity, a quantity that can be rapidly absorbed by the market and thus is readily convertible to cash.

In this Case, it appears that there is no clear business purpose for structuring the transactions separately. Therefore, the facts point to the conclusion that the purchase and sale were done as a structured transaction with one counterparty to circumvent the definition of a derivative instrument under this Subtopic. However, if the facts indicated that both contracts required physical delivery of the commodity at different locations that are significantly distant from one another and each counterparty is expected to deliver the gross amount of the commodity to the other, those facts may reflect a valid substantive business purpose for the transaction.

The following examples from ASC 815-10-55 demonstrate the application of this guidance in the context of interest rate swaps and lending transactions.

**Example 3-2: Recognition—Viewing separate transactions as a unit (ASC 815-10-55-171 through 55-174)**

The following Cases illustrate when separate transactions should be viewed as a unit:

a. Swaps that should be viewed as a unit (Case A)

b. Swaps that should not be viewed as a unit (Case B).

In Cases A and B, an entity that is the issuer of fixed-rate debt enters into an interest rate swap (Swap 1) and designates it as a hedge of the fair value exposure of the debt to interest rate risk. The fair value hedge of the fixed-rate debt involving Swap 1 meets the required criteria in Section 815-20-25 to qualify for hedge accounting. The entity simultaneously enters into a second interest rate swap (Swap 2) with the same counterparty with the exact mirror terms as Swap 1 and does not designate Swap 2 as part of that hedging relationship.

**Case A: Swaps that Should Be Viewed as a Unit**

If Swap 2 was entered into in contemplation of Swap 1 and the overall transaction was executed for the sole purpose of obtaining fair value accounting treatment for the debt, it should be concluded that the purpose of the transaction was not to enter into a bona fide hedging relationship involving Swap 1. In that instance, the two swaps should be viewed as a unit and the entity would not be permitted to adjust the carrying value of the debt to reflect changes in fair value attributable to interest rate risk.

**Case B: Swaps that Should Not Be Viewed as a Unit**

If Swap 2 was not entered into in contemplation of Swap 1 or there is a substantive business purpose for structuring the transactions separately, and if both Swap 1 and Swap 2 were entered into in arm's-length transactions (that is, at market rates), then the swaps should not be viewed as a unit. For example, some entities have a policy that requires a centralized dealer subsidiary to enter into third-party derivative contracts on behalf of other subsidiaries within the entity to hedge the subsidiaries' interest rate risk exposures. The dealer subsidiary also enters into internal derivative contracts with those subsidiaries to operationally track those hedges within the entity. (As discussed beginning in paragraph 815-20-25-61, internal derivatives do not qualify in consolidated financial statements as hedging instruments for risks other than foreign exchange risk.)

**RSM COMMENTARY:** It is relatively common for lending institutions to enter into interest rate swap agreements with their loan customers (so that the customer can convert a variable rate loan to a fixed rate) and contemporaneously enter into an interest rate swap with a dealer that has terms that mirror the interest rate swap the lender entered into with its loan customer. The interest rate swaps in this scenario are viewed as two separate swaps (rather than one unit netted together) because each swap is with a different counterparty. Additionally, there is a substantive business purpose for structuring the transactions this way in that the lender desires a variable rate loan and its customer desires a fixed rate loan. The mirror swaps are a vehicle to accomplish the opposite objectives of the lender and its customer. The combination of the swap with the customer and mirroring swap with a dealer is commonly referred to as back-to-back swaps.

**Example 3-3: Recognition—Viewing separate transactions as a unit for purposes of evaluating net settlement (ASC 815-10-55-179 through 55-180)**

**Case B: Borrowing and Lending Transactions Viewed as a Unit**

Entity C loans $100 to Entity B. The loan has a 5-year bullet maturity and an 8 percent fixed interest rate, payable semiannually. Entity B simultaneously loans $100 to Entity C. The loan has a five-year bullet maturity and a variable interest of LIBOR, payable semiannually and reset semiannually. Entity B and Entity C enter into a netting arrangement that permits each party to offset its rights and obligations under the agreements. The netting arrangement meets the criteria for offsetting in Subtopic 210-20. The net effect of offsetting the contracts for both Entity B and Entity C is the economic equivalent of an interest rate swap arrangement, that is, one party receives a fixed interest rate from, and pays a variable interest rate to, the other.

In this Case, based on the facts presented, there is no clear business purpose for the separate transactions, and they should be accounted for as an interest rate swap under this Subtopic. However, in other instances, a clear substantive business purpose for entering into two separate loan transactions may exist (for example, as a means to overcome foreign currency expatriation restrictions).

**RSM COMMENTARY:** Typically, it is not difficult to determine whether two or more transactions related to the same risk were entered into contemporaneously and with the same counterparty. As a result, the key determining factor as to whether an entity should view two or more transactions as one unit of account often is whether there is a substantive business purpose for structuring the transactions separately.

ASC 815-10-15-9 sets forth the indicators that an entity should consider in determining whether individual nonderivative contracts or transactions should be viewed as one unit of account for purposes of

evaluating whether that unit of account is a derivative instrument within the scope of ASC 815. In addition, ASC 815-10-25-6 addresses whether an entity should consider two derivative instrument contracts that are within the scope of ASC 815 as one unit of account for recognition and other purposes by providing indicators that are essentially the same as those in ASC 815-10-15-9.

Often, multiple embedded derivatives (i.e., derivative features that are contained within a nonderivative contract) are found in a single contract. An example is a convertible debt instrument that has multiple scenarios under which the holder could elect to convert the debt into common stock. In cases like this, the multiple embedded derivatives are analyzed to determine the unit of account—namely, whether an entity should analyze each embedded derivative individually or in combination with another feature or features when performing the analysis to determine if derivative recognition is necessary for any or all of the embedded derivatives within the contract. Refer to Chapter 4 for more information about the accounting analysis for embedded derivatives.

ASC 815-10-25-7 through 25-13 provides guidance on whether an entity should account for combinations of put and call option contracts separately or as a single forward contract when those options have the same key terms and neither option is required to be exercised. Generally, if at least one of the options is freestanding and transferable from the other, each of the options would be viewed as separate units of account. Conversely, if both options are embedded in a single contract and have the same terms, it may be appropriate to view them as a single forward contract. ASC 815-10-55-3 and the examples that begin in ASC 815-10-55-66 reinforce the concept that if a put or call option can be transferred to a third party, it is viewed as a separate unit of account from the bond or other instrument to which it relates.

## 3.2 Determining what is a derivative instrument

The FASB originally considered developing a list of instruments that are typically thought of as derivatives to form the scope of ASC 815. However, the board recognized that, over time, such a list would likely become outdated. As a result, the FASB created a definition of a derivative instrument supplemented with a list of scope exceptions. In other words, a contract or an instrument that meets the definition of a derivative instrument is within the scope of ASC 815 unless it qualifies for a scope exception as discussed in Section 3.3.

### 3.2.1 Definition of derivative instrument

ASC 815-10-15-83 defines the characteristics of a derivative instrument.

**ASC 815-10-15-83**

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

a. Underlying, notional amount, payment provision. The contract has both of the following terms, which determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required:

   1. One or more underlyings

   2. One or more notional amounts or payment provisions or both.

b. Initial net investment. The contract requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

c. Net settlement. The contract can be settled net by any of the following means:

   1. Its terms implicitly or explicitly require or permit net settlement.

   2. It can readily be settled net by a means outside the contract.

3. It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

As indicated in ASC 815-10-15-3, a contract that does not qualify as a derivative instrument upon its initial recognition may subsequently meet the definition of a derivative instrument, at which time it should be accounted for as a derivative instrument. Because of this, certain contracts may need to be continually assessed to ensure that they are accounted for properly.

Each of the characteristics of a derivative instrument is explained in further detail in the following subsections.

#### 3.2.1.1 Underlying

For a financial instrument or contract to meet the definition of a derivative instrument, it must contain an underlying, which is defined in ASC 815-10-15-88.

**ASC 815-10-15-88**

An underlying is a variable that, along with either a notional amount or a payment provision, determines the settlement of a derivative instrument. An underlying usually is one or a combination of the following:

a. A security price or security price index

b. A commodity price or commodity price index

c. An interest rate or interest rate index

d. A credit rating or credit index

e. An exchange rate or exchange rate index

f. An insurance index or catastrophe loss index

g. A climatic or geological condition (such as temperature, earthquake severity, or rainfall), another physical variable, or a related index

h. The occurrence or nonoccurrence of a specified event (such as a scheduled payment under a contract)

An underlying is a variable (e.g., price, rate, index) associated with an asset or liability, but it is not the asset or liability itself. For example, the price of a commodity is an underlying, but the commodity itself is not.

An underlying is a key characteristic of a derivative instrument. Generally, when the underlying fluctuates, the fair value of the derivative instrument changes. For example, as the price of cocoa fluctuates, the fair value of a cocoa forward contract will increase or decrease, resulting in a corresponding gain or loss. This is because derivative instruments such as forwards, futures and options typically specify a price or rate related to the underlying asset that is fixed. As a result, as the market price or rate changes, the derivative instrument becomes more or less valuable due to its fixed-settlement price. For example, assume Entity A agrees to buy a commodity for $50 per unit in 90 days. If the fair value of the commodity is $59 per unit when the contract settles on the 90th day, Entity A will close out the contract with a $9 gain per unit. In this example, the upward movement of the underlying price away from the fixed-purchase price of $50 per unit created the $9 gain per unit. However, if Entity A instead agreed to buy the same commodity in 90 days at the then-fair value, Entity A would have paid $59 per unit for the commodity at settlement, which would have resulted in no gain or loss. Therefore, although a contract that will settle at the then-fair value contains an underlying and may meet the definition of a derivative instrument, its fair value will typically be zero at all times.

As indicated in ASC 815-10-15-89, an underlying can be any variable whose changes can be observed or objectively verified. Therefore, the occurrence or nonoccurrence of an event qualifies as an underlying. A contract contains an underlying if it requires payment only if certain conditions are met (e.g., Party A is required to pay Party B if the S&P 500 index increases by a stated amount). In such cases, a change in the likelihood of the event occurring changes the fair value of the derivative instrument.

A financial instrument or other contract that does not contain an underlying does not meet the definition of a derivative instrument.

Examples of determining an underlying in contracts that are comprised of a fixed price component, a variable price component and a combination thereof are provided in ASC 815-10-55-77 through 55-83.

### 3.2.1.2 Notional amount or payment provision

For a financial instrument or contract to meet the definition of a derivative instrument, it must contain either a notional amount or payment provision, as defined in ASC 815-10-15-92 and 15-93, respectively.

**ASC 815-10-15-92 - Notional Amount**

A notional amount is a number of currency units, shares, bushels, pounds, or other units specified in the contract. Other names are used, for example, the notional amount is called a face amount in some contracts. The settlement of a derivative instrument with a notional amount is determined by interaction of that notional amount with the underlying. The interaction may be simple multiplication, or it may involve a formula with leverage factors or other constants. As defined in the glossary, the effective notional amount is the stated notional amount adjusted for any leverage factor. If a requirements contract contains explicit provisions that support the calculation of a determinable amount reflecting the buyer's needs, then that contract has a notional amount. See paragraphs 815-10-55-5 through 55-7 for related implementation guidance. For implementation guidance on identifying a commodity contract's notional amount, see paragraph 815-10-55-5.

**ASC 815-10-15-93 – Payment Provision**

As defined in the glossary, a payment provision specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner. For example, a derivative instrument might require a specified payment if a referenced interest rate increases by 300 basis points.

As discussed in Section 3.2.1.1, an underlying is a variable associated with a derivative instrument. The notional amount is the quantity specified in the derivative contract. The interaction of the underlying and notional amount of a derivative instrument, which may be simple multiplication or involve a leverage factor, determines its settlement amount. Similarly, a fixed or determinable payment provision based on the behavior of a specified underlying also determines the settlement amount of a derivative contract.

The following are examples of underlyings, notional amounts and payment provisions found in common derivative financial instruments.

| Derivative instrument | Underlying | Notional amount | Payment provision |
|---|---|---|---|
| Interest rate swap where one party is owed payments based on 1% per annum on $10,000,000 and the counterparty is owed payments based on one-month SOFR on $10,000,000 | One-month SOFR | $10,000,000 | N/A |
| Forward contract to purchase $1,000,000 for 860,000 Euros | USD/Euro exchange rate | $1,000,000 | N/A |
| Futures contract traded on the Chicago Board of Trade (CBOT) to buy 5,000 bushels of wheat | Price of CBOT wheat | 5,000 bushels | N/A |
| Option to buy 100 shares of common stock of Entity A | Price of Entity A's common stock | 100 shares | N/A |
| Contract to pay $500,000 if Entity A's stock price falls below $75 | The occurrence of Entity A's stock price falling below $75 | N/A | Payment amount of $500,000 |

A financial instrument or other contract that does not contain both an underlying and either a notional amount or payment provision does not meet the definition of a derivative instrument.

## Determining the notional amount in requirements contracts

Unlike a typical commodity contract that specifies a fixed number of units to be bought or sold, certain contracts, commonly referred to as requirements contracts, require a seller to supply the amount of units that the purchaser will need during a certain period of time for purposes other than resale. Determining whether a requirements contract contains a notional amount requires careful analysis of the contractual arrangements between the parties.

To conclude that a requirements contract contains a notional amount, there must be a reliable means to determine the quantity that will be required to be bought or sold. If there is not a reliable way to determine a quantity, the contract does not contain a notional amount.

Generally, the seller of a particular commodity would understand the buyer's needs for that commodity because the expected quantity influences pricing. Additionally, without such an understanding, the seller may not be able to determine if it can meet the buyer's needs. As a result, those needs are often quantified in either the requirements contract itself or its related attachments or side agreements. Thus, an entity should consider the full set of documents between the parties when determining if there are terms that support a determinable quantity such that the contract has a notional amount.

The default provisions of a requirements contract may provide a way of determining the quantity of a contract and, thus, its notional amount. ASC 815-10-55-7 in part provides guidance on analyzing the default provisions of a requirements contract.

**ASC 815-10-55-7**

Often the default provisions of requirements contracts will specifically refer to anticipated quantities to utilize in the calculation of penalty amounts in the event of nonperformance. Other default provisions stipulate penalty amounts in the event of nonperformance based on average historical usage quantities of the buyer. If those amounts are determinable, they shall be considered the notional amount of the contract.

Some requirements contracts specify minimum and (or) maximum quantities of units to be bought (sold), in which case, determining the notional amount can be more complicated. The notional amount of a requirements contract cannot exceed any stated maximum in the contract or its related side agreements. Also, the notional amount of a requirements contract cannot be less than any stated minimum in the contract or its related side agreements.

The following table indicates the quantity that would be considered the notional amount based on whether a requirements contract specifies a minimum and (or) maximum quantity and whether there is an otherwise determinable quantity. The concept communicated through this table is that the notional amount of a requirements contract is the amount determinable from the contract (including any related side agreements), but limited by any minimum or maximum quantity amounts specified in those contracts and any related side agreements. When there is not an otherwise determinable amount, but the contract has a stated minimum quantity, the notional amount is the stated minimum quantity, even if the contract has a stated maximum quantity.

| Minimum quantity specified | Maximum quantity specified | Otherwise determinable quantity[(a)] | Notional amount |
|---|---|---|---|
| Yes | No | Less than the minimum | Minimum quantity |
| Yes | No | Greater than the minimum | Otherwise determinable quantity |
| Yes | No | Not determinable | Minimum quantity |
| No | Yes | Less than the maximum | Otherwise determinable quantity |
| No | Yes | Greater than the maximum | Maximum quantity |
| No | Yes | Not determinable | Not determinable |
| Yes | Yes | Less than the minimum | Minimum quantity |
| Yes | Yes | More than the minimum and less than the maximum | Otherwise determinable quantity |

| Minimum quantity specified | Maximum quantity specified | Otherwise determinable quantity[(a)] | Notional amount |
|---|---|---|---|
| Yes | Yes | More than the maximum | Maximum quantity |
| Yes | Yes | Not determinable | Minimum quantity |

(a) The otherwise determinable quantity refers to the quantity that is reliably determinable from the requirements contract and related side agreements, other than any contractually specified minimum or maximum quantity.

An entity is required to determine the notional amount of a requirements contract over the term of the contract. Consequently, the notional amount may change over time if, for example, the notional amount was based on default provisions that refer to a rolling average historical usage.

The following are four examples of how to determine the notional amount of a requirements contract.

**Example 3-4: Identifying a commodity contract's notional amount (ASC 815-10-55-5 through 55-7)**

Many commodity contracts specify a fixed number of units of a commodity to be bought or sold under the pricing terms of the contract (for example, a fixed price). However, some contracts do not specify a fixed number of units. For example, consider the following four contracts that require one party to buy the following indicated quantities:

a. Contract 1: As many units as required to satisfy its actual needs (that is, to be used or consumed) for the commodity during the period of the contract (a requirements contract). The party is not permitted to buy more than its actual needs (for example, the party cannot buy excess units for resale).

b. Contract 2: Only as many units as needed to satisfy its actual needs up to a maximum of 100 units. The party is not permitted to buy more than its actual needs (for example, the party cannot buy excess units for resale).

c. Contract 3: A minimum of 60 units and as many units needed to satisfy its actual needs in excess of 60 units. The party is not permitted to buy more than its actual needs (for example, the party cannot buy excess units for resale).

d. Contract 4: A minimum of 60 units and as many units needed to satisfy its actual needs in excess of 60 units up to a maximum of 100 units. The party is not permitted to buy more than its actual needs (for example, the party cannot buy excess units for resale).

Generally, the anticipated number of units covered by a requirements contract is equal to the buyer's needs. When a requirements contract is negotiated between the seller and buyer, both parties typically have the same general understanding of the buyer's estimated needs. Given the buyer's often exclusive reliance on the seller to supply all its needs of the commodity, it is imperative from the buyer's perspective that the supplier be knowledgeable with respect to anticipated volumes. In fact, the pricing provisions within requirements contracts are directly influenced by the estimated volumes.

This guidance focuses solely on whether the contracts under consideration have a notional amount pursuant to the definition in this Subtopic. These types of contracts may not satisfy certain of the other required criteria in this Subtopic for them to meet the definition of a derivative instrument. The conclusion that a requirements contract has a notional amount as defined in this Subtopic can be reached only if a reliable means to determine such a quantity exists. Application of this guidance to specific contracts is as follows:

a. Contract 1—requirements contract. The identification of a requirements contract's notional amount may require the consideration of volumes or formulas contained in attachments or appendixes to the contract or other legally binding side agreements. The determination of a requirements contract's notional amount must be performed over the life of the contract and could result in the fluctuation of the notional amount if, for instance, the default provisions reference a rolling cumulative average of historical usage. If the notional amount is not determinable, making the quantification of such an amount highly subjective and relatively unreliable (for example, if a contract does not contain settlement and default provisions that explicitly reference quantities or provide a formula based on historical usage), such contracts are considered not to contain a notional amount as that term is used in this Subtopic. One technique to quantify and validate the notional amount in a requirements contract is to base the estimated volumes on the contract's settlement and default provisions. Often the default provisions of requirements contracts will specifically refer to anticipated quantities to utilize in the calculation of penalty amounts in the event of nonperformance. Other default provisions stipulate penalty amounts in the event of nonperformance based on average historical usage quantities of the buyer. If those amounts are determinable, they shall be considered the notional amount of the contract.

b. Contract 2—requirements contract with a specified maximum quantity. Whether the contract has a notional amount depends. The same considerations discussed in (a) with respect to Contract 1 also apply to Contract 2; however, the notional amount cannot exceed 100 units.

c. Contract 3—requirements contract with a specified minimum quantity. The contract has a notional amount. The same considerations discussed in (a) with respect to Contract 1 also apply to Contract 3; however, the notional amount of Contract 3 cannot be less than 60 units. A contract that specifies a minimum number of units always has a notional amount at least equal to the required minimum number of units. Only that portion of the requirements contract with a determinable notional amount would be accounted for as a derivative instrument under this Subtopic.

d. Contract 4—requirements contract with a specified maximum and minimum quantities. The contract has a notional amount. The same considerations discussed in (a) with respect to Contract 1 also apply to Contract 4; however, the notional amount of Contract 4 cannot be less than 60 units or greater than 100 units. A contract that specifies a minimum number of units always has a notional amount at least equal to the required minimum number of units. Only that portion of the requirements contract with a determinable notional amount would be accounted for as a derivative instrument under this Subtopic.

#### 3.2.1.3 Initial net investment

For a financial instrument or contract to meet the definition of a derivative instrument, it must require 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. Although guidance on the initial net investment characteristic of a derivative instrument is written from the perspective of one party (i.e., the party that is making the initial net investment), the determination of whether this characteristic is met applies to both parties of a potential derivative instrument, as noted in ASC 815-10-15-98.

The reason why derivative instruments often require little or no initial net investment is because a derivative instrument reflects an investment in a change in value resulting from a change in an underlying, rather than an investment in the item associated with the underlying.

For example, if an investor wishes to have the exposure to the risks and rewards of owning gold over a period of time without an initial capital outlay and the inconvenience of having to store the gold, rather than purchasing gold upfront, the investor could enter into a forward contract to purchase gold at a date in the future for a price that is fixed at the inception of the contract. For example, if the forward contract price was fixed at $1,700 per ounce and the fair value of the gold was $1,790 per ounce at contract settlement, the investor would have a $90 gain per ounce upon settlement. As a result, the investor would have

benefited during the term of the contract from the change in the price of gold without having owned the gold or making an initial net investment.

As another example, if an investor wishes to participate in the potential upside of the common stock in Entity A with limited downside risk, the investor could purchase a call option on the common stock of Entity A. The investor would pay a small (relative to the price of the stock) premium and would obtain the right, but not the obligation, to buy common stock of Entity A at a stated price within a stated period of time. For example, when Entity A's stock is trading around $70, the investor may pay around $20 to purchase an option with a 10-year term that gives it the right to purchase a share of Entity A's stock at an exercise price of $70 per share during that term. As the fair value of the common stock increases, the investor will experience similar gains on the option despite its initial net investment being small relative to the price of the common stock at the time it purchased the option.

Further general information about the size of the initial net investment of a derivative instrument as well as examples of an initial net investment of a derivative instrument is provided in ASC 815-10-15-95.

**ASC 815-10-15-95**

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. For example:

a. A commodity futures contract generally requires no net investment, while purchasing the same commodity requires an initial net investment equal to its market price. However, both contracts reflect changes in the price of the commodity in the same way (that is, similar gains or losses will be incurred).

b. A swap or forward contract generally does not require an initial net investment unless the terms favor one party over the other.

c. An option generally requires that one party make an initial net investment (a premium) because that party has the rights under the contract and the other party has the obligations.

Further information on derivative instruments that require an initial net investment as compensation is provided in ASC 815-10-15-94.

**ASC 815-10-15-94**

Many derivative instruments require no initial net investment. Some require an initial net investment as compensation for one or both of the following:

a. Time value (for example, a premium on an option)

b. Terms that are more or less favorable than market conditions (for example, a premium on a forward purchase contract with a price less than the current forward price).

Others require a mutual exchange of currencies or other assets at inception, in which case the net investment is the difference in the fair values of the assets exchanged.

As indicated in ASC 815-10-15-94, a derivative instrument may require an initial net investment to pay for off-market terms, such as an upfront payment on an interest rate swap because the swap terms are more favorable than the current market rate. The size of the upfront payment determines whether the initial net investment characteristic in ASC 815-10-15-83(b) exists.

Some derivative instruments require a mutual exchange of currencies or other assets, potentially at the inception and maturity of the derivative instrument. In such instances, the initial net investment would be considered the difference between the fair values of the currencies or assets exchanged at inception. For

example, if at the inception of a currency swap the two parties exchange currencies of equal fair values, this results in an initial net investment of zero. As noted in ASC 815-10-55-8, such a currency swap is a derivative instrument if it obligates the two parties to the transaction to exchange specified currencies on specified dates at specified prices.

General guidance on meeting the initial net investment characteristic is addressed in ASC 815-10-15-96 through 15-97.

**ASC 815-10-15-96**

If the initial net investment in the contract (after adjustment for the time value of money) is less, by more than a nominal amount, than the initial net investment that would be commensurate with the amount that would be exchanged either to acquire the asset related to the underlying or to incur the obligation related to the underlying, the characteristic in paragraph 815-10-15-83(b) is met. The amount of that asset acquired or liability incurred should be comparable to the effective notional amount of the contract. This does not imply that a slightly off-market contract cannot be a derivative instrument in its entirety. That determination is a matter of facts and circumstances and shall be evaluated on a case-by-case basis. Example 16, Case C (see paragraph 815-10-15-166) illustrates this guidance in this paragraph.

**ASC 815-10-15-97**

A contract that requires an initial net investment in the contract that is in excess of the amount determined by applying the effective notional amount to the underlying is not a derivative instrument in its entirety. Example 16, Case A (see paragraph 815-10-55-150) illustrates such a contract.

ASC 815 does not precisely define what is meant by “less, by more than a nominal amount.” However, the FASB did provide an example comprised of three cases of prepaid interest rate swaps in ASC 815-10-55-148 through 55-168 that provides insight into the concept, which is summarized in the following table.

| | Case A | Case B | Case C |
|---|---|---|---|
| Term | 2 years | 2 years | 2 years |
| Notional amount | $10,000,000 | $10,000,000 | $10,000,000 |
| Settlement | Quarterly | Quarterly | Quarterly |
| Variable-rate | 3-month LIBOR | 3-month LIBOR plus 300 basis points (bps) | 3-month LIBOR minus 100 bps |
| Fixed-rate | 6.65% | 9.65% | 5.65% |
| Initial net investment[(a)] | $1,228,179 | $1,782,245 | $1,043,490 |
| Commensurate initial net investment[(b)] | $1,228,179 | $1,228,179 | $1,228,179 |
| The initial net investment characteristic of a derivative instrument is met | No | No | Yes |

(a) The initial net investment is the amount that is prepaid, which for each case mirrors the sum of the present values of the eight fixed-rate quarterly payments. The quarterly payments of each interest rate swap are determined by multiplying the notional amount of the swap by its annual fixed rate divided by four (being that the settlements are quarterly). In each case, the initial net investment is different because the fixed interest rate is different.

(b) The commensurate initial net investment is the initial net investment that would be commensurate with the amount that would be exchanged to acquire the asset related to the underlying (i.e., the 3-month LIBOR rate). The commensurate initial net investment is determined by summing the present value of the 3-month LIBOR portion of the eight variable-rate quarterly payments, excluding any interest spread. Only the 3-month LIBOR portion is used because 3-month LIBOR is the underlying. The quarterly payments are determined by multiplying the swap's notional amount by the annual 3-month LIBOR swap rate in effect at the inception of the swap (6.65%) divided by four (being that the settlements are quarterly). Because the underlying (3-month LIBOR) is the same in each case, the commensurate initial net investment is the same in each case.

In Case A (the base case), the rate on the variable rate leg of the swap is 3-month LIBOR. The forward 3-month LIBOR rate curve in this example is 6.65%, which is why the rate on the fixed-rate leg of the swap in Case A is 6.65%. The terms of the swap in Case B and Case C are the same as Case A except that for Case B, there is a 300-basis point (i.e., 3%) positive spread included in the rate for each leg of the swap and for Case C, a 100-basis point spread is subtracted from the rate for each leg of the swap.

In each of the three cases, the fixed-rate payer prepaid the present value of all of the fixed-rate payments under the interest rate swap agreement. The amount of the prepayment is considered its initial net investment and needs to be assessed to determine if it is less than the commensurate initial net investment by more than a nominal amount.

In Case A, the initial net investment of the swap is the same as the commensurate initial net investment. In Case B, the initial net investment of the swap is greater than the commensurate initial net investment. This means that the prepaid interest rate swaps in Case A and Case B do not have the initial net investment characteristic of a derivative instrument because their initial net investments are not smaller than the commensurate initial net investment. As a result, the prepaid interest rate swaps in Case A and Case B are not considered derivative instruments in their entirety pursuant to ASC 815. However, in Case C, the initial net investment of the swap is approximately 15% less than the commensurate initial net investment. The FASB concluded that in Case C, the initial net investment of the swap is less than, by more than a nominal amount, the initial net investment that would be commensurate with the amount that would be exchanged to acquire an asset that is associated with the underlying (i.e., the 3-month LIBOR).

The guidance in ASC 815-10-55-168 makes clear that Case C was not meant to make a distinction between a "nominal amount" and "more than a nominal amount." That paragraph also indicates that a percentage less than 15% could also be considered more than a nominal amount. In practice, we have observed that 10% is generally considered more than a nominal amount for purposes of assessing the initial net investment characteristic of a derivative instrument.

Although the prepaid interest rate swaps in Case A and Case B are not derivative instruments in their entirety, they each contain an embedded interest rate swap that needs to be separately recognized as a derivative instrument unless the entire instrument is accounted for at fair value through earnings, as elaborated on at 815-10-55-158 through 55-168. Embedded derivatives are discussed more fully in Chapter 4.

**RSM COMMENTARY: Determining the initial net investment when a derivative instrument (e.g., interest rate swap) is modified**

It is not uncommon for entities to modify the terms of outstanding interest rate swaps for reasons that may include a desire to extend the maturity date (referred to as a "blend and extend" transaction) or to better align the terms of the swap with the debt it may be hedging. In addition, an entity may wish to modify an interest rate swap to essentially refinance to obtain a preferential interest rate. When a critical term or terms of a derivative instrument is modified, that is generally viewed as a termination of the original derivative instrument and the issuance of a new derivative instrument. As a result, at the time of the modification, it is generally necessary to do an analysis like what is illustrated in the aforementioned prepaid interest rate swap examples to determine whether the new interest rate swap is a derivative instrument in its

entirety or a hybrid instrument in the form of a debt host contract and an "at-market" interest rate swap. When these modifications occur, the new swap is often structured so that its value is equivalent to the old swap's value immediately prior to the modification so that no cash exchanges hands. Generally, this is accomplished by setting the fixed rate for the new swap at the rate that would result in it having the same value pre and post modification. In these circumstances, the fair value of the modified (new) swap as of the modification date would be considered its initial net investment, which would be compared to the commensurate initial net investment to determine if the initial net investment characteristic is met, which would make the new swap a derivative instrument in its entirety.

The following example illustrates the analysis to determine whether the criterion related to initial net investment is met for a forward contract, and if not, whether the contract has an embedded derivative that warrants separate accounting.

**Example 3-5: Initial net investment—Forward contract embedded with equity derivative (ASC 815-10-55-74 through 55-76)**

An entity enters into a forward contract that requires the purchase of 1 share of an unrelated entity's common stock in 1 year for $110 (the market forward price) and at inception of the contract, the entity elects to prepay the contract pursuant to its terms for $105 (the current price of the share of common stock).

If no prepayment is made at inception, the contract would meet the criterion in paragraph 815-10-15-83(b) because it does not require an initial net investment but, rather, contains an unexercised election to prepay the contract at inception. If the contract gives the entity the option to prepay the contract at a later date during its 1-year term (at $105 or some other specified amount), exercise of that option would be accounted for as a loan that is repayable at $110 at the end of the forward contract's 1-year term. If, instead, the entity elects to prepay the contract at inception for $105, the contract does not meet the definition of a freestanding derivative instrument. The initial net investment of $105 is equal to the initial price of the 1 share of stock being purchased under the contract and therefore is equal to the investment that would be required for other types of contracts that would be expected to have a similar response to changes in market factors. That is, the initial net investment is equal to the amount that would be exchanged to acquire the asset related to the underlying.

However, the entity must assess whether that nonderivative instrument contains an embedded derivative that, pursuant to paragraph 815-15-25-1, requires separate accounting as a derivative unless the fair value election is made pursuant to paragraph 815-15-25-4. In this instance, the prepaid contract is a hybrid instrument that is composed of a debt instrument as the host contract (that is, a loan that is repayable at $110 at the end of the forward contract's 1-year term) and an embedded derivative based on equity prices. The host contract is a debt instrument because the holder has none of the rights of a shareholder, such as the ability to vote the shares and receive distributions to shareholders. (See paragraph 815-15-25-16.) Unless the hybrid instrument is remeasured at fair value with changes in value recorded in earnings as they occur, the embedded derivative must be separated from the host contract because the economic characteristics and risks of a derivative based on equity prices are not clearly and closely related to a debt host contract, and a separate instrument with the same terms as the embedded derivative would be a derivative instrument subject to the requirements of this Subtopic.

### 3.2.1.4 Net settlement

Whether a financial instrument or other contract meets the definition of a derivative instrument is often determined by whether the net settlement characteristic exists. To meet the net settlement characteristic of a derivative instrument, a contract must either contractually permit or require net settlement or be able to be settled in a manner that provides a result that is tantamount to contractual net settlement.

ASC 815-10-15-99 lists the ways in which the net settlement characteristic is met:

- Contractual net settlement
- Net settlement through a market mechanism
- Net settlement by the delivery of a derivative instrument or an asset that is readily convertible to cash

A financial instrument or other contract that does not have any of the three forms of net settlement previously described does not meet the definition of a derivative instrument. Each of the three forms of net settlement are discussed further in the following subsections.

## Contractual net settlement

ASC 815-10-15-100 describes net settlement under contract terms.

**ASC 815-10-15-100**

In this form of net settlement, neither party is required to deliver an asset that is associated with the underlying and that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (or the notional amount plus a premium or minus a discount). (For example, most interest rate swaps do not require that either party deliver interest-bearing assets with a principal amount equal to the notional amount of the contract.) Net settlement may be made in cash or by delivery of any other asset (such as the right to receive future payments—see the discussion beginning in paragraph 815-10-15-104) whether or not that asset is readily convertible to cash.

Gross settlement refers to a two-way form of settlement. That is, one party transfers cash and the other party transfers a physical asset. Contractual net settlement refers to a one-way transfer to settle a contract whereby the party in a loss position transfers an asset (generally cash) to the party in a gain position. For example, assume that Entity A holds an option contract to buy 10 shares of Entity B's common stock for $40 per share that permits net cash settlement. Entity A chooses to exercise its option when Entity B's common stock is trading at $50 per share. As permitted, Entity A chooses net cash settlement and receives $100 ($50 fair value minus $40 strike price equals $10 gain per share. A $10 gain per share multiplied by 10 shares equals $100). If instead the contract requires gross settlement, Entity A would have paid the $400 extended strike price and received 10 shares of common stock from Entity B in settlement of the contract. In other words, with gross settlement, Entity B is required to deliver an asset (the shares) that is associated with the underlying (price of the shares) in a number equal to the notional amount of 10.

Although contractual net settlement is often made in cash, the following additional forms of contractual net settlement are listed and discussed further, beginning in ASC 815-10-15-101:

- Net share settlement
- Net settlement in the event of nonperformance or default
- Structured settlement
- Net settlement of debt via the exercise of an embedded put or call option

### Net share settlement

Net share settlement is considered to meet the net settlement characteristic of a derivative instrument because even though one party is required to deliver shares (an asset that is associated with an underlying), the number of shares that are delivered do not equate to the notional amount of the contract plus or minus a premium or discount. Effectively, the number of shares the holder receives upon exercise of the contract is reduced in lieu of paying the exercise price in cash and receiving the full number of shares that are subject to the contract, as is the case with gross settlement. This is why net share settlement is commonly referred to as cashless exercise. We most commonly see cashless exercise provisions in warrants or other option agreements that give the holder the right to purchase shares. Whereas net cash settlement requires the party in a loss position to transfer the gain (loss) in the form of cash to the party in the gain position, net share settlement requires the party in a loss position to transfer the gain (loss) in the form of shares to the party in the gain position. In the example of net cash settlement in the preceding section, Entity A (the option holder) received $100 (i.e., the total gain in cash). If net share settlement was required in that example, Entity A would have received 2 shares ($100 gain divided by $50 per share price) of Entity B's common stock as settlement. Like net cash settlement, net share settlement may be either permitted or required.

A contract that can be net share settled may still qualify for the scope exception in ASC 815-10-15-74(a) from the perspective of the issuer of the shares, in which case it would not be accounted for as a derivative instrument.

### Net settlement in the event of nonperformance or default

Contracts often contain penalties for nonperformance or default. When assessing whether a contract meets the definition of a derivative instrument, an entity should consider any nonperformance or default provision in the contract before concluding net settlement does not exist because such provisions may constitute a form of net settlement.

#### Variable, fixed and mixed penalties

Generally, the net settlement characteristic of a derivative instrument exists if the amount of the nonperformance or default penalty is based substantively on the changes in price of the item that is the subject of the contract. The concepts in the following table are provided in ASC 815-10-15-103 to illustrate this point.

| Nonperformance or default penalty | Net settlement characteristic |
|---|---|
| A variable penalty based on changes in the price of the items subject to the contract (common in commodity contracts that require physical delivery) | The net settlement characteristic exists because the penalty amount is based on changes in the price of the items subject to the contract. See ASC 815-10-15-103(a). |
| A variable penalty based on changes in the price of the item that also includes an incremental penalty of a fixed amount (or fixed amount per unit) that is expected to be significant throughout the remaining life of the contract to make the possibility of nonperformance remote | The net settlement characteristic does not exist because, as noted in ASC 815-10-15-103(c), the inclusion of a fixed penalty that is significant enough to make the possibility of nonperformance remote effectively requires performance because it compels the delivery of the asset that is associated with the underlying. An entity should assess the significance of the fixed incremental penalty only at the inception of the contract and on its own as a disincentive for nonperformance rather than its magnitude in relation to the overall penalty. |

| Nonperformance or default penalty | Net settlement characteristic |
|---|---|
| A fixed penalty amount (e.g., $10,000) | The net settlement characteristic does not exist because the amount of the penalty is not based on changes in the price of the items subject to the contract. See ASC 815-10-15-103(b). |
| A per-unit fixed penalty amount ($100 per unit) | The net settlement characteristic does not exist because the amount of the penalty is not based on changes in the price of the items subject to the contract. See ASC 815-10-15-103(b). |

## Symmetrical provisions

ASC 815-10-55-18 describes a symmetrical provision as one that permits one party to net settle the contract (by default or otherwise) under any pricing circumstance and participate in either only favorable price changes or both favorable and unfavorable changes in the underlying. A symmetrical provision constitutes contractual net settlement because it does not require the delivery of an asset that is associated with the underlying and has a quantity equal to the notional amount.

## Asymmetrical default provisions

ASC 815-10-15-103(d) indicates that an asymmetrical default provision does not meet the net settlement characteristic of a derivative instrument. ASC 815-10-20 defines an asymmetrical default provision as "a nonperformance penalty provision that requires the defaulting party to compensate the nondefaulting party for any loss incurred but does not allow the defaulting party to receive the effect of favorable price changes". However, ASC 815-10-55-17 should be considered; it states that "a pattern of having the asymmetrical default provision applied in contracts between certain counterparties would indicate the existence of a tacit agreement between those parties that the party in a loss position would always elect the default provision, thereby resulting in the understanding that there would always be net settlement. In that situation, those kinds of commodity contracts would meet the characteristic described as net settlement in paragraph 815-10-15-100."

The following examples explain asymmetrical default provisions that do not constitute net settlement.

**Example 3-6: Asymmetrical default provision does not constitute net settlement (ASC 815-10-55-10 through 55-16)**

Many commodity forward contracts contain default provisions that require the defaulting party (the party that fails to make or take physical delivery of the commodity) to reimburse the nondefaulting party for any loss incurred as illustrated in the following examples:

a. If the buyer under the forward contract (Buyer) defaults (that is, does not take physical delivery of the commodity), the seller under that contract (Seller) will have to find another buyer in the market to take delivery. If the price received by Seller in the market is less than the contract price, Seller incurs a loss equal to the quantity of the commodity that would have been delivered under the forward contract multiplied by the difference between the contract price and the current market price. Buyer must pay Seller a penalty for nonperformance equal to that loss.

b. If Seller defaults (that is, does not deliver the commodity physically), Buyer will have to find another seller in the market. If the price paid by Buyer in the market is more than the contract price, Seller must pay Buyer a penalty for nonperformance equal to the quantity of the commodity that would have been delivered under the forward contract multiplied by the difference between the contract price and the current market price.

For example, Buyer agreed to purchase 100 units of a commodity from Seller at $1.00 per unit:

a. Assume Buyer defaults on the forward contract by not taking delivery and Seller must sell the 100 units in the market at the prevailing market price of $.75 per unit. To compensate Seller for the loss incurred due to Buyer's default, Buyer must pay Seller a penalty of $25.00—that is, 100 units × ($1.00 – $.75).

b. Similarly, assume that Seller defaults and Buyer must buy the 100 units it needs in the market at the prevailing market price of $1.30 per unit. To compensate Buyer for the loss incurred due to Seller's default, Seller must pay Buyer a penalty of $30.00—that is, 100 units × ($1.30 – $1.00).

Note that an asymmetrical default provision is designed to compensate the nondefaulting party for a loss incurred. The defaulting party cannot demand payment from the nondefaulting party to realize the changes in market price that would be favorable to the defaulting party if the contract were honored.

Under the forward contract in the example, if Buyer defaults when the market price is $1.10, Seller will be able to sell the units of the commodity into the market at $1.10 and realize a $10.00 greater gain than it would have under the contract. In that circumstance, the defaulting Buyer is not required to pay a penalty for nonperformance to Seller, nor is Seller required to pass the $10.00 extra gain to the defaulting Buyer.

Similarly, if Seller defaults when the market price is $.80, Buyer will be able to buy the units of the commodity in the market and pay $20.00 less than under the contract. In that circumstance, the defaulting Seller is not required to pay a penalty for nonperformance to Buyer, nor is Buyer required to pass the $20.00 savings on to the defaulting Seller.

In a forward contract with only an asymmetrical default provision, neither Buyer nor Seller can realize the benefits of changes in the price of the commodity through default on the contract. That is, Buyer cannot realize favorable changes in the intrinsic value of the forward contract except in both of the following circumstances:

a. By taking delivery of the physical commodity

b. In the event of default by Seller (which is an event beyond the control of Buyer).

Similarly, Seller cannot realize favorable changes in the intrinsic value of the forward contract except in either of the following circumstances:

a. By making delivery of the physical commodity

b. In the event of default by Buyer, which is an event beyond the control of Seller.

### Structured settlement

As an alternative to immediate net cash settlement of a contract, ASC 815-10-15-104 and ASC 815-10-55-19 address situations whereby the party in a gain position is paid over a period of time rather than in one payment at settlement. Such a structured payout meets the net settlement characteristic of a derivative instrument if the fair value of the cash flows that will be received or paid over time approximates the amount that would be received or paid if the contract had provided for immediate and full payout at settlement.

However, ASC 815-10-15-105 and ASC 815-10-55-20 note that the net settlement characteristic of a derivative instrument does not exist if one party must make an investment in or borrow from the other party to obtain the benefits of the gain on a contract over time as a traditional adjustment to either the yield on the amount invested or the interest element on the amount borrowed. A very common example of this is a fixed-rate mortgage commitment whereby a potential borrower obtains a commitment to obtain a mortgage at a fixed rate. If rates go up, the borrower will be in a gain position. However, the borrower can only realize the benefits of that gain in the form of a lower interest rate over the life of the mortgage if the borrower actually borrows the funds from the party who issued the mortgage commitment.

Conversely, ASC 815-10-15-106 indicates that if that adjustment to either the yield on the amount invested or the interest element on the amount borrowed previously discussed was nontraditional, the net settlement characteristic of a derivative instrument may be met. ASC 815-10-55-21 provides an example.

**ASC 815-10-55-21 [Partial Excerpt]**

…if a contract required the party in a gain position under the contract to invest $100 in the other party's debt instrument that paid an abnormally high interest rate of 5,000 percent per day for a term whose length is dependent on the changes in the contract's underlying, an analysis of those terms would lead to the conclusion that the contract's settlement terms were in substance a structured payout of the contract's gain and thus that contract would be considered to have met the characteristic of net settlement in that paragraph.

### Net settlement of debt via the exercise of an embedded put or call option

In accordance with ASC 815-10-15-107, the potential settlement of a debt instrument through the exercise of a prepayment feature, or call or put option that is embedded within it, meets the net settlement characteristic of a derivative instrument. This is because neither the debtor nor the creditor is required to deliver an asset that is associated with the underlying. Refer to ASC 815-10-15-108 through 15-109 for further information.

### When contractual net settlement does not exist

If a financial instrument or other contract does not permit or require net settlement according to its terms, that instrument or contract may still meet the net settlement characteristic of a derivative instrument if it can be settled net by either:

- A market mechanism
- Delivery of a derivative instrument or an asset that is readily convertible to cash

## Net settlement through a market mechanism

Unlike contractual net settlement, where neither party is required to deliver an asset that is associated with the underlying as described in ASC 815-10-15-100, when net settlement exists through a market mechanism, one of the parties is required to deliver an asset that is associated with the underlying; however, a market mechanism facilitates net settlement. An example of a market mechanism is an exchange through which an entity can sell a contract or enter into an offsetting contract. Many derivative instruments are traded in active markets where they can be settled net before they expire.

Although an entity should interpret the term market mechanism broadly, a market mechanism must possess all of the primary characteristics described in ASC 815-10-15-111. ASC 815-10-15-113 through 15-116 provides indicators for each of those primary characteristics. Not all of the indicators need to be present for each primary characteristic for an entity to conclude that a market mechanism exists for a particular contract. The following table summarizes the primary characteristics of a market mechanism, including the indicators for evaluating their existence.

| Primary characteristic | Description | Indicators that the primary characteristic is met |
|---|---|---|
| Ready liquidation | A market mechanism provides a way to settle a contract that enables one party to easily liquidate its net position. It enables an entity to realize the gain or loss on a contract through a net payment in cash or any other asset. If settlement results only in a gross exchange of cash (or payment-in-kind) for an asset, this primary characteristic of a market mechanism does not exist. | • There is access to potential counterparties, regardless of the seller's size or market position.<br>• The risks taken on by a market maker from acquiring a contract can be transferred in a manner other than by changing the original form of the contract. |
| Full relief of rights and obligations | A market mechanism enables one of the parties to relinquish all of its future rights and avoid all of its future obligations under the contract. If a contract does not allow an original party to the contract to assign its rights and obligations under the contract to another party, the contract does not meet the characteristic of net settlement through a market mechanism. Offsetting (or the ability to offset) one contract with another, in and of itself, does not meet the characteristic of a market mechanism. The offsetting contract carries a new set of legal rights and obligations; however, those rights and obligations generally offset, rather than relieve, the original contract's set of legal rights and obligations. Conversely, an exchange that offers a ready opportunity to offset a contract that cancels the rights and obligations of that contract because the exchange is the counterparty does constitute a market mechanism. Refer to Example 6 in in ASC 815-10-55-91 through 55-98. | • There are multiple market participants who are willing and able to assume the rights and obligations of the seller under a contract.<br>• The market has sufficient liquidity for the contract, which is indicated by transaction volume and a relatively narrow observable bid-ask spread. |

| Primary characteristic | Description | Indicators that the primary characteristic is met |
|---|---|---|
| Lack of significant transaction costs | A market mechanism enables a party to the contract to liquidate its net position without incurring significant transaction costs. This characteristic of a market mechanism focuses on a single contract. As a result, the absence of a liquid market for a group of contracts is not a factor in determining whether a market mechanism exists.<br>Whether the market could rapidly absorb the amount of assets to be delivered under the contract without significantly affecting the price of the asset is not a consideration for this primary characteristic of a market mechanism. | • The transaction costs are less than 10% of the fair value of the contract. An exchange, as an example, may allow the opportunity for a party to sell a contract and be relieved of its contractual rights and obligations without incurring significant transaction costs. |
| Expeditious liquidation | A market mechanism enables a party to the contract to liquidate its net position without significant negotiation and due diligence. In addition, liquidation occurs within a period of time that is customary for settling the type of contract. | • Binding prices for the contract are readily available.<br>• The transfer of the instrument involves standardized documentation and standardized settlement procedures.<br>• Sales of individual contracts do not require significant negotiation.<br>• Sales of individual contracts do not require unique structuring.<br>• The extent of legal consultation and document review is such that the closing period is not extensive. |

The possible existence of a market mechanism is performed at contract inception and on an ongoing basis during the life of the contract. In other words, different conclusions may be reached at different times as to whether net settlement through a market mechanism exists for a contract. See Example 3-8 in Section "Ongoing assessment of a market mechanism and whether the assets to be delivered are readily convertible to cash" for related implement guidance.

A futures exchange generally satisfies all of the characteristics of a market mechanism as explained in the following table.

| Primary characteristic | Does the primary characteristic exist for a futures exchange? |
|---|---|
| Ready liquidation | Yes. The futures exchange creates a market for the counterparties to the futures contract. |
| Full relief of rights and obligations | Yes. At any point in time during the term of a futures contract, a party can close out its position by transferring it to another party. As a result, the party closing out its position is relieved of all of its rights and obligations under the contract and pays or receives the fair value change in the contract since its inception. |
| Lack of significant transaction costs | Yes. A futures exchange enables a party to a futures contract to liquidate its net position without incurring significant transaction costs. |
| Expeditious liquidation | Yes. A futures exchange enables a party to the contract to liquidate its net position with no negotiation or due diligence. |

### A market without an exchange, but with many brokers

**Question 3-1: Does a market that lacks an exchange for settling certain contracts, but that possesses many brokers for effectuating such transactions, qualify as a market mechanism under ASC 815?**

It depends on the facts and circumstances. The existence of many brokers to settle certain contracts would not constitute a market mechanism in any of the following situations:

- Binding prices are not always available for the contract (the expeditious liquidation characteristic does not exist).
- The broker is only making payment or accepting payment on behalf of the party to the contract without fully relieving the rights and obligations of the party under the contract (the full relief of rights and obligations characteristic does not exist).
- Transaction costs are 10% or more of the fair value of the contract (the lack of significant transaction costs characteristic does not exist).

### Effects of an assignment clause on a market mechanism

A contract may contain a clause that permits one or both parties to assign its rights and obligations to another party with the permission of the other party to the contract. This type of assignment would replace the nonperformance risk of the assigning party with the nonperformance risk of a new party if the assigning party were released of all of its contractual rights and obligations. Often, the nonassigning party could withhold consent in certain circumstances (e.g., one party wishes to assign the contract to another party who is a higher credit risk than the assignor). An entity would have to analyze an assignment clause to determine if a party is permitted from being relieved of all its rights and obligations under the contract (a necessary step in determining whether a market mechanism exists). ASC 815-10-15-117 provides relevant guidance.

**ASC 815-10-15-117**

As noted in the primary characteristic in paragraph 815-10-15-111(b), an assessment of the substance of any assignment clause is required to determine whether that assignment clause precludes a party from being relieved of all rights and obligations under the contract. Although permission to assign a contract shall not be unreasonably withheld by the counterparty in accordance with the terms of a contract, an assignment feature cannot be viewed simply as a formality because it may be invoked at any time to prevent the nonassigning party from being exposed to unacceptable credit or performance risk. Accordingly, the existence of an assignment clause may or may not permit a party from being relieved of its rights and obligations under the contract. If it is remote that the counterparty will withhold permission to assign the contract, the mere existence of the clause shall not preclude the contract from possessing the net settlement characteristic described in paragraph 815-10-15-110 as a market mechanism. Such a determination requires assessing whether a sufficient number of acceptable potential assignees exist in the marketplace such that assignment of the contract would not result in imposing unacceptable credit risk or performance risk on the nonassigning party. Consideration shall be given to past counterparty and industry practices regarding whether permission to be relieved of all rights and obligations under similar contracts has previously been withheld. However, if it is reasonably possible or probable that the counterparty will withhold permission to assign the contract, the contract does not possess the net settlement characteristic described in paragraph 815-10-15-110 as a market mechanism.

## Net settlement by the delivery of a derivative instrument or an asset that is readily convertible to cash

If a financial instrument or other contract does not provide for contractual net settlement and cannot be settled through a market mechanism, that instrument or contract may still meet the net settlement characteristic of a derivative instrument if its settlement will result in the delivery of a derivative instrument or an asset that is readily convertible to cash.

Unlike contractual net settlement, in this form of net settlement, as indicated in ASC 815-10-15-119, one of the parties to a contract is required to deliver an asset that is associated with the underlying (e.g., the delivery of gold under a contract where the price of gold is the underlying), but that asset is either:

- Readily convertible to cash, or
- A derivative instrument itself (e.g., net settlement would exist in a swaption contract because the asset to be delivered, a swap, is a derivative instrument)

The thought process is that if the asset to be delivered can be readily converted to cash, the party taking delivery is in a position that does not differ substantially from net settlement. In other words, a party would generally be indifferent about whether it receives the asset or net settles the contract as discussed in ASC 815-10-15-122. This would be the case if there is an active market whereby the asset could be sold for a net amount of cash that is equal to or not significantly less than the amount that would be received under a net settlement provision. ASC 815-10-15-126 notes that costs to convert an asset to cash are significant if they are 10% or more of the gross sales proceeds that would be received in the closest or most economical active market.

As mentioned in ASC 815-10-15-123, an entity should not combine individual instruments when determining if the asset to be delivered can be readily converted to cash. ASC 815-10-55-111 illustrates this in the context of a long-term commodity supply contract, where determining whether the asset to be delivered can be readily converted to cash is based on the quantity to be delivered on each individual delivery date rather than the total quantity that will be delivered over the entire contract term.

The following are examples of assets that, depending on the facts and circumstances, may be considered readily convertible to cash:

- An exchange-traded security in which the number of shares to be delivered under the contract is small relative to the daily trading volume of that security
- Commodities traded in an active market (e.g., gold, crude oil, gas)
- A unit of foreign currency that is readily convertible into the reporting entity's functional currency and no regulatory restrictions govern the trade of the currency, as described in ASC 815-10-15-121

ASC 815-10-15-129 points out that the ability to use an asset as collateral in a borrowing does not in and of itself mean that the asset is readily convertible to cash.

### Readily convertible to cash analysis

The term "readily convertible to cash" is defined in the ASC Master Glossary.

**Master Glossary – Readily Convertible to Cash**

Assets that are readily convertible to cash have both of the following:

a. Interchangeable (fungible) units

b. Quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.

All of the following conditions must exist for the assets to be delivered under a contract to be deemed readily convertible to cash:

- The assets are interchangeable, fungible units.
- They have prices quoted in an active market.
- The quantity to be delivered can be rapidly absorbed in an active market without significantly affecting the price.
- The conversion costs are not significant.

Each of these requirements is discussed further below.

### Assets that are interchangeable (fungible) units

For assets to be delivered to be considered readily convertible to cash so that a contract can be considered to have the net settlement characteristic of a derivative, the assets must be interchangeable. This would be the case if any one of the individual assets within the group could replace any one of the other assets within that group without the replacement making a difference or being noticed. Commodity products of the same likeness (e.g., bushels of wheat) as well as many manufactured products of the same likeness (e.g., rubber tires of the same exact type) are considered indistinguishable from one another.

### Quoted prices in an active market

For assets to be delivered to be considered readily convertible to cash so that a contract can be considered to have the net settlement characteristic of a derivative, the assets must have prices quoted in an active market.

The term "active market" is defined in the ASC Master Glossary.

**Master Glossary – Active Market**

A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

### The market must be able to rapidly absorb the quantity of assets to be delivered without significantly affecting the quoted price

For the assets to be delivered under a contract to be considered readily convertible to cash so that a contract can be considered to have the net settlement characteristic of a derivative, the market must be active enough to be able to rapidly absorb the quantity of assets to be delivered without significantly affecting the quoted price. To determine this, an entity should consider the quantity of the asset to be delivered under the contract relative to the daily transaction volume of that asset. In addition, an entity should consider the effect on the market price of the asset if that quantity of the asset was sold within a few days as well as the feasibility of doing so. Generally, a publicly traded security can be rapidly absorbed in an active market without a significant effect on the quoted price of the security if the number of shares of the security is small relative to the shares daily trading volume. Although GAAP does not provide a definition of "within a few days," we have observed in practice that this is typically viewed to mean less than one week. Therefore, if the quantity of assets to be delivered could be sold in less than one week without significantly affecting the market price of those assets, we believe that the assets would be considered readily convertible to cash, assuming the other conditions are met.

A contract may involve the delivery of assets on multiple dates. ASC 815-10-15-128 requires an entity to determine whether the expected quantity of each delivery can be rapidly absorbed in the market without significantly affecting the quoted price. For example, if an entity contracts to deliver 1,000 units of a particular commodity on the first day of the month over an 18-month period, the entity does not consider whether the market can rapidly absorb 18,000 units on a single date. Rather, consistent with the contract, it determines whether the market can rapidly absorb 1,000 units of the commodity on the first day of each month over the 18-month period without significantly affecting the price of the commodity on those dates. A contract may not specify multiple delivery dates, but may instead allow for settlement in increments. For example, a contract may permit the entity to purchase 18,000 units in minimum increments of 1,000 units over the course of the next 18 months, in which case the minimum increment of 1,000 units would be compared to the daily transaction volume of the asset in determining if it could be rapidly absorbed in the market. See Example 3-9.

ASC 815 provides the following example illustrating how to consider daily transaction volumes when determining if net settlement exists. This example discusses net settlement in the context of embedded derivatives rather than a freestanding instrument. More specifically, it discusses a single bond with multiple embedded conversion options and multiple bonds each having a single embedded conversion option. Although the example involves embedded derivatives, the concepts regarding net settlement are the same for an embedded derivative and a freestanding instrument. Refer to Chapter 4 for further information on embedded derivatives.

**Example 3-7: Net settlement—Readily convertible to cash - effect of daily transaction volumes (ASC 815-10-55-99 through 55-110)**

The following Cases illustrate consideration of the relevance of daily transaction volumes to the characteristic of net settlement in deciding whether, from the investor's perspective, the convertible bond contains an embedded derivative that must be accounted for separately:

a. Single bond with multiple conversion options (Case A)

b. Multiple bonds each having single conversion option (Case B).

The Cases illustrate that the form of the financial instrument is important; paragraph 815-10-15-123 explains that individual instruments cannot be combined for evaluation purposes to circumvent

compliance with the criteria beginning in paragraph 815-10-15-119. Further, paragraph 815-10-15-111(c) explains that contracts shall be evaluated on an individual basis, not on an aggregate-holdings basis.

**Case A: Single Bond with Multiple Conversion Options**

Investor A holds a convertible bond classified as an available-for-sale security under Topic 320. The bond has all of the following additional characteristics:

a. It is not exchange-traded and can be converted into common stock of the debtor, which is traded on an exchange.

b. It has a face amount of $100 million and is convertible into 10 million shares of common stock.

c. It may be converted in full or in increments of $1,000 immediately or at any time during the next 2 years.

d. If it were converted in a $1,000 increment, Investor A would receive 100 shares of common stock.

Assume further that the market condition for the debtor's stock is such that up to 500,000 shares of its stock can be sold rapidly without the share price being significantly affected.

The embedded conversion option meets the criteria in paragraph 815-10-15-83(a) through (b) but does not meet the criteria in paragraphs 815-10-15-100 and 815-10-15-110, in part because the option is not traded and it cannot be separated and transferred to another party.

It is clear that the embedded equity conversion feature is not clearly and closely related to the debt host instrument. [**RSM Commentary**: As discussed in Chapter 4, this factor is relevant in determining if an embedded derivative requires separate recognition from the host contract.]

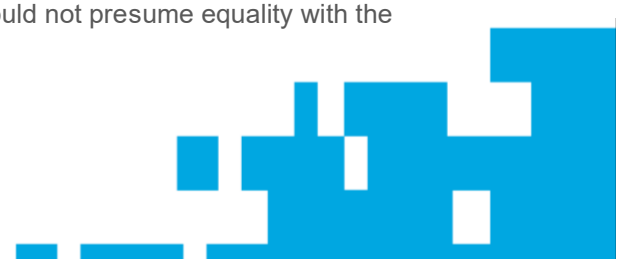
The bond may be converted in $1,000 increments and those increments, by themselves, may be sold rapidly without significantly affecting price, in which case the criteria discussed beginning in paragraph 815-10-15-119 would be met. However, if the holder simultaneously converted the entire bond, or a significant portion of the bond, the shares received could not be readily converted to cash without incurring a significant block discount.

From Investor A's perspective, the conversion option should be accounted for as a compound embedded derivative in its entirety, separately from the debt host, because the conversion feature allows the holder to convert the convertible bond in 100,000 increments and the shares converted in each increment are readily convertible to cash under the criteria discussed beginning in paragraph 815-10-15-119. Investor A need not determine whether the entire bond, if converted, could be sold without affecting the price. [**RSM Commentary**: The conversion option would also be a compound embedded derivative from the bond issuer's perspective; however, ASC 815-10-15-74(a) provides an exception to derivative treatment such that the issuer would not account for it as a derivative instrument if all the requirements to apply that exception are met.]

Because the $100 million bond is convertible in increments of $1,000, the convertible bond is essentially embedded with 100,000 equity conversion options, each with a notional amount of 100 shares. Each of the equity conversion options individually has the characteristic of net settlement discussed beginning in paragraph 815-10-15-119 because the 100 shares to be delivered are readily convertible to cash. Because the equity conversion options are not clearly and closely related to the host debt instrument, they must be separately accounted for. However, because an entity cannot identify more than 1 embedded derivative that warrants separate accounting, the 100,000 equity conversion options must be bifurcated as a single compound derivative. (Paragraphs 815-15-25-7 through 25-10 say an entity is not permitted to account separately for more than one derivative feature embedded in a single hybrid instrument.)

There is a substantive difference between a $100 million convertible debt instrument that can be converted into equity shares only at one time in its entirety and a similar instrument that can be converted in increments of $1,000 of tendered debt; the analysis of the latter should not presume equality with the former.





**Case B: Multiple Bonds Each Having Single Conversion Option**

Investor B has 100,000 individual $1,000 bonds that each convert into 100 shares of common stock. Assume those bonds are individual instruments but they were issued concurrently to Investor B.

From Investor B's perspective, the individual bonds each contain an embedded derivative that must be separately accounted for. Each individual bond is convertible into 100 shares, and the market would absorb 100 shares without significantly affecting the price of the stock.

## Significance of conversion costs

For the assets to be delivered to be considered readily convertible to cash so that a contract can be considered to have the net settlement characteristic of a derivative, the transaction costs of conversion must not be significant. This is because significant transaction costs would affect whether an entity would be indifferent to settling the contract on a net cash basis or by receiving the assets associated with the underlying of the contract and converting those assets to cash. The costs to be considered are not only transaction fees and sales commissions, but any cost to obtain the asset and convert it to cash, (e.g., transportation, maintenance, storage).

ASC 815-10-15-125 through 15-127 provides guidance for purposes of assessing the significance of conversion costs.

**ASC 815-10-15-125**

If an entity determines that the estimated costs that would be incurred to immediately convert the asset to cash are not significant, then receipt of that asset puts the entity in a position not substantially different from net settlement. Therefore, an entity shall evaluate, in part, the significance of the estimated costs of converting the asset to cash in determining whether those assets are readily convertible to cash.

**ASC 815-10-15-126**

For purposes of assessing significance of such costs, an entity shall consider those estimated conversion costs to be significant only if they are 10 percent or more of the gross sales proceeds (based on the spot price at the inception of the contract) that would be received from the sale of those assets in the closest or most economical active market.

**ASC 815-10-15-127**

The assessment of the significance of those conversion costs shall be performed only at inception of the contract.

### Determining whether shares of stock are readily convertible to cash

A financial instrument or other contract may require settlement by delivery of shares of stock. As indicated in ASC 815-10-15-130, if a contract will be settled by delivering a security that is publicly traded in a market that is not very active, determining whether the security is readily convertible to cash hinges on the amount of shares or other units of the security to be delivered relative to the daily trading volume of that security. If the number of shares of the security to be delivered is relatively small compared to the daily trading volume, the security is readily convertible to cash, assuming the other conditions are met. However, that same security would not be readily convertible to cash if the number of shares to be exchanged is large relative to the daily trading volume. See Example 7 that begins in ASC 815-10-55-99. The need to consider the smallest increment is applicable here, as well as in the aforementioned example.

## Stock purchase warrants

Stock purchase warrants generally give the holder the ability to purchase a stated number of an entity's shares for a stated price during a stated term. These warrants may meet the definition of a derivative instrument, either because they have a cashless exercise provision (i.e., net share settlement exists as illustrated under ASC 815-10-55-90) or because the shares to be delivered if the warrant is exercised are readily convertible to cash.

Stock purchase warrants often place restrictions on the sale or transfer of the shares of stock that are received from the exercise of the warrant. These restrictions may affect whether the shares to be delivered under the warrant are considered readily convertible to cash. In accordance with ASC 815-10-15-131 through 15-138, if the issuer restricts the sale or transfer of the underlying stock for more than 31 days from the date the warrant is exercised, the stock would not be considered readily convertible to cash unless the holder has the ability, by contract or otherwise, to cause a requirement to sell to be met within 31 days of exercise. Conversely, an issuer's restriction only on the ability to post the shares as collateral would not by itself prevent the stock from being considered readily convertible to cash. If the shares of actively traded stock to be received upon the exercise of the stock purchase warrant can be reasonably expected to qualify for sale within 31 days of exercise, which may be the case for example under SEC Rule 144, such shares would be considered readily convertible to cash, absent any greater issuer-imposed restriction. It is important to note that even if there are no restrictions on the sale of the shares, the entity would still consider whether the shares can be readily converted to cash, as discussed further in ASC 815-10-15-136. Additionally, as noted in ASC 815-10-15-132, the accounting for restricted stock to be received upon exercise of a warrant should not be applied to other types of contracts by analogy.

### Ongoing assessment of a market mechanism and whether the assets to be delivered are readily convertible to cash

ASC 815-10-15-118 requires an entity to perform the assessment of whether a market mechanism exists at the inception of a contract and on an ongoing basis throughout the life of a contract. Similarly, ASC 815-10-15-139 requires an entity to assess whether the assets to be delivered under a financial instrument or a contract are readily convertible to cash at the inception of a contract and on an ongoing basis. Conclusions reached may change as market activity changes. The following example illustrates these requirements.

**Example 3-8: Net settlement at inception and throughout a contract's life (ASC 815-10-55-84 through 55-89)**

As required by paragraphs 815-10-15-110 through 15-118 and 815-10-15-119 through 15-120, respectively, the evaluation of whether a market mechanism exists and whether items to be delivered under a contract are readily convertible to cash must be performed at inception and on an ongoing basis throughout a contract's life. For example, if a market develops, if an entity effects an initial public offering, or if daily trading volume changes for a sustained period of time, then those events need to be considered in reevaluating whether the contract meets the definition of a derivative instrument. Similarly, if events occur after the inception or acquisition of a contract that would cause a contract that previously met the definition of a derivative instrument to cease meeting the criteria (for example, an entity becomes delisted from a national stock exchange), then that contract cannot continue to be accounted for under this Subtopic. The guidance in paragraphs 815-10-15-125 through 15-127 about assessing the significance of transaction costs is not relevant when determining whether such a contract no longer meets the definition of a derivative instrument.

The following Cases illustrate the importance of ongoing evaluation:

a. Market mechanism develops after contract inception (Case A).

b. Initial public offering makes shares readily convertible to cash after contract inception (Case B).

c. Increased trading activity makes shares readily convertible to cash after contract inception (Case C).

d. Delisting makes shares not readily convertible to cash after contract inception (Case D).

**Case A: Market Mechanism Develops After Contract Inception**

A purchase contract for future delivery of commodity X is entered into and, at the inception of the contract, the market for contracts on commodity X is a relatively thin market, such that brokers do not stand ready to buy and sell the contracts. As time passes, the market for commodity X matures and broker-dealer networks develop. The existence of the broker-dealer market and the ability of the purchaser to be relieved of its rights and obligations under the purchase contract are consistent with the characteristics of a market mechanism as discussed beginning in paragraph 815-10-15-110. Accordingly, the purchase contract will have the characteristics of net settlement as defined by paragraph 815-10-15-110 as broker-dealer networks develop.

**Case B: Initial Public Offering Makes Shares Readily Convertible to Cash After Contract Inception**

A nontransferable forward contract on a nonpublic entity's stock that provides only for gross physical settlement is generally not a derivative instrument because the net settlement criteria are not met. If the entity, at some point in the future, accomplishes an initial public offering of its shares and the original contract is still outstanding, the shares to be delivered would be considered to be readily convertible to cash (assuming that the shares under the contract could be rapidly absorbed in the market without significantly affecting the price).

**Case C: Increased Trading Activity Makes Shares Readily Convertible to Cash After Contract Inception**

A nontransferable forward contract on a public entity's stock provides for delivery on a single date of a significant number of shares that, at the inception of the contract, would significantly affect the price of the public entity's stock in the market if sold within a few days. As a result, the contract does not satisfy the readily-convertible-to-cash criterion. However, at some later date, the trading activity of the public entity's stock increases significantly. Upon a subsequent evaluation of whether the shares are readily convertible to cash, the number of shares to be delivered would be minimal in relation to the new average daily trading volume such that the contract would then satisfy the net settlement characteristic.

**Case D: Delisting Makes Shares Not Readily Convertible to Cash After Contract Inception**

A nontransferable forward contract on a public entity's stock meets the net settlement criteria (as discussed beginning in paragraph 815-10-15-119) in that, at inception of the contract, the shares are expected to be readily convertible to cash when delivered under the contract. Assume that there is no other way that the contract meets the net settlement criteria. The public entity subsequently becomes delisted from the stock exchange, thus causing the shares to be delivered under the contract to no longer be readily convertible to cash.

The following example illustrates the effect of multiple deliveries on the analysis of the net settlement characteristic of a derivative instrument.

**Example 3-9: Net settlement—Effect of multiple deliveries (ASC 815-10-55-111 through 55-117)**

This Example illustrates the effect of multiple deliveries on the consideration of net settlement described in Section 815-10-15. An entity has a five-year supply contract that obligates it to deliver at a specified price each month a specified quantity of a commodity that has interchangeable (fungible) units and for which quoted prices are available in an active market. However, the quoted prices that are available are for either a spot sale or a forward sale of the commodity with a maturity of 12 months or less. In other words, the forward market for the commodity beyond the next 12 months does not currently exist and is not expected to develop. There are brokers who are willing to take over the rights and obligations relating to the next 12 months of the supply contract, but not for periods beyond the next 12 months. With respect to the active spot market for the commodity, it can rapidly absorb the quantity specified in the supply contract for each individual month but not the total quantity for the entire five-year period in a single transaction (or in multiple transactions over the course of a day or so).

The supply contract does not contain a net settlement provision as described in paragraphs 815-10-15-100 through 15-109.

The 5-year commodity supply contract does not meet the net settlement characteristic in paragraph 815-10-15-110 at its inception because there is no market mechanism to net settle the entire 5-year contract—the forward market exists only for the next 12 months while the contract period is for the next 5 years. Accordingly, there is no market mechanism for the entity to settle the entire contract on a net basis. However, if the contract contained contractually separable increments that individually met the net settlement criteria, those contractually separable increments may be embedded derivatives. In this instance, the brokers in the market will not assume the rights and obligations of the entire contract. Note that the market mechanism in the net settlement characteristic in paragraph 815-10-15-110 relates to whether a party to the contract can be relieved of its rights and obligations under the entire contract, not merely whether an independent broker in the market stands ready to assume the selected rights and obligations.

The definition of a derivative instrument in this Subtopic must be applied based on the actual terms of the contract, including its maturity date and the total quantity of the underlying. This Subtopic does not permit bifurcation of a 5-year contract into 5 annual contracts, 60 monthly contracts, or 1,826 daily contracts in an attempt to assert that only a portion of the contract meets the definition of a derivative instrument. To do so would be to disregard one of the critical terms of the contract, that is, the term to the maturity date of the contract.

Based on the guidance in paragraph 815-10-15-3, the five-year commodity supply contract in the example, would, at the beginning of the fifth year, be reevaluated to determine whether the contract meets the net settlement characteristic in paragraph 815-10-15-110 and would likely meet the characteristic because a forward market for the contract would then exist for the remaining term of the contract.

The five-year commodity supply contract meets the net settlement characteristic as discussed beginning in paragraph 815-10-15-119. The criterion discussed beginning in that paragraph is met because an active spot market for the commodity exists today and is expected to be in existence in the future for each delivery date (for example, for quantities to be delivered each day or each month for the next five years) under the multiple delivery supply contract. The spot market can rapidly absorb the quantities specified for each monthly delivery without significantly affecting the price. The fact that the spot market may not be able to absorb within a few days the quantity specified in the entire five-year contract is irrelevant because the performance of the contract is spread out over a five-year period and, therefore, is not expected to occur within a few days.

This Example does not address whether the contract would qualify for the normal purchases and normal sales scope exception as discussed beginning in paragraph 815-10-15-22.

## 3.3 Scope exceptions

The scope of ASC 815 is comprised of a broadly crafted definition of a derivative instrument along with an extensive list of scope exceptions. The FASB intentionally created a broad definition of a derivative instrument to ensure that instruments that truly are derivatives were captured by the definition. However, given the breadth of the definition, certain instruments that the FASB did not intend to be accounted for as derivatives may meet the definition of a derivative instrument. As a result, ASC 815 contains many scope exceptions, which are discussed in this section.

The following table provides a high-level summary of each of the instruments and contracts listed in ASC 815-10-15-13 that are exempt from the derivative accounting requirements of ASC 815. Each of the scope exceptions and the requirements that need to be met for them to apply are described further in subsequent sections of this chapter.

| Scope exception | Can apply to: | Description of contracts scoped out |
|---|---|---|
| Regular-way security trades (ASC 815-10-15-15 through 15-21) | Both parties to the contract | A contract in which the securities to settle the contract are delivered within the regulatory required period of time or the marketplace's generally accepted period of time following the trade date. For example, if a security is generally settled the next business day, but the contract allows for up to a week for settlement, the regular-way scope exception cannot be applied. |
| Normal purchases and normal sales (ASC 815-10-15-22 through 15-51) | Both buyer and seller (the buyer and seller may come to different conclusions) | A contract for the purchase or sale of a commodity or other non-financial instrument that will be delivered in quantities expected to be used or sold by the reporting entity in the normal course of its business. |
| Certain insurance contracts and market risk benefits (ASC 815-10-15-52 through 15-57) | The holder and issuer of the contract | Certain insurance contracts that entitle the holder of the contract to be compensated only as a result of an identifiable insurable event other than a change in price. |
| Certain financial guarantee contracts (ASC 815-10-15-58) | The guarantor and guaranteed party | A financial guarantee that meets very narrow criteria, including the fact that the guarantee provides for payments to be made to the guaranteed party solely to reimburse that party for an obligor's failure to make a payment to the guaranteed party. |
| Certain nonexchange-traded contracts (ASC 815-10-15-59 through 15-62) | Both parties to the contract | A contract that is not traded on an exchange and that has any of the following as an underlying:[1]<br>• A climatic, geological or other physical variable<br>• The price or value of a nonfinancial asset of one of the parties to the contract that meets certain conditions |

[1] Following the adoption of ASU 2025-07, an additional underlying is added to the listing: "an underlying that is based on operations or activities specific to one of the parties to the contract." Additionally, the citation references will be updated to ASU 815-10-15-59 through 15-60 and 15-62. Refer to the ASU for effective date and transition requirements.

| Scope exception | Can apply to: | Description of contracts scoped out |
|---|---|---|
| | | • The price or value of a nonfinancial liability of one of the parties to the contract that meets certain conditions<br>• Specified volumes of sales or service revenues of one of the parties to the contract |
| Derivative instruments that impede sale accounting (ASC 815-10-15-63 through 15-64) | The seller or transferor and buyer | A freestanding or embedded derivative whose existence serves as an impediment to recognizing a related contract as a sale by one party or a purchase by the other party. |
| Investments in life insurance (ASC 815-10-15-67) | The investor | A policyholder's investment in a life insurance contract (e.g., corporate- or bank-owned life insurance) that is accounted for in accordance with ASC 325-30. |
| Certain investment contracts (ASC 815-10-15-68 through 15-68A) | The investor | The following type of investments of a defined benefit plan:<br>• Investments accounted for under ASC 960-325-35-1<br>• Insurance contracts accounted for under ASC 960-325-35-3 |
| Certain loan commitments (ASC 815-10-15-69 through 15-71) | The lender<br><br>The borrower | All commitments that a lender makes to originate a loan other than a commitment for a mortgage loan that will be held for sale.<br><br>Any loan commitment held by a borrower. |
| Certain interest- or principal-only strips (ASC 815-10-15-72 through 15-73) | The issuer and investor | Interest- or principal-only strips that result from separating a debt instrument into:<br>• An instrument that entitles its holder to receive payments associated with the repayment of the principal of the debt instrument<br>• An instrument that entitles its holder to receive payments associated with the payments of interest on the principal balance of the debt instrument |
| Certain contracts involving an entity's own equity (ASC 815-10-15-74 through 15-78) | The issuer of the underlying shares, with the exception of the third bullet point, which may apply to both parties | • Contracts issued or held by a reporting entity that are both indexed to its own stock and classified in stockholders' equity<br>• Contracts subject to ASC 718<br>• Certain contracts to enter into:<br>- A business combination<br>- Acquisition by or merger of a not-for-profit entity<br>- Joint venture formation contracts within the scope of ASC 805-60<br>• Certain forward contracts that require the reporting entity to deliver cash in exchange for the acquisition of a fixed number of its equity shares |

| Scope exception | Can apply to: | Description of contracts scoped out |
|---|---|---|
| Leases (ASC 815-10-15-79) | The lessor and lessee | A lease that is within the scope of ASC 842. |
| Residual value guarantees (ASC 815-10-15-80 through 15-81) | The party who accounts for the residual value guarantee under 842 | A residual value guarantee that is within the scope of ASC 842. |
| Registration payment arrangements (ASC 815-10-15-82) | Both parties to the arrangement | A registration payment arrangement that is within the scope of ASC 825-20. |
| Certain fixed-odds wagering contracts (ASC 815-10-15-82A) | The casino or entity with casino operations | A fixed-odds wagering contract that is within the scope of ASC 606 for an entity operating as a casino and for the casino operations of other entities. |

### 3.3.1 Regular-way security trades

The definition and example of regular-way security trades are provided in ASC 815-10-15-15.

**ASC 815-10-15-15**

Regular-way security trades are defined as contracts that provide for delivery of a security within the period of time (after the trade date) generally established by regulations or conventions in the marketplace or exchange in which the transaction is being executed. 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 scope exception applies, but if the contract requires settlement in five days, the regular-way security trades scope exception does not apply unless the reporting entity is required to account for the contract on a trade-date basis.

If net settlement exists (e.g., contractually, through delivery of a security that is readily convertible to cash or through a market mechanism), a typical purchase or sale of a security would generally meet the definition of a derivative instrument from its trade date until the purchase or sale is settled. However, the FASB did not intend for an entity to account for such transactions as derivative instruments between their trade and settlement dates. For this reason, the regular-way security trades scope exception was established. For a contract that meets the conditions of the regular-way security trades scope exception in ASC 815-10-15-15 through 15-20, neither the purchaser nor seller of the security will account for it as a derivative instrument.

For an entity to properly analyze whether a contract meets this scope exception, it is crucial that the entity understands the customary settlement period, as well as the regulations and marketplace conventions of the relevant market. Previously in the U.S., the standard settlement cycle for most broker-dealer security trades was within two business days. However, in February 2023, the SEC adopted a final rule that shortened the standard settlement cycle for most broker-dealer transactions to one day after trade. The compliance date for this rule was May 28, 2024. The guidance in ASC 815-10-15-15 was not amended for this change in standard settlement cycles. However, we believe it is important for an entity to consider current regulations and conventions in the marketplace or exchange in which the transaction is being executed when determining if this scope exception applies.

Further discussion of which transactions may qualify for the regular-way security trades scope exception is provided in ASC 815-10-15-16 through 15-17.

**ASC 815-10-15-16**

Except as provided in (a) in the following paragraph, a contract for an existing security does not qualify for the regular-way security trades scope exception if either of the following is true:

a. It requires or permits net settlement (as discussed in paragraphs 815-10-15-100 through 15-109).

b. A market mechanism exists to facilitate net settlement of that contract (as discussed in paragraphs 815-10-15-110 through 15-118).

**ASC 815-10-15-17**

The scope exception for regular-way security trades applies only to a contract that requires delivery of securities that are readily convertible to cash except that the scope exception also shall or may apply in any of the following circumstances:

a. If an entity is required, or has a continuing policy, to account for a contract to purchase or sell an existing security on a trade-date basis, rather than a settlement-date basis, and thus recognizes the acquisition (or disposition) of the security at the inception of the contract, then the entity shall apply the regular-way security trades scope exception to that contract.

b. If an entity is required, or has a continuing policy, to account for a contract for the purchase or sale of when-issued securities or other securities that do not yet exist on a trade-date basis, rather than a settlement-date basis, and thus recognizes the acquisition or disposition of the securities at the inception of the contract, that entity shall apply the regular-way security trades scope exception to those contracts.

c. Contracts for the purchase or sale of when-issued securities or other securities that do not yet exist, except for those contracts accounted for on a trade-date basis, are excluded from the requirements of this Subtopic as a regular-way security trade only if all of the following are true:

   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,

   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. (The entity shall document the basis for concluding that it is probable that the contract will not settle net and will result in physical delivery.)

Example 9 (see paragraph 815-10-55-118) illustrates the application of item (c) in this paragraph.

Entities can generally make an accounting policy election to account for sales (and purchases) of securities on either the trade date or settlement date. Trade date accounting is required for brokers and dealers, investment companies, depository and lending institutions and certain benefit plans. Because trading securities are accounted for at fair value with changes in fair value reported in earnings, an entity that applies trade date accounting would not record a derivative instrument between the trade date and settlement date.

### 3.3.1.1 "When-issued" or "to-be announced" securities

Some securities are purchased on what is commonly referred to as a "when-issued" basis. That is, at the time of purchase, the security does not exist, but there is a contractual agreement to deliver the security when it is issued at a later date. A common example of this would be the purchase of mortgage-backed securities that will arise from a planned securitization. In accordance with ASC 815-10-15-17(c), a

contract to purchase or sell a when-issued security, or another security that does not yet exist, is a regular-way security trade and is excluded from the requirements of ASC 815 if it meets the following conditions:

- There is no other way to purchase or sell that security.
- Delivery of that security and settlement will occur within the shortest period possible for that type of security.
- 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. (The entity shall document the basis for concluding that it is probable that the contract will not settle net and will result in physical delivery.)

An entity should document its rationale for concluding that it is probable, both at inception and throughout the life of the contract, that it will result in physical delivery, not net settlement. An entity's subsequent decision to net settle contracts to which it originally applied the regular-way security trades scope exception would call into question the entity's application of this exception to other similar contracts.

Contrary to the guidance in ASC 815-10-15-16, which applies to contracts to purchase or sell securities that are in existence, the guidance provided in ASC 815-10-15-19 for the purchase or sale of when-issued securities or other securities that do not yet exist indicates that such transactions are eligible for the regular-way security trades scope exception (as discussed in ASC 815-10-15-17) even if either of the following are true:

- That contract permits net settlement (as discussed in ASC 815-10-15-100 through 15-109).
- A market mechanism exists to facilitate net settlement of that contract (as discussed in ASC 815-10-15-110 through 15-118).

A "to-be-announced" security may offer a choice of settlement dates. Example 9 in ASC 815-10-55-118 through 55-120 illustrates the application of this scope exception in such a circumstance.

**Example 3-10: Regular-way security trades-shortest-period criterion (ASC 815-10-55-118 through 55-120)**

This Example illustrates the application of paragraph 815-10-15-17(c). Assume a variety of forward contracts exists for a when-issued security, such as a to-be-announced security, that provides a choice of settlement dates for each of the next three months (such as November, December, or January). An entity enters into a forward contract to purchase the to-be-announced security, which will otherwise meet the qualifications of paragraphs 815-10-15-13 through 15-20, that requires delivery in the second-nearest month (such as December), not the nearest month (such as November). The entity may not apply the regular-way security trade exception to the forward purchase contract that requires delivery of the to-be-announced security in the second-nearest month (such as December).

In this Example, the to-be-announced security (identified by issuer, contractual maturity of the underlying loans, and the net coupon, such as 30-year Government National Mortgage Association [GNMA] securities bearing interest of 7 percent) is available under multiple settlement periods (that is, the standardized settlement date in November, December, or January). The regular-way security trade exception may be applied only to forward contracts for that to-be-announced security that require delivery in November, the shortest period permitted for that type of to-be-announced security. The December and January settlement to-be-announced forward contracts must be accounted for as derivative instruments under this Subtopic.

If the forward contracts in this Example meet the hedge accounting criteria, they may be designated in cash flow hedges of the anticipated purchase of the securities, as discussed in paragraph 815-20-25-22.

#### 3.3.1.2 Repurchase agreements, wash sales and short sales

ASC 815-10-55-56 addresses repurchase agreements and wash sales where a security is transferred in a transaction that is accounted for as a sale and the transferor is obligated and entitled to repurchase the transferred security at a fixed or determinable price. Generally, the repurchase element of these transactions requires derivative accounting treatment if the net settlement characteristic of a derivative instrument is met.

Short sales of securities (also referred to as sales of borrowed securities) typically involve all of the following activities (noted in ASC 815-10-55-57), which are generally documented in three separate contracts:

- Selling a security (by the short seller to the purchaser)
- Borrowing a security (by the short seller from the lender)
- Delivering the borrowed security (by the short seller to the purchaser)
- Purchasing a security (by the short seller from the market)
- Delivering the purchased security (by the short seller to the lender)

As noted in ASC 815-10-55-58 through 55-59, these arrangements typically do not constitute derivative instruments. However, they may if there is a forward purchase or sale involved that does not qualify for the regular-way security trades scope exception.

### 3.3.2 Normal purchases and normal sales

It is not uncommon that a contract to buy or sell a fungible asset, like a commodity, meets the definition of a derivative instrument. However, the FASB did not intend for contracts that result in the delivery of a commodity or other asset in quantities that are to be used or sold in the normal course of an entity's business to be accounted for as derivative instruments. This is why the FASB established the normal purchases and normal sales scope exception.

A contract that meets the conditions of the normal purchases and normal sales scope exception in ASC 815-10-15-22 through 15-51 is not required to be accounted for as a derivative instrument. This is the only scope exception in ASC 815 that is optional. One of the conditions to take advantage of this scope exception is to document the designation of the contract as a normal purchase or normal sale. Although the designation may be made at inception or on a later date, the proper documentation must be prepared contemporaneously with the application of the scope exception. If the designation is made after inception, a contract that meets all the characteristics of a derivative instrument is accounted for as a derivative instrument until the designation is made.

ASC 815-10-15-22 provides an explanation of what constitutes normal purchases and normal sales.

> **ASC 815-10-15-22**
>
> 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.

Given the preceding explanation, an entity seeking to take advantage of this derivative scope exception should assess the quantities subject to a purchase or sales contract with consideration to the operational requirements of its business. Although the preceding guidance refers to selling in the normal course of business, we believe that the normal purchases and normal sales scope exception does not apply to trading activities where the objective is to make a profit on market price movements.

Consistent with ASC 815-10-15-23 and 15-39, an entity performs the overall assessment as to whether a contract qualifies for the normal purchases and normal sales scope exception at the inception of the

contract or, if later, at the date the entity decides to elect to account for that contract as a normal purchase or normal sale. However, as noted in ASC 815-10-15-35, an entity needs to consider whether it remains probable that a contract that has contractual net settlement provisions or a market mechanism for net settlement will result in physical delivery of the asset and not net settle on an ongoing basis.

This scope exception may be available to both the buyer and seller. As described in ASC 815-10-15-24, the buyer and seller could come to different conclusions related to whether they qualify for the scope exception. For example, the seller may expect the quantities that are subject to the contract to be sold over a reasonable period in the normal course of business, but the buyer may not expect to use the quantities over a reasonable period in the normal course of business (or vice versa). Additionally, even if both parties qualify for the scope exception, they may make different decisions about whether they want to elect it. Consider the example below.

**Example 3-11: Normal purchases and normal sales – Differing elections**

A-1 Manufacturer enters into long-term purchase contracts with its oil supplier that have all the characteristics of a derivative instrument to lock in a fixed oil price for quantities that are reflective of its expected future needs. A-1 Manufacturer does not want the earnings volatility associated with carrying these contracts as derivative assets or liabilities and continuously adjusting the carrying amounts to fair value through earnings. A-1 Manufacturer therefore designates the contracts as normal purchase contracts as discussed in ASC 815-10-15-37 after verifying that it meets all the requirements to do so.

In addition to entering into fixed price contracts to sell oil to its customers like A-1 Manufacturer, A-1's oil supplier also enters into derivative futures contracts to lock in its purchase price of oil and protect its gross margin. A-1's oil supplier decides not to designate the contracts with A-1 Manufacturer as normal sales contracts, as it prefers to account for these contracts as derivative instruments so that the earnings impact from adjusting the carrying amount of these contracts to fair value through earnings offsets the earnings impact of accounting for the related futures contracts as derivative instruments at fair value through earnings.

**RSM COMMENTARY: Typical commodity contracts**

If the normal purchases and normal sales scope exception is properly elected and applied (i.e., all of the required conditions, including documentation requirements, are met), typical contracts for the purchase or sale of commodities, inventory and other nonfinancial assets are not required to be accounted for as derivative instruments even if the contract otherwise meets the definition of a derivative instrument. Instead, reporting entities should look to other relevant GAAP including, ASC 606, *Revenue from Contracts with Customers,* when accounting for sale contracts. As it relates to purchase contracts, ASC 330-10-35-17 requires an entity to recognize a net loss for firm unhedged inventory purchase commitments (measured the same way as inventory losses).

The conditions that must be met to apply the normal purchases and normal sales scope exception are described in further detail in the subsequent sections. These conditions relate to:

- Normal terms
- Clearly and closely related underlying
- Probable physical settlement
- Documentation

### 3.3.2.1 Normal terms

A contract must have normal terms to qualify for the normal purchases and normal sales scope exception. A basic premise underlying the normal purchases and normal sales scope exception is that the terms of a contract must be consistent with an entity's normal purchases or normal sales. This means that the quantity to be purchased or sold must be reasonable in relation to the entity's business needs, as indicated in ASC 815-10-15-27. These determinations require judgment.

ASC 815-10-15-28 through 15-29 provides guidance for determining whether a contract includes normal terms in relation to an entity's business requirements.

**ASC 815-10-15-28**

In making those judgments, an entity should consider all relevant factors, including all of the following:

a. The quantities provided under the contract and the entity's need for the related assets

b. The locations to which delivery of the items will be made

c. The period of time between entering into the contract and delivery

d. The entity's prior practices with regard to such contracts

**ASC 815-10-15-29**

Further, each of the following types of evidence should help in identifying contracts that qualify as normal purchases or normal sales:

a. Past trends

b. Expected future demand

c. Other contracts for delivery of similar items

d. An entity's and industry's customs for acquiring and storing the related commodities

e. An entity's operating locations

For guidance on normal purchases and normal sales as hedged items, see paragraph 815-20-25-7.

As an example, an entity may conclude that a forward contract to purchase two tons of steel would be for a quantity that it expects to use over a reasonable period in the normal course of its business if it normally enters into contracts to purchase two tons of steel, has consistently used those quantities in its manufacturing process within a reasonable period of time and expects demand to be stable. However, if that same entity entered into a contract to purchase two tons of steel at a time when it expected future demand to be much lower, the entity may conclude that the contract would not qualify for the normal purchases and normal sales scope exception because it would not have terms that are normal in relation to its business needs. However, in coming to this conclusion, the entity would have to apply its judgment and consider the factors and evidence as described in the guidance in ASC 815-10-15-28 through 15-29. When determining if the quantity to be purchased or sold is reasonable in relation to the entity's business needs, an entity would need to consider its purchase or sales contracts in the aggregate in comparison to its needs.

A contract that does not contain normal terms does not qualify for the normal purchases and normal sales scope exception. A contract that contains normal terms must also meet all other applicable conditions in ASC 815-10-15-30 through 15-51 to qualify for this scope exception.

### 3.3.2.2 Clearly and closely related underlying

Although purchase or sale contracts for items like commodities that will be used or sold in the normal course of business often specify a fixed price, contracts may also have variable pricing or fixed pricing that includes an adjustment based on a market index or other factor. The pricing in the contract must be "clearly and closely related" to the asset being purchased or sold, as noted in ASC 815-10-15-30, for the contract to qualify for the normal purchases and normal sales scope exception. The term "clearly and closely related" means something different in this context than it does in the context of assessing whether an embedded derivative requires bifurcation (Refer to Chapter 4 for a discussion on embedded derivatives). For example, if a contract to sell jet fuel contains a price formula tied to a crude oil index, the pricing in the contract would be considered "clearly and closely related" to the asset being sold because jet fuel is refined from crude oil. On the other hand, if the pricing of the jet fuel was tied to the equity shares of airlines, the contract would fail to meet the "clearly and closely related underlying" condition.

ASC 815-10-15-31 provides guidance on analyzing the phrase "clearly and closely related."

**ASC 815-10-15-31**

For purposes of determining whether a contract qualifies for the normal purchases and normal sales scope exception, the application of the phrase not clearly and closely related to the asset being sold or purchased shall involve an analysis of both qualitative and quantitative considerations.

ASC 815-10-15-32 presents the following three situations in which the "clearly and closely related" condition is not met. A contract that contains any of these price adjustments would not qualify for the normal purchases and normal sales scope exception:

1. The underlying is extraneous (i.e., irrelevant and not pertinent) to both the changes in the cost and the changes in the fair value of the asset being sold or purchased, including being extraneous to an ingredient or direct factor in the customary or specific production of that asset.
2. The magnitude and direction of the impact of the price adjustment are not consistent with the relevancy of the underlying. In other words, the magnitude of the price adjustment based on the underlying is significantly disproportionate to the impact of the underlying on the fair value or cost of the asset being purchased or sold (or of an ingredient or direct factor, as appropriate).
3. The underlying is a currency exchange rate involving a foreign currency that meets none of the criteria in ASC 815-15-15-10(b) for that reporting entity.

Guidance for evaluating a contractual price adjustment that is based on the change in the fair value of the asset being purchased or sold is provided in ASC 815-10-15-33.

**ASC 815-10-15-33**

For example, in the case in which the price adjustment focuses on the changes in the fair value of the asset being purchased or sold, if the terms of the price adjustment are expected, at the inception of the contract, to affect the purchase or sales price in a manner comparable to the outcome that would be obtained if, at each delivery date, the parties were to reprice the contract amount under the then-existing conditions for the asset being delivered on that date, the price adjustment's underlying is considered to be clearly and closely related to the asset being sold or purchased and the price adjustment would not be an impediment to the contract qualifying for the normal purchases and normal sales scope exception.

A contract that does not meet the clearly and closely related underlying condition does not qualify for the normal purchases and normal sales scope exception. A contract that does meet the clearly and closely related underlying condition must also meet all of the other conditions of the normal purchases and

normal sales scope exception (i.e., the conditions in ASC 815-10-15-27 through 15-29 and 15-35 through 15-51 that are applicable to qualify for this scope exception).

### 3.3.2.3 Probable physical settlement

For contracts that have contractual net settlement provisions or a market mechanism for net settlement, to qualify for the normal purchases and normal sales scope exception, it must be probable at inception and throughout the term of the contract that the contract will not settle net and will result in physical delivery. This condition is provided in ASC 815-10-15-35.

**ASC 815-10-15-35**

For a contract that meets the net settlement provisions of paragraphs 815-10-15-100 through 15-109 and the market mechanism provisions of paragraphs 815-10-15-110 through 15-118 to qualify for the normal purchases and normal sales scope 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.

ASC 815-10-15-36 states that the normal purchases and normal sales scope exception may only be applied to a contract that results in physical delivery of the item under that contract. An entity may not apply this scope exception to a derivative instrument that requires cash settling gains or losses or other periodic settlements of gains or losses because such settlements are considered net settlements. An example of this would be a futures contract.

A contract that is probable of physical settlement must also meet all the other conditions of the normal purchases and normal sales scope exception (i.e., the conditions in ASC 815-10-15-27 through 15-34 and 15-37 through 15-51).

ASC 815-10-15-41 states in part that “net settlement (as described in paragraphs 815-10-15-100 through 15-109 and 815-10-15-110 through 15-118) 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.” In practice, calling into question similarly designated contracts has been referred to as “tainting.”

We believe that an entity should analyze the underlying reasons that caused a contract designated as a normal purchase or normal sale to settle net. If an entity chooses to net settle a contract because, for example, it wanted to benefit from favorable market price changes, we believe this would clearly call into question the classification of similar contracts designated as normal purchases and sales. However, if the entity was forced to net settle a contract due to the occurrence of an unexpected event that was outside of its control and other similarly designated contracts were not affected in the same manner by that event, the settlement of that one contract may not call into question the classification of other similar contracts designated as normal purchases and normal sales. We believe the entity should clearly document its justification for newly classifying or continuing to maintain the classification of similarly designated contracts as normal purchases or normal sales.

### 3.3.2.4 Documentation

It is clear from ASC 815-10-15-38 that the designation of a contract as a normal purchase or normal sale must be documented properly for an entity to apply this scope exception. ASC 815-10-15-39 allows an entity to document this designation at contract inception or subsequently (in which case the contract would be accounted for as a derivative instrument until the designation is made). Once an entity documents its compliance with the conditions of the normal purchases and normal sales scope exception, it cannot voluntarily revoke the designation. However, as described in Section 3.3.2.3, an entity may lose the ability to apply this scope exception.

In accordance with ASC 815-10-15-39, the documentation of the normal purchase normal sales scope exception should demonstrate compliance with all relevant requirements in ASC 815-10-15-22 through 15-51.

If a contract does not meet these documentation requirements, it does not qualify for the normal purchases and normal sales scope exception. A contract that meets the documentation requirements must also meet all the other applicable conditions in ASC 815-10-15-27 through 15-36A and 15-40 through 15-51 to qualify for the normal purchases and normal sales scope exception.

### Level of application

ASC 815-10-15-38 allows the documentation requirements associated with the normal purchases and normal sales scope exception to be applied to either an individual contract or a group of similar contracts. It is important to adequately describe the contract or similar contracts to which the normal purchases and sales scope exception is being applied.

**RSM COMMENTARY: Practical considerations for designating a contract or group of contracts as a normal purchase or normal sale**

An entity may put in place a process (e.g., a standard template to be updated each time a contract is entered into) for documenting the contracts it is designating as normal purchases and normal sales along with the date of the designation to make it clear which contracts the designation pertains to and the date the designation became effective. For forward contracts, this documentation should include the rationale for determining that the contract will result in physical delivery and not settle net. For contracts designated as power purchase or sales agreements, this documentation should include the basis for concluding that the agreement meets the conditions in ASC 815-10-15-45 through 15-51 to apply this scope exception, including the basis for concluding that the agreement is a capacity contract. In addition, in accordance with ASC 815-10-15-39, the documentation of the normal purchase normal sales scope exception should demonstrate compliance with all relevant requirements in ASC 815-10-15-22 through 15-51.

Rather than complying with the documentation requirements at the specific contract level, entities could consider designating groups of similar contracts collectively as normal purchases and normal sales contracts. For example, clearly describing through an accounting policy the type of qualifying contracts that will be designated as normal purchases or sales upon their origination, along with the rationale for determining the contracts meet all relevant requirements could be a way to designate groups of similar contracts collectively as normal purchases and normal sales contracts.

## 3.3.2.5 Futures contracts

A futures contract may be physically settled (i.e., the purchaser may take delivery of the item it purchased at the settlement of the contract). However, futures exchanges commonly require daily cash settlements to cover the net gain or loss position of the derivative instrument, which make a futures contract ineligible for the normal purchases and normal sales scope exception pursuant to ASC 815-10-15-36.

## 3.3.2.6 Contracts with optionality features

Rather than entering into forward contracts that commit the parties to purchase or sell a stated quantity of a certain item, entities may enter into purchases or sales contracts that give them the option to purchase or sell certain quantities of an item. Additionally, a forward contract might contain an optionality feature permitting the purchaser to adjust the quantity of the asset to be delivered under the contract. For example, to meet its business need for corn, an entity may enter into a forward contract to buy 10,000 bushels of corn with an option to buy an additional 5,000 bushels at $4 per bushel. Contracts with optional quantities generally are not eligible for the normal purchases and normal sales scope exception. This is because at contract inception, it cannot be determined that physical delivery is probable to occur because delivery is contingent on exercise of the option. Exceptions to the general rule are explained in ASC 815-10-15-42, 55-24, 55-28 and 55-29. A forward contract with an option to adjust the quantity of the

asset to be delivered may qualify for the normal purchases and normal sales scope exception if one of the following conditions exist:

- The contract is a power purchase or sales agreement as discussed in ASC 815-10-15-45 through 15-51 (refer to the Section "Power purchase or sales agreements").
- The option component only permits the holder to purchase or sell additional quantities at the market price on the delivery date.

If the optionality feature that allows for quantity adjustments expires or is exercised and the forward contract has not settled, the contract may then qualify for the normal purchases and normal sales scope exception because the uncertainty as to the quantity to be delivered no longer exists, as discussed in ASC 815-10-15-43.

A forward contract that provides optionality features that modify something other than the quantity of the asset to be delivered (e.g., the price) may qualify for the normal purchases and normal sales scope exception.

ASC 815 provides the following example regarding the normal purchases and normal sales scope exception and forward contracts that contain optionality features.

**Example 3-12: Normal purchases and normal sales—Application to forward contracts that contain optionality features (ASC 815-10-55-121 through 55-131)**

In some circumstances, an option may be combined with a forward contract. In some instances, the optionality feature in the forward contract can modify the quantity of the asset to be delivered under the contract. In other cases, the optionality feature in the forward contract can modify only the price to be paid or the timing of the delivery.

This Example presents three Cases of forward contracts with optionality features:

a. Optionality feature involving price floor (cash-settled put option) written by purchaser and price cap (cash-settled call option) written by seller (Case A)

b. Optionality feature involving cash-settled put option written by purchaser (Case B)

c. Optionality feature involving physically settled put option written by purchaser (Case C)

In Cases A, B, and C, the optionality feature must be analyzed to determine whether it could modify the quantity of the asset to be delivered under the contract. In doing so, the conclusion as to whether the contract is eligible for the normal purchases and normal sales scope exception applies in the same way to both counterparties—the purchaser and the writer of the option (within the forward contract).

The contracts addressed in this Example do not have a price based on an underlying that is not clearly and closely related to the asset being purchased, nor do they require cash settlement of gains or losses as stipulated in paragraph 815-10-15-22.

Paragraph 815-10-15-43 explains that, if the optionality feature in the forward contract can modify the quantity of the asset to be delivered under the contract, but that option feature has expired or has been completely exercised (even if delivery has not yet occurred), there is no longer any uncertainty as to the quantity to be delivered under the forward contract. That paragraph explains that, following such expiration or exercise, the forward contract would be eligible for designation as a normal purchase or normal sale, provided that the other conditions in paragraph 815-10-15-22 are met.

**Case A: Optionality Feature Involving Price Floor (Cash-Settled Put Option) Written by Purchaser and Price Cap (Cash-Settled Call Option) Written by Seller**

Entity A enters into a forward contract to purchase on a specified date a specified quantity of a raw material that is readily convertible to cash. The purchase price is the current market price on the date of

purchase, not to exceed a specified maximum price (a cap) nor to be less than a specified minimum price (a floor).

In this Case, the optionality feature cannot modify the quantity to be delivered; thus, the contract is eligible to qualify for the normal purchases and normal sales scope exception.

**Case B: Optionality Feature Involving Cash-Settled Put Option Written by Purchaser**

Entity B enters into a forward contract to purchase on a specified date a specified quantity of a raw material that is readily convertible to cash. The contract's purchase price is a fixed amount per unit that is below the current forward price; however, if the market price on the date of purchase has fallen below a specified level, Entity B's purchase price would be adjusted to a higher fixed amount significantly in excess of the current forward price at the inception of the contract. (The contract entered into by Entity B is a compound derivative consisting of a forward contract to purchase raw material at the original fixed price and a written option that obligates Entity B to purchase the raw material for the higher adjusted price if the market price of the raw material falls below the specified level. In exchange for the written option, Entity B received a premium representing the difference between the purchase price in the contract and the forward market price of the raw material at the inception of the contract.)

The forward purchase contract in this Case is eligible to qualify for the normal purchases and normal sales scope exception because the optionality feature in the contract cannot modify the quantity to be delivered.

**Case C: Optionality Feature Involving Physically Settled Put Option Written by Purchaser**

Entity C enters into a forward contract to purchase on a specified date a specified quantity of a raw material that is readily convertible to cash. The contract's purchase price is a fixed amount per unit that is below the current forward price. However, if the market price on the date of purchase has fallen below a specified level that is below the contract's fixed purchase price, Entity C would be required to purchase a specified additional quantity of the raw material at the contract's fixed purchase price (which is above the current market price on the date of purchase). (The contract entered into by Entity C is a compound derivative consisting of a forward contract to purchase raw material at the original fixed price and a written option that obligates Entity C to purchase additional quantities of the raw material at an above-market price if the market price of the raw material falls below the specified level.)

The contract in this Case is not eligible to qualify for the normal purchases and normal sales scope exception because the optionality feature in the contract can modify the quantity of the asset to be delivered under the contract.

**RSM COMMENTARY: Contracts that combine a forward contract and a purchased option contract**

As explained in ASC 815-10-55-26, an entity cannot separate a forward contract with an optionality feature into two derivative instruments, one of which is an option that does not qualify for the scope exception and another that is a forward contract without optionality that may qualify for the scope exception. This is because an entity cannot separate a compound derivative instrument into two or more derivative instruments.

However, ASC 815-10-55-27 explains that an entity can enter into a forward contract and a separate option contract that together can achieve the same economic results as a single derivative instrument. The entity may then be able to apply the normal purchases and normal sales scope exception to the forward contract.

Similarly, as described in ASC 815-10-55-30, if an entity has a single supply contract that is a forward contract with optionality and later replaces that single contract with two contracts, one being a forward contract for a fixed quantity and the other being an option contract for additional quantities, the new forward contract may be eligible for the normal purchases and

normal sales scope exception. However, the option contract would not be eligible for this scope exception.

ASC 815-10-55-24 through 55-30 provide further guidance on accounting for forward contracts with optionality.

### 3.3.2.7 Electricity contracts

ASC 815-10-15-36A addresses the purchase or sale of electricity on a forward basis, whether such transactions with transmission services constitute a series of sequential contracts intended to accomplish the ultimate acquisition or sale of a commodity, and whether the use of locational marginal pricing to determine transmission charges or credits constitutes net settlement.

**ASC 815-10-15-36A**

Certain contracts for the purchase or sale of electricity on a forward basis that necessitate transmission through, or delivery to a location within, an electricity grid operated by an independent system operator result in one of the contracting parties incurring charges (or credits) for the transmission of that electricity based in part on locational marginal pricing differences payable to (or receivable from) the independent system operator. For example, this is the case when the delivery location under the contract (for example, a hub location) is not the same location as the point of ultimate consumption of the electricity or the point from which the electricity exits the electricity grid for transmission to a customer load zone. Delivery to the point of ultimate consumption or the exit point is facilitated by the independent system operator of the grid. The purchase or sale contract and the transmission services do not constitute a series of sequential contracts intended to accomplish the ultimate acquisition or sale of a commodity as discussed in paragraph 815-10-15-41, and the use of locational marginal pricing to determine the transmission charge (or credit) does not constitute net settlement, even in situations in which legal title to the associated electricity is conveyed to the independent system operator during transmission.

#### Power purchase or sales agreements

In the electric power industry, it is common for one party to purchase electricity from a sole provider. Although some of these contracts require the delivery of a fixed quantity of power, others provide optionality regarding the quantity of electricity to be delivered. The optionality provides the purchaser the opportunity to meet fluctuating demand and may also be responsive to regulatory requirements. A unique aspect of electricity is that it cannot be easily stored. Because electricity cannot be easily stored and the general requirement that an entity take physical delivery of the asset that is the subject of the contract to which the normal purchases and normal sales scope exception would be applied, ASC 815-10-15-45 through 15-51 provides guidance in for the application of this scope exception to power purchase or sales agreements.

A power purchase or sales agreement may qualify for the normal purchases and normal sales scope exception whether it is a forward contract, option contract or a combination of a forward and option contract if certain conditions are met. Those conditions are set forth in ASC 815-10-15-37 and 15-45 and are summarized in the following table.

| Conditions apply to | Condition to be met |
|---|---|
| Both the purchaser and seller | The contract requires the physical delivery of electricity (i.e., net settlement is not permitted). If the contract is an option contract, physical delivery of electricity is required upon exercise. The use of locational marginal pricing for calculating transmission charges (or credits) does not equate to net settlement, even if legal title to the electricity is conveyed to the Independent System Operator (ISO). |
| | The contract must be a capacity contract. Judgment based on the facts and circumstances is needed to distinguish between a capacity contract and a financial option contract on electricity. When an entity analyzes power purchase or sale agreements that contain optionality features, it should consider the characteristics discussed in ASC 815-10-55-31. However, other characteristics may also be relevant to the analysis. Refer to the table in the *Capacity contract* section of this chapter. |
| | The entity must document why the contract qualifies for the normal purchases and normal sales scope exception. |
| The purchaser | The purchaser expects to use or sell the quantity of electricity that is deliverable under the contract in its normal course of business. |
| | The purchaser engages in retail or wholesale sale of electricity to customers and is obligated by statute or contract to maintain sufficient electricity capacity to meet the needs of its customers. |
| | The contract is entered into to meet the purchaser's obligation to maintain sufficient electricity capacity. Such obligations could include a reasonable reserve margin to comply with a regulatory commission, local standards, regional reliability councils or regional transmission organizations. |
| The seller | The electricity that is deliverable under the contract must involve quantities that the seller expects to sell in the normal course of its business. |

Some of the concepts introduced in the preceding table are discussed in further detail in the following subsections.

As discussed in ASC 815-10-15-47, forward contracts to purchase or sell electricity that do not meet all the conditions in the preceding table may still qualify for the normal purchases and normal sales scope exception if all the requirements for the scope exception other than ASC 815-10-15-45 are met and they are not subject to unplanned netting (unplanned netting is referred to in the electric power industry being booked out). See the following section on physical delivery of electricity.

### Physical delivery of electricity

As explained in ASC 815-10-15-35, to qualify for the normal purchases and normal sales scope exception if net settlement exists under the terms of a contract or through a market mechanism, it must be probable at inception and throughout the term of the contract that the contract will not settle net and will result in physical delivery. However, as indicated in ASC 815-10-15-45(a), physical delivery must be required for a capacity contract to qualify for the normal purchases and normal sales scope exception. Therefore, we believe that a capacity contract that contains a provision for market-based liquidating damages would not qualify for the normal purchases and normal sales scope exception because the damages clause is a form of net settlement. Certain power purchase or sale agreements allow for a book out. A book out occurs when an electricity entity nets offsetting transactions with the same counterparty (or group of counterparties). Scheduled as well as unplanned book outs are common when two or more power entities

have offsetting transactions. A contract that contains a book out provision is not eligible for the normal purchases and normal sales scope exception unless it is a capacity contract and meets the conditions in the preceding table. A power purchase or sales agreement that meets the conditions described in the preceding table qualifies for the normal purchases and normal sales scope exception, even if it is subject to book out provisions.

Electricity wholesalers often join Regional Transmission Organizations (RTO). An RTO is an electric power transmission system operator that controls, coordinates and monitors an electric grid across multiple states. The operations of the grid are managed by an ISO. The ISO is profit neutral and does not generate, market or trade power for itself. The transmission of electricity commonly involves contractual delivery locations that differ from the location where the electricity is ultimately consumed or the point from which it exits the grid to be transmitted to an end consumer. Typically, an ISO takes legal title to the electricity for transmission through the grid and assigns prices to the electricity at locations on the grid (otherwise known as nodes) where the electricity can be delivered and withdrawn. The price an ISO charges for electricity typically includes any cost recovery as well as locational pricing differentials at the delivery and withdrawal locations.

ASC 815-10-15-45 indicates that a contract with an RTO is not considered net settled because it:

- Requires delivery locations that differ from the location where the electricity is ultimately consumed or the point from which the electricity exits the grid to be transmitted to a customer
- Transfers the legal title of the electricity to the ISO during transmission
- Involves locational marginal pricing

### Capacity contract

For a contract with optionality to be considered a capacity contract such that it may be eligible for the normal purchases and normal sales scope exception, it must meet the definition provided in ASC 815-10-20.

**Master Glossary – Capacity Contract**

An agreement by an owner of capacity to sell the right to that capacity to another party so that it can satisfy its obligations. For example, in the electric industry, capacity (sometimes referred to as installed capacity) is the capability to deliver electric power to the electric transmission system of an operating control area.

Distinguishing an option contract that is a capacity contract from a financial (traditional) option contract requires significant judgment based on facts and circumstances. The following table from ASC 815-10-55-31 compares the characteristics of an option that is a capacity contract and a financial option contract on electricity.

| | Option Contract That Is a Capacity Contract | Financial Option Contract on Electricity |
|---|---|---|
| 1 | The contract usually specifies the power plant or group of power plants providing the electricity. | No reference is made to the generation origination of the electricity. |
| 2 | 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. | The strike price is structured based on the expected forward prices of power. |
| 3 | The specified quantity is based on individual needs of parties to the agreement. | The specified quantity reflects standard amounts of electric energy, which facilitate market liquidity (for example, |

| | Option Contract That Is a Capacity Contract | Financial Option Contract on Electricity |
|---|---|---|
| | | exercise in increments of 10,000 kilowatt-hours). |
| 4 | The title transfer point is usually at one or a group of specified physical delivery point(s), as opposed to a major market hub. | The specified index transfer point is a major market hub (liquid trading hub), not seller- or buyer-site specific. |
| 5 | The contract usually specifies certain operational performance by the facility (for example, the achievement of a certain heat rate). | No operational performance is specified (not plant specific). |
| 6 | The contract sometimes incorporates requirements for interconnection facilities, physical transmission facilities or reservations for transmission services. | None specified. |
| 7 | The contract may specify jointly agreed-to plant outages (for example, for maintenance) and provide for penalties in the event of unexpected outages. | Penalties for outages are not specified (not plant specific). |
| 8 | 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. | Damage provisions upon default are based on market liquidating damages. |
| 9 | The contract's term is usually long (one year or more). | The contract's term is not longer than 18 to 24 months because financial options on electricity are currently illiquid beyond that period. |

In accordance with ASC 815-10-15-49, the guidance on power purchase or sales agreements does not impact the accounting for a requirements contract that does not meet the definition of a derivative because for example, it does not have a notional amount. As indicated in ASC 815-10-15-50, a contract that qualifies for the normal purchases and normal sales scope exception based on the guidance on power purchase or sales agreements is not required to comply with any additional guidance in ASC 815-10-15-22 through 15-44 (i.e., the guidance summarized in Section 3.3.2, exclusive of this subsection on power purchases or sales agreements). However, a contract whose price is based on an underlying that is not clearly and closely related to the electricity being purchased or sold or that is denominated in a foreign currency that does not meet the conditions in ASC 815-15-15-10(b) is not eligible for the normal purchases and normal sales scope exception.

In accordance with ASC 815-10-15-51, the guidance on power purchase or sales agreements should not be applied by analogy to contracts that do not meet the conditions in ASC 815-10-15-45.

### 3.3.2.8 Take-or-pay contracts

A take-or-pay contract is a contract in which an entity agrees to purchase goods or services and pay for them even if it does not take delivery of them. A take-or-pay contract may meet the definition of a derivative instrument and would qualify for the normal purchases and normal sales scope exception if all of the relevant conditions are met.

### 3.3.3 Certain insurance contracts and market risk benefits

U.S. GAAP has long-standing accounting guidance for traditional insurance contracts. The FASB did not intend to affect the accounting for these contracts by requiring them to be accounted for as derivative instruments. Specifically, neither the holder nor issuer of a contract that meets all of the conditions provided in ASC 815-10-15-52 should account for the contract as a derivative instrument. The required conditions are:

- The holder of the contract will only be compensated as the result of an identifiable insurable event other than a change in price.
- Because of the identifiable insurable event, the holder incurs a liability or there is an unfavorable change in the value of a specific asset or liability for which the holder is at risk.
- Payment of a claim is triggered only by a bona fide insurable exposure (i.e., the contract needs to have an insurance component but, as noted in a discussion that follows, there can also be a derivative component).
- The contract must provide for a legitimate transfer of risk (i.e., a deposit or form of self-insurance does not qualify).

Generally, insurance contracts that fall within the scope of ASC 944 would meet the conditions of the insurance contract scope exception. If any of the preceding conditions are not met, this scope exception does not apply.

Traditional life insurance contracts and traditional property and casualty insurance contracts are the most common types of insurance contracts that are excluded from the guidance in ASC 815 because of the insurance contract scope exception. The rationale for excluding these insurance contracts from the guidance in ASC 815 is provided in ASC 815-10-15-53 and summarized in the following table.

| Contract type | Rationale as to why the contract is not subject to ASC 815 |
|---|---|
| Life insurance | The payment of death benefits is the result of an identifiable insurable event (i.e., death of the insured) instead of changes in a variable. |
| Property and casualty | The payment of benefits is the result of an identifiable insurable event (e.g., theft or fire) instead of changes in a variable. |

A contract may be a combination of a derivative instrument and an insurance product or nonderivative contract. The following are examples of insurance products that may contain a derivative component:

- Indexed annuities
- Variable life insurance contracts
- Property and casualty contracts with foreign currency options
- Nontraditional life insurance contracts that are primarily investments that incidentally provide a death benefit

An entity should evaluate such a contract to determine if it contains an embedded derivative that must be accounted for separately as a standalone derivative instrument. Example 11 that begins in ASC 815-10-55-132 discusses this scope exception in the context of a reinsurance contract whereby the retention amount is adjusted downward based on a scale tied to the Dow Jones Industrial Average. The death benefit component of an investment-like contract may be excluded from ASC 815. Even if that is the case, an entity should assess the investment component to determine if it is subject to the guidance in ASC 815. Refer to Chapter 4 for further information on embedded derivatives.

In accordance with ASC 815-10-15-55, a property and casualty insurance contract that provides for benefits or claims as a result of both changes in a variable and an identifiable insurable event is not

subject to the guidance in ASC 815 in its entirety and does not contain an embedded derivative that requires separate accounting if it meets the following conditions:

- Benefits or claims are paid under the contract only if an identifiable insurable event occurs (e.g., a fire).
- The payment amount is limited to the amount of the policyholder's incurred insured loss.
- The contract does not involve essentially assured amounts of cash flows (regardless of the timing of those cash flows) based on insurable events highly probable of occurring, because the insured would nearly always receive the benefits (or suffer the detriment) of changes in the variable.

ASC 815 provides the following example to illustrate a contract that involves essentially assured amounts that do not qualify for the scope exception.

**Example 3-13: Certain insurance contracts—Essentially assured amounts (ASC 815-10-55-134)**

This Example illustrates the guidance in paragraph 815-10-15-55(c) for a contract involving essentially assured amounts. Insured Entity has received at least $2 million in claim payments from its insurance entity (or at least $2 million in claim payments were made by the insurance entity on the insured entity's behalf) for each of the previous 5 years related to specific types of insured events that occur each year. That minimum level of coverage would not qualify for the insurance contract scope exclusion.

In accordance with ASC 815-10-15-56, the component of a contract that provides for an actuarially-determined minimum amount of expected claim payments resulting from insurable events that are highly probable of occurring does not qualify for the insurance contract scope exception if the minimum payments are both:

- Indexed to or altered by changes in a variable
- Expected to be paid each policy year (or on another predictable basis)

In these circumstances, the actuarially-determined minimum amount of expected claim payments that are highly probable of occurring is considered to be the minimum notional amount when performing the embedded derivative analysis under ASC 815-15-25. Refer to Chapter 4 for further information on embedded derivatives.

**RSM COMMENTARY: Insurable event versus a change in a price or index**

One of the conditions that must be met for a contract to qualify for the insurance contract scope exception is that benefits or claims are paid under the contract only if an identifiable insurable event occurs.

To illustrate, a traditional property insurance contract whereby the policyholder receives benefits in the event of fire or other damage to the property would meet this requirement. Conversely, a property insurance contract that would pay benefits to the holder because of changes in a real estate price index would not meet this requirement.

Certain property and casualty insurance contracts are referred to as dual-trigger policies because they pay the holder benefits only if two events occur. One of the events is typically the occurrence of a traditional insurable event and the other event is typically a change in a pre-identified variable such as a climatic variable or the price of a commodity. Refer to ASC 815-10-55-37 through 55-40 and Example 11 beginning in ASC 815-10-55-132 for illustrations and the application of the accounting guidance to policies of this type. Dual trigger contracts often qualify for either the insurance contract scope exception or the nonfinancial asset scope exception to derivative accounting, which is discussed later in this chapter.

### 3.3.4 Certain financial guarantee contracts

A financial guarantee is an agreement in which one party guarantees a debt will be repaid by another party if the obligor defaults. Many financial guarantee contracts meet the definition of a derivative instrument. However, the FASB created a scope exception so that certain financial guarantee contracts would not be accounted for as derivative instruments. Specifically, neither the guaranteed party nor the guarantor account for a contract that meets all the conditions in ASC 815-10-15-58 is a derivative instrument.

**ASC 815-10-15-58**

Financial guarantee contracts are not subject to this Subtopic only if they meet all of the following conditions:

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

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

c. The guaranteed party is, as a precondition in the contract (or in the back-to-back arrangement, if applicable) for receiving payment of any claim under the guarantee, exposed to the risk of nonpayment both at inception of the financial guarantee contract and throughout its term either through direct legal ownership of the guaranteed obligation or through a back-to-back arrangement with another party that is required by the back-to-back arrangement to maintain direct ownership of the guaranteed obligation.

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

Paragraph A22 of Statement of Financial Accounting Standards No. 149—Amendment of Statement 133 on Derivative Instruments and Hedging Activities provides the following insights.

**Statement of Financial Accounting Standards No. 149—Amendment of Statement 133**

…Accordingly, the Board determined that, in order for a financial guarantee contract to qualify for the scope exception in paragraph 10(d), the guaranteed party must demand payment from the debtor and that once it is determined that the required obligation will not be satisfied by the debtor, the guaranteed party must relinquish to the guarantor its rights to receive payment from the debtor in order to receive payment from the guarantor. The Board also concluded that the language in paragraph 10(d) should be clarified to eliminate use of the term loss incurred and instead focus on amounts due to the guaranteed party but not paid by the debtor.

If any of the preceding conditions are not met, the financial guarantee scope exception does not apply.

The following table describes certain financial guarantees and whether they qualify for the financial guarantee scope exception.

| Description of the contract | Financial guarantee scope exception |
|---|---|
| Credit default swap that requires a payment due to unfavorable changes in the credit rating of a specified entity | Does not apply. For a contract to qualify for the financial guarantee scope exception, it must provide for payments to be made solely to reimburse the guaranteed party for failure of the debtor to satisfy its required payment obligations. That is not the case with a credit default swap that requires a payment upon an unfavorable change in the credit rating of a specified entity. |
| A guarantee that requires the guarantor to make a payment if the specified party files for bankruptcy | Does not apply. For a contract to qualify for the financial guarantee scope exception, it must provide for payments to be made solely to reimburse the guaranteed party for failure of the debtor to satisfy its required payment obligations. That is not the case with a guarantee that requires the guarantor to make a payment solely because of the specified party filing for bankruptcy and indicates payments are not being made solely to reimburse the guaranteed party for failure of the debtor to satisfy its required payment obligations. |
| A guarantee that requires the guarantor to make a payment if the specified party violates a debt covenant | Does not apply. For a contract to qualify for the financial guarantee scope exception, it must provide for payments to be made solely to reimburse the guaranteed party for failure of the debtor to satisfy its required payment obligations. That is not the case with a guarantee that requires the guarantor to make a payment if the specified party violates a debt covenant. An entity may violate a debt covenant without failing to satisfy its required payment obligations. |
| A guarantee that requires the guarantor to make a payment because a payment obligation under a nonderivative contract becomes automatically accelerated due to the occurrence of a “nonpayment-based” default (e.g., bankruptcy, debt covenant violation, change in control) | May apply. For a contract to qualify for the financial guarantee scope exception, payments can only be reimbursement for payments that are both due and unpaid. A debtor whose payment schedule is accelerated because of a nonpayment default may still be making its payments under the accelerated schedule. |
| A guarantee that requires the guarantor to make a payment to the guaranteed party, regardless of whether the guaranteed party is exposed to a risk of nonpayment | Does not apply. For a contract to qualify for the financial guarantee scope exception, the guaranteed party, at inception of the financial guarantee contract and throughout its term must be exposed to the risk of nonpayment as a contractual precondition for receiving a claim payment under the guarantee. That is not the case with a guarantee that requires the guarantor to make a payment to the guaranteed party, regardless of whether the guaranteed party is exposed to a risk of nonpayment. |
| A contract that promises to pay the guaranteed party the difference between a post-credit-event fair value and the book value of an asset | Does not apply. For a contract to qualify for the financial guarantee scope exception, it must provide for payments to be made solely to reimburse the guaranteed party for failure of the debtor to satisfy its required payment obligations. That is not the case with a contract that requires the guarantor to pay the guaranteed party the difference between a post-credit-event fair value and the book value of an asset because it does not provide for payments solely to reimburse the guaranteed party |

| Description of the contract | Financial guarantee scope exception |
|---|---|
| | for failure of the debtor to satisfy its required payment obligations. |
| A contract that entitles the holder to claims to the extent its credit losses exceed a specified minimum level, further limited by the amount to which credit losses on a customized pool or index of loans exceed that minimum level | Applies if all the conditions in ASC 815-10-15-58 are met. The limitations on the claims do not prevent the contract from qualifying for the scope exception. (Refer to the example that begins in ASC 815-10-55-32). |
| Credit derivative instruments that transfer credit risk from one party to another party | May apply. Some credit derivative instruments do not require the party who purchased the credit protection to maintain a direct exposure to the referenced asset at contract inception and throughout the life of the contract. In addition, they may provide for payments to be made in circumstances that go beyond the debtor failing to satisfy a required payment obligation. In these and other circumstances where one or more of the conditions in ASC 815-10-15-58 are not met, the scope exception does not apply. |

**RSM COMMENTARY: Financial guarantees and ASC 460**

A financial guarantee determined to be outside the scope of ASC 815 should also be evaluated under ASC 460 to determine whether that Topic's recognition, measurement and disclosure requirements apply. Also, as discussed in ASC 460-10-50-1, certain disclosures required by ASC 460 are also applicable to guarantees that are outside the scope of ASC 460 (e.g., guarantees accounted for as derivative instruments in accordance with ASC 815, except for credit derivative instruments). In addition, ASC 944-20 provides accounting guidance for financial guarantees that are insurance contracts and reinsurance contracts issued by insurance entities that do not meet the definition of a derivative instrument.

### 3.3.5 Certain nonexchange-traded contracts

ASC 815 provides scope exceptions for certain contracts that are not traded on an exchange:

- Climatic, geological or other physical variable scope exception
- Nonfinancial asset scope exception
- Nonfinancial liability scope exception
- Specified volumes of sales or service revenues scope exception
- Underlying based on operations or activities specific to one of the parties to the contract

These scope exceptions can apply to both parties to the nonexchange-traded contract.

The nature of the underlying upon which the settlement of a nonexchange-traded contract is based determines whether the contract qualifies for one of the aforementioned scope exceptions. However, a contract that meets the definition of a derivative instrument may have more than one underlying and not every underlying may qualify for one of these scope exceptions. As explained in ASC 815-10-15-60 through 15-61,[2] determining whether a contract qualifies for one of the nonexchange-traded scope

[2] Following the adoption of ASU 2025-07, the reference to ASC 815-10-15-61 will be removed. Refer to the ASU for effective date and transition requirements.

exceptions depends on the contract's predominant characteristics. This means that an entity should account for a contract as a derivative instrument if all of the contract's underlyings, considered in combination, behave in a manner that is highly correlated with the behavior of any of the contract's component variables that do not qualify for a scope exception.

For the purposes of the following discussion, the nonfinancial asset scope exception and the nonfinancial liability scope exception are combined.

#### 3.3.5.1 Climatic, geological or other physical variable

As noted in ASC 815-10-15-59(a), this scope exception applies to nonexchange-traded contracts in which the underlying the settlement is based on is a climatic, geological or other physical variable.

Examples of underlyings contained in certain contracts that may qualify for this scope exception include:

- Inches of rainfall (e.g., to hedge against a ruined crop)
- Inches of snowfall (e.g., to hedge against a bad ski season)
- Severity of earthquakes as measured by the Richter scale (e.g., to hedge against property casualty)
- The category of hurricanes as measured by the Saffir-Simpson Hurricane Wind scale (e.g., to hedge against property casualty)
- Temperature or average temperature exceeding a certain degree for a particular number of days (e.g., to hedge against poor heating oil sales because of a warm winter)

For this scope exception to apply, the contract must include an underlying that is based on a climatic, geological or other physical variable. It does not apply to a contract that has an underlying that is based on a financial variable. The following table compares an underlying based on a climatic variable to an underlying based on a financial variable.

| Underlying based on a climatic variable | Underlying based on a financial variable |
|---|---|
| A contract that requires the issuer to pay the holder $250 million if a hurricane equal to or greater than Category 3 on the Saffir-Simpson Hurricane Wind Scale occurs in the northeast region of the U.S. during 2020. The underlying is the occurrence of a hurricane of the specified magnitude. Given the occurrence of a hurricane is a climatic variable, this contract qualifies for this scope exception. | A contract that requires the issuer to pay the holder if hurricane damage in the northeast region of the U.S. during 2020 exceeds $250 million. The underlying is the occurrence of damage that exceeds $250 million, which is a financial variable. Therefore, this contract does not qualify for this scope exception.<br>However, a contract that requires the issuer to reimburse the holder for the dollar amount of damages that the holder incurred as a result of a hurricane would likely qualify for the insurance contract scope exception discussed in Section 3.3.3. |

Example 13 in ASC 815-10-55 illustrates the difference between physical and financial variables for purposes of applying the scope exception in ASC 815-10-15-59(a).

**Example 3-14: Certain contracts that are not traded on an exchange—Distinguishing between physical and financial variables (ASC 815-10-55-135 through 55-141)**

The following Cases illustrate the difference between physical and financial variables for purposes of applying the scope exception in paragraph 815-10-15-59(a):

a. Contract containing both a physical variable and a financial variable (Case A)

b. Contract containing only a physical variable (Case B)

c. Contract containing only a financial variable (Case C).

**Case A: Contract Containing Both a Physical Variable and a Financial Variable**

A contract's payment provision specifies that the issuer will pay to the holder $10,000,000 if aggregate property damage from all hurricanes in the state of Florida exceeds $50,000,000 during the year 2001.

In this Case,[3] the payment under the contract occurs if aggregate property damage from all hurricanes in the state of Florida exceeds $50,000,000 during the year 2001. The contract contains 2 underlyings—a physical variable (that is, the occurrence of at least 1 hurricane) and a financial variable (that is, aggregate property damage exceeding a specified or determinable dollar limit of $50,000,000). Because of the presence of the financial variable as an underlying, the derivative instrument does not qualify for the scope exclusion in paragraph 815-10-15-59(a).

**Case B: Contract Containing Only a Physical Variable**

A contract specifies that the issuer pays the holder $10,000,000 in the event that a hurricane occurs in Florida in 2001.

If a contract contains a payment provision that requires the issuer to pay to the holder a specified dollar amount that is linked solely to a climatic or other physical variable (for example, wind velocity or flood-water level), paragraph 815-10-15-59(a) provides that the contract is not subject to the requirements of this Subtopic.

In this Case, the payment provision is triggered if a hurricane occurs in Florida in 2001. The underlying is a physical variable (that is, occurrence of a hurricane). Therefore, the contract qualifies for the scope exclusion in paragraph 815-10-15-59(a).

**Case C: Contract Containing Only a Financial Variable**

A contract would be a traditional insurance contract that is excluded from the scope of this Subtopic under the exception discussed beginning in paragraph 815-10-15-52 if the contract requires a payment only if the holder incurs a decline in revenue or an increase in expense as a result of an event (for example, a hurricane) and the amount of the payoff is solely compensation for the amount of the holder's loss.

Weather derivative instruments that qualify for this scope exception may be within the scope of ASC 815-45.

### 3.3.5.2 Nonfinancial asset or liability

A contract that is not traded on an exchange for which the underlying the settlement is based on is a nonfinancial asset or liability may qualify for a scope exception under either ASC 815-10-15-59(b) or 15-59(c).

**ASC 815-10-15-59 [Partial Excerpt]**

Contracts that are not exchange-traded are not subject to the requirements of this Subtopic if the underlying on which the settlement is based is any one of the following:

...

b. The price or value of a nonfinancial asset of one of the parties to the contract provided that the asset is not readily convertible to cash. This scope exception applies only if both of the following are true:

[3] Following the adoption of ASU 2025-07, this sentence will be preceded by an introductory sentence: "If the contract contains a payment provision that requires the issuer to pay to the holder a specified dollar amount based on a financial variable, the contract is subject to the requirements of this Subtopic." Refer to the ASU for effective date and transition requirements.

1. The nonfinancial assets are unique.
2. The nonfinancial asset related to the underlying is owned by the party that would not benefit under the contract from an increase in the fair value of the nonfinancial asset. (If the contract is a call option, the scope exception applies only if that nonfinancial asset is owned by the party that would not benefit under the contract from an increase in the fair value of the nonfinancial asset above the option's strike price.)

c. The fair value of 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.

**RSM COMMENTARY: Reassessment of the nonfinancial asset or liability scope exception**

We believe that an entity should periodically reevaluate the application of the nonfinancial asset or liability scope exception because for a contract to qualify, the underlying asset cannot be considered readily convertible to cash. As internet-based marketplaces continue to develop, more assets may become readily convertible to cash.

If any of the preceding conditions are not met, the nonfinancial asset or liability scope exception does not apply.

An entity cannot apply the nonfinancial asset scope exception to a contract if the nonfinancial assets that are subject to the contract are interchangeable or fungible units because the assets subject to the contract would not be unique.

Some examples of nonfinancial assets that we believe may be considered unique are:

- A landmark building in a city
- A parking lot associated with a sports arena
- A unique work of art
- A specialty-manufactured good
- A special-ordered part of an automobile, aircraft, watercraft, etc.

The preceding list is not meant to be all inclusive.

## Equity kicker

A lender may make a loan to a borrower so that the borrower can acquire an operating property that grants the lender the right to participate in the profit from the sale of the property or its refinancing. Similarly, a lender may make a loan to a borrower to help the borrower finance its operations that grants the lender the right to participate in a certain portion of the borrower's operations. These rights within loans to participate in the profit from the sale or refinancing of the property or to participate in a portion of the borrower's operations are referred to as embedded equity kickers. An equity kicker (whether embedded in a loan agreement or not) typically qualifies for the nonfinancial asset scope exception in ASC 815-10-15-59(b) or the specified volumes of sales or service revenues scope exception in ASC 815-10-15-59(d) (discussed later). This is explained in ASC 815-15-55-10 as follows.

**ASC 815-15-55-10**

Under paragraph 815-10-15-59(b), an embedded equity kicker would typically not be subject to the requirements of this Subtopic because the separate instrument with the same terms is not exchange traded and is indexed to nonfinancial assets that are not readily convertible to cash. Similarly, if an equity kicker is based on a share in net earnings or operating cash flows, it would also typically qualify for the scope exception in paragraph 815-10-15-59(d). If the embedded derivative does not need to be accounted

for separately under this Subtopic, the Acquisition, Development, and Construction Arrangements Subsections of Subtopic 310-10 shall be applied.

Purchase options for unique properties are a common example of contracts that qualify for the nonfinancial asset scope exception assuming all the criteria are met. Another example of how this scope exception may come into play is provided in ASC 815-15-55-8 and 55-9.

**Example 3-15: Participating mortgage (ASC 815-15-55-8 through 55-9)**

Under an example participating mortgage, the investor receives a below-market interest rate and is entitled to participate in the appreciation in the fair value of the project that is financed by the mortgage upon sale of the project, at a deemed sale date, or at the maturity or refinancing of the loan. The mortgagor must continue to own the project over the term of the mortgage.

The instrument has a provision that entitles the investor to participate in the appreciation of the referenced real estate (the project). However, a separate contract with the same terms would be excluded by the exception in paragraph 815-10-15-59(b) because settlement is based on the value of a nonfinancial asset of one of the parties that is not readily convertible to cash. (This Subtopic does not modify the guidance in Subtopic 470-30).

Example 14 in ASC 815-10-55 that follows illustrates that for this scope exception to apply, the asset must be unique and owned by the party that would not benefit under the contract if the asset increased in price or value.

**Example 3-16: Certain contracts that are not traded on an exchange—Nonfinancial asset of one of the parties to a contract (ASC 815-10-55-142 through 55-143)**

Entity A enters into a non-exchange-traded forward contract to buy from Entity B 100 interchangeable (fungible) units of a nonfinancial asset that are not readily convertible to cash. The contract permits net settlement through its default provisions. Entity A already owns more than 100 units of that nonfinancial asset, but Entity B does not own any units of that nonfinancial asset.

The scope exception in paragraph 815-10-15-59(b) does not apply to the accounting for the contract for both of the following reasons:

a. The contract's settlement is based on an underlying associated with a nonfinancial asset that is not unique (because it is based on the price or value of an interchangeable, nonfinancial unit).

b. The entity that owns the nonfinancial asset related to the underlying (that is, Entity A) is the buyer of the units and thus would benefit from the forward contract if the price or value increases.

Consequently, neither Entity A nor Entity B qualifies for the scope exception in paragraph 815-10-15-59(b).

### 3.3.5.3 Specified volumes of sales or service revenues

A contract that is not traded on an exchange for which the underlying the settlement is based on is specified volumes of sales or service revenues of one of the parties to the contract is not accounted for as a derivative instrument under ASC 815-10-15-59(d).

**ASC 815-10-15-59 [Partial Excerpt]**

Contracts that are not exchange-traded are not subject to the requirements of this Subtopic if the underlying on which the settlement is based is any one of the following:

…

d. Specified volumes of sales or service revenues of one of the parties to the contract. (This scope exception applies to contracts with settlements based on the volume of items sold or services rendered, for example, royalty agreements. This scope exception does not apply to contracts based on changes in sales or revenues due to changes in market prices.)

If the preceding conditions are not met, the specified volumes of sales or service revenues scope exception does not apply.

The underlying premise for this scope exception is that the FASB did not intend for a contract that provides for settlements that are based on sales volume or service revenues of one of the parties to the contract to be accounted for as a derivative instrument. A lease contract may contain a clause stating the tenant must pay the landlord a percentage of its monthly sales as a component of the lease payment. Another common example is a royalty agreement contract that requires a franchisee to pay the franchisor a specified rate based on the sales volume of the franchisee. While this scope exception does not apply to payments based on changes in sales or revenues due to changes in market prices, it is evident from the example in ASC 815-15-55-10 that in addition to volume of sales or service revenues, the scope exception applies to payments based on a portion of net earnings or operating cash flows.

#### 3.3.5.4 Underlying based on operations or activities specific to one of the parties to the contract – Following the adoption of ASU 2025-07

A contract that is not traded on an exchange for which the underlying settlement is based on the financial operating results (or components of those results) of one of the parties to the contract is not accounted for as a derivative instrument under ASC 815-10-15-59(e). This scope exception also applies to underlyings based on the occurrence or nonoccurrence of an event specific to the operations or activities of one of the parties to the contract.

**ASC 815-10-15-59 [Partial Excerpt]**

Contracts that are not exchange-traded are not subject to the requirements of this Subtopic if the underlying on which the settlement is based is any one of the following:

…

e. An underlying that is based on operations or activities specific to one of the parties to the contract. This scope exception applies to underlyings based on the financial operating results (or components of those results) of one of the parties to the contract. This scope exception also applies to underlyings based on the occurrence or nonoccurrence of an event specific to the operations or activities of one of the parties to the contract (such as obtaining regulatory approval, achieving a product development milestone, or achieving a greenhouse gas emissions reduction target). When evaluating whether operations or activities are specific to one of the parties to the contract, an entity does not need to consider whether the outcome is within its control. This scope exception does not apply to any of the following:

1. Underlyings that are based on a market rate, market price, or market index (including those in paragraph 815-10-15-88(a) through (f)). (See Example 14A—Case F [paragraph 815-10-55-143K] and Case I [paragraphs 815-10-55-143P through 55-143Q] that illustrate the application of this exclusion to the scope exception.)
2. Underlyings that are based on the price or performance (including default) of a financial asset or financial liability of one of the parties to the contract. For example, the scope

exception does not apply to underlyings based on (i) a rate of return or a default rate on a pool of loans held by one of the parties to the contract or (ii) the occurrence or nonoccurrence of an event of default or other credit event by a borrower (or reference entity) on a loan held by one of the parties to the contract. (See Example 14A—Case J [paragraphs 815-10-55-143R through 55-143S] that illustrates the application of this exclusion to the scope exception.)

3. Contracts involving an entity's own equity that are subject to paragraph 815-10-15-74(a) and Subtopic 815-40.
4. Call options and put options on debt instruments that are subject to paragraphs 815-15-25-41 through 25-43.

Solely for purposes of applying the scope exception in (e), the term party to the contract includes the parent, subsidiaries, or other entities consolidated by the parent for both consolidated financial statements and the standalone financial statements of individual entities within the consolidated group.

In September 2025, the FASB issued ASU 2025-07, *Derivatives and Hedging (Topic 815) and Revenue from Contracts with Customers (Topic 606) No. 2025-07 September 2025 Derivatives Scope Refinements and Scope Clarification for Share-Based Noncash Consideration from a Customer in a Revenue Contract* (ASU 2025-07), in response to stakeholder concerns that the definition of a derivative in ASC 815 is too broad and is being applied to contracts where derivative accounting does not provide decision-useful information. Stakeholders raised questions about applying the derivative definition and related scope exceptions to certain emerging transactions (such as environmental, social and governance (ESG)-linked bonds) and longstanding arrangements (such as research and development and litigation funding arrangements), particularly when contracts contain underlyings based on the operations or activities specific to one of the parties. Respondents noted that the cost and complexity of applying derivative accounting to these contracts—combined with the less decision-useful financial reporting that results—has led some entities to structure transactions specifically to avoid derivative accounting. To address these concerns, the Board created the scope exception in ASC 815-10-15-59(e).

ASU 2025-07 is effective for all entities for annual reporting periods beginning after December 15, 2026, and interim reporting periods within those annual reporting periods. Early adoption is permitted.

**Example 3-17: Certain Contracts That Are Not Traded on an Exchange—Underlyings Based on Operations or Activities Specific to One of the Parties to the Contract (ASC 815-10-55-143A through 55-143S)**

The following Cases illustrate application of the scope exception in paragraph 815-10-15-59(e):

a. Research and Development Funding Arrangement—Underlyings based on the occurrence of regulatory approval and achieving an earnings target (Case A)
b. Monetization Transaction—Underlyings based on the occurrence of regulatory approval and achieving a sales target (Case B)
c. Sustainability-Linked Bond—Underlying based on the failure to meet a greenhouse gas emissions reduction target (Case C)
d. Litigation Funding Arrangement between Litigant and Funder—Underlying based on the occurrence of a successful litigation outcome (Case D)
e. Litigation Funding Arrangement between Law Firm and Funder—Underlying based on the occurrence of a successful litigation outcome (Case E)
f. Commodities-Based Arrangement—Underlying based on a market price of gold (Case F)

g. Variable Payment Arrangement—Underlying based on the occurrence of regulatory approval (Case G)

h. Earnout Arrangement—Underlying based on earnings activity (Case H)

i. Variable Payment Arrangement—Underlying based on stock price differential (Case I)

j. Credit Default Swap Arrangement—Underlying based on the occurrence of a credit event by the reference entity (Case J).

**Case A: Research and Development Funding Arrangement—Underlyings Based on the Occurrence of Regulatory Approval and Achieving an Earnings Target**

Entity A and Entity B enter into a research and development funding arrangement. Under the arrangement, Entity B provides funding of $50 million so that Entity A may develop and commercialize a drug compound. The arrangement has no clawback feature. Upon regulatory approval of the drug, Entity A pays $20 million to Entity B. Once the drug is commercialized, Entity A pays an additional $80 million to Entity B when gross profit related to the drug exceeds $500 million.

The arrangement contains 2 underlyings: the occurrence of regulatory approval and an earnings measure (gross profit related to the drug exceeding $500 million). Because the occurrence of regulatory approval and gross profit relate to the drug that Entity A is developing, both of the underlyings are based on the operations or activities of Entity A. Whether the occurrence of regulatory approval is within the control of Entity A does not impact the conclusion that the underlying qualifies for the scope exception. Neither underlying is based on a market rate, market price, market index, or the price or performance (including default) of a financial asset or financial liability of one of the parties to the contract as described in paragraph 815-10-15-59(e)(1) and (e)(2). Also, the exclusions related to contracts involving an entity's own equity or call options and put options on debt instruments as described in paragraph 815-10-15-59(e)(3) and (e)(4) do not apply. Therefore, those two underlyings each qualify for the scope exception in paragraph 815-10-15-59(e).

**Case B: Monetization Transaction—Underlyings Based on the Occurrence of Regulatory Approval and Achieving a Sales Target**

Entity A licenses its intellectual property to a third party to develop and commercialize a drug compound. While Entity A is not involved in the development and commercialization activities of the drug compound, the third party has agreed to pay Entity A (a) $20 million upon regulatory approval of the drug and (b) future royalties based on sales of the drug once the drug is commercialized. Entity A separately enters into an arrangement with Entity B. Under this arrangement, Entity B pays $50 million to Entity A in exchange for the right to receive a portion of both the (a) $20 million payment upon regulatory approval of the drug and (b) future royalties based on sales of the drug. Entity B is involved in the arrangement solely for investment purposes and is not involved in the development and commercialization of the drug.

The evaluation of the scope exception in this Example focuses on the arrangement between Entity A and Entity B. That arrangement contains two underlyings: the occurrence of regulatory approval and sales of the drug. Both of the underlyings are based on the operations or activities of Entity A because in this arrangement Entity A licenses the intellectual property and receives licensing income for both the regulatory approval payment and the royalties from sales of the drug. Whether the occurrence of regulatory approval is within the control of Entity A does not impact the conclusion that the underlying qualifies for the scope exception. Neither underlying is based on a market rate, market price, market index, or the price or performance (including default) of a financial asset or financial liability of one of the parties to the contract as described in paragraph 815-10-15-59(e)(1) and (e)(2). Also, the exclusions related to contracts involving an entity's own equity or call options and put options on debt instruments as described in paragraph 815-10-15-59(e)(3) and (e)(4) do not apply. Therefore, those two underlyings each qualify for the scope exception in paragraph 815-10-15-59(e).

**Case C: Sustainability-Linked Bond—Underlying Based on the Failure to Meet a Greenhouse Gas Emissions Reduction Target**

On July 1, 20X1, Entity A issues a five-year fixed-rate bond. If Entity A's parent entity, Parent Company, fails to meet a specified greenhouse gas emissions reduction target that includes both direct and indirect greenhouse gas emissions (including upstream and downstream emissions) at the consolidated group level by June 30, 20X3, the fixed interest rate on Entity A's bond increases by 0.25 percent for the remaining term. Entity A and Parent Company are committed to meeting the target and taking actions to reduce greenhouse gas emissions. The bond is a hybrid instrument that contains an embedded feature that is required to be evaluated for bifurcation. The embedded feature contains one underlying: the failure to meet a greenhouse gas emissions reduction target at the consolidated group level. Because Entity A is a subsidiary of Parent Company, the failure to meet the greenhouse gas emissions reduction target at the consolidated level is considered an activity specific to one of the parties to the contract for the purposes of both Entity A's standalone financial statements and Parent Company's consolidated financial statements. The underlying is not based on a market rate, market price, market index, or the price or performance (including default) of a financial asset or financial liability of one of the parties to the contract as described in paragraph 815-10-15-59(e)(1) and (e)(2). Also, the exclusions related to contracts involving an entity's own equity or call options and put options on debt instruments as described in paragraph 815-10-15-59(e)(3) and (e)(4) do not apply. Therefore, the underlying qualifies for the scope exception in paragraph 815-10-15-59(e).

**Case D: Litigation Funding Arrangement between Litigant and Funder—Underlying Based on the Occurrence of a Successful Litigation Outcome**

Entity A, a litigant seeking to recover patent infringement damages, enters into a funding arrangement with Entity B. Under the arrangement, Entity B provides $1 million to fund Entity A's litigation. The arrangement has no clawback feature. Upon a successful litigation outcome, Entity A will pay Entity B 50 percent of the settlement amount that it receives from the resolution of the litigation.

The arrangement between Entity A and Entity B contains one underlying: the occurrence of a successful litigation outcome. The settlement amount (and the percentage of this amount) received from the resolution of the litigation is a payment provision. Because Entity A is engaged in the legal proceeding, the underlying is based on the operations or activities of Entity A. The underlying is not based on a market rate, market price, market index, or the price or performance (including default) of a financial asset or financial liability of one of the parties to the contract as described in paragraph 815-10-15-59(e)(1) and (e)(2). Also, the exclusions related to contracts involving an entity's own equity or call options and put options on debt instruments as described in paragraph 815-10-15-59(e)(3) and (e)(4) do not apply. Therefore, the underlying qualifies for the scope exception in paragraph 815-10-15-59(e).

**Case E: Litigation Funding Arrangement between Law Firm and Funder—Underlying Based on the Occurrence of a Successful Litigation Outcome**

Entity C, a law firm, has been engaged to represent a litigant whereby legal fees are calculated as 30 percent of the final judgment (the settlement amount). Entity C separately enters into a funding arrangement with Entity B. Under the arrangement, Entity B provides funding of $1 million so that Entity C may hire additional staff to perform research related to the litigant's legal proceeding. The arrangement has no clawback feature. Upon a successful litigation outcome, Entity C will pay Entity B 50 percent of the legal fees received from the litigant.

The evaluation of the scope exception in this Example focuses on the arrangement between Entity C and Entity B. That arrangement contains one underlying: the occurrence of a successful litigation outcome related to the litigant that Entity C is representing. The settlement amount (and the percentage of this amount) received by the litigant is a payment provision. Because Entity C is engaged to represent the litigant in the legal proceeding, the underlying is based on the operations or activities of Entity C. The underlying is not based on a market rate, market price, market index, or the price or performance (including default) of a financial asset or financial liability of one of the parties to the contract as described in paragraph 815-10-15-59(e)(1) and (e)(2). Also, the exclusions related to contracts involving an entity's

own equity or call options and put options on debt instruments as described in paragraph 815-10-15-59(e)(3) and (e)(4) do not apply. Therefore, the underlying qualifies for the scope exception in paragraph 815-10-15-59(e).

**Case F: Commodities-Based Arrangement—Underlying Based on a Market Price of Gold**

Entity A buys and sells gold as part of its operations. Entity A enters into a contract with Entity B whereby Entity A receives an upfront payment in exchange for a specified percentage of a price increase in the market price of gold. The arrangement contains one underlying: the market price of gold. The underlying is based on a market price as described in paragraph 815-10-15-59(e)(1). Therefore, the underlying does not qualify for the scope exception in paragraph 815-10-15-59(e).

**Case G: Variable Payment Arrangement—Underlying Based on the Occurrence of Regulatory Approval**

Entity A, a pharmaceutical company, acquires Entity B, a biotechnology start-up company that does not meet the definition of a business. As part of the transaction, Entity A and the sellers of Entity B enter into a variable payment arrangement whereby Entity A will pay the sellers of Entity B an additional $2 million upon regulatory approval of a drug compound that Entity B is developing.

The arrangement contains one underlying: the occurrence of regulatory approval. The occurrence of regulatory approval relates to the drug that Entity B is developing as part of its operations. The underlying is not based on a market rate, market price, market index, or the price or performance (including default) of a financial asset or financial liability of one of the parties to the contract as described in paragraph 815-10-15-59(e)(1) and (e)(2). Also, the exclusions related to contracts involving an entity's own equity or call options and put options on debt instruments as described in paragraph 815-10-15-59(e)(3) and (e)(4) do not apply. Therefore, the underlying qualifies for the scope exception in paragraph 815-10-15-59(e).

**Case H: Earnout Arrangement—Underlying Based on Earnings Activity**

Entity A acquires a patent from Entity B. As part of the transaction, Entity A and Entity B enter into an earnout arrangement whereby Entity A will pay Entity B $3 for each $1 that earnings before interest, taxes, depreciation, and amortization (EBITDA) associated with the manufacturing and sale of products that rely on that patent is in excess of $1 million on the 1-year anniversary of the purchase date. If EBITDA associated with the manufacturing and sale of products using the patent does not exceed $1 million, Entity A does not owe Entity B any amounts under the earnout arrangement.

The arrangement contains one underlying: an earnings measure (EBITDA) related to the manufacturing and sale of products that rely on the patent acquired by Entity A. The underlying is not based on a market rate, market price, market index, or the price or performance (including default) of a financial asset or financial liability of one of the parties to the contract as described in paragraph 815-10-15-59(e)(1) and (e)(2). Also, the exclusions related to contracts involving an entity's own equity or call options and put options on debt instruments as described in paragraph 815-10-15-59(e)(3) and (e)(4) do not apply. Therefore, the underlying qualifies for the scope exception in paragraph 815-10-15-59(e).

**Case I: Variable Payment Arrangement—Underlying Based on Stock Price Differential**

Entity A acquires Entity B (which does not meet the definition of a business) in exchange for two million shares of Entity A's common stock. As part of the acquisition agreement, Entity A agrees to pay cash to the sellers of Entity B if the quoted market price of Entity A's common stock is less than $100 on the 1-year anniversary of the acquisition date. Specifically, if the quoted market price of Entity A's common stock is less than $100 on the 1-year anniversary of the acquisition date, the total amount paid in cash to the sellers of Entity B is equal to $100 minus Entity A's common stock price on the 1-year anniversary of the acquisition date multiplied by 2 million shares.

The arrangement contains 1 underlying: the common stock price differential ($100 less Entity A's common stock price at the 1-year anniversary of the acquisition date). The underlying is based on a market price as described in paragraph 815-10-15-59(e)(1). Therefore, the underlying does not qualify for the scope exception in paragraph 815-10-15-59(e).

**Case J: Credit Default Swap Arrangement—Underlying Based on the Occurrence of a Credit Event by the Reference Entity**

Entity A holds a debt instrument issued by Entity C. Entity A separately enters into a credit default swap arrangement with Entity B to obtain credit protection on its debt investment in Entity C (the reference entity). As part of that arrangement, Entity A makes periodic premium payments to Entity B, and, in exchange, Entity B agrees to make a cash payment to Entity A if the reference entity defaults on the debt instrument.

The arrangement contains one underlying: the occurrence of an event of default by the reference entity. While the underlying is not based on a market rate, market price, or market index as described in paragraph 815-10-15-59(e)(1), the underlying is based on the price or performance (including default) of a financial asset of one of the parties to the contract (the debt instrument held by Entity A) as described in paragraph 815-10-15-59(e)(2). Therefore, the underlying does not qualify for the scope exception in paragraph 815-10-15-59(e).

### 3.3.6 Derivative instruments that impede sale accounting

ASC 815-10-15-63 explains that a freestanding or embedded derivative like a call option may qualify for this scope exception if the existence of the derivative instrument impedes the recognition of a related contract as a sale. An example would be an entity that sells loans and has an option to repurchase them. This call option may prevent the transfer of the loans from being accounted for as a sale under ASC 860, in which case the loans would remain on the entity's balance sheet. A call option associated with a failed sale would qualify for this scope exception so an entity would not account for the loans twice—once through the recognition of the loan and the other through the recognition of the option. This scope exception applies to the transferor and transferee of a transfer that is subject to ASC 860.

Pursuant to ASC 815-10-15-63, a derivative instrument that is held by a transferor and related to assets that were transferred as part of a transaction accounted for as a financing in accordance with ASC 860, but which does not itself impede sale accounting, is not within the scope of ASC 815 if recognizing the derivative instrument and either the transferred asset or liability brought about by the transfer results in accounting for the same item twice in the transferor's balance sheet. However, if recognizing the derivative instrument and either the transferred asset or liability brought about by the transfer would not result in accounting for the same item twice in the transferor's balance sheet, the derivative instrument would be in the scope of ASC 815.

The following table describes certain derivative instruments and whether they qualify for the sale accounting impediment scope exception.

| Description of the derivative instrument | Applicability of the sale accounting impediment scope exception |
|---|---|
| Cleanup call—an option held by the servicer or its affiliate, which may be the transferor, to purchase the remaining transferred financial assets or the remaining beneficial interests not held by the transferor, its affiliates or its agents in an entity (or in a series of beneficial interests in transferred financial assets within an entity) if the amount of outstanding financial assets or beneficial interests falls to a level at which the cost of servicing those assets or beneficial interests becomes | An arrangement that meets the definition of a cleanup call option in ASC 860-10-20 does not impede sale accounting in accordance with ASC 860-10-40-34. Therefore, the scope exception would not apply unless the transfer was accounted for as a financing for other reasons, such that recognizing both the cleanup call as a derivative instrument and the transferred asset would be double counting the assets on the balance sheet. |

| Description of the derivative instrument | Applicability of the sale accounting impediment scope exception |
|---|---|
| burdensome in relationship to the benefits of servicing. | |
| A call option (other than a cleanup call, described in the preceding row) that gives a transferor the unilateral right to repurchase transferred financial assets that are not readily obtainable. | Applies. The call option will cause the transfer to fail to meet the condition in ASC 860-10-40-5(c) and therefore impede sale accounting. In general, if a derivative instrument is an impediment to recognizing the sale of a financial asset (from a related contract), that derivative instrument is specifically excluded from ASC 815. This scope exception avoids the double counting that would occur if the transferred financial asset was not derecognized and a derivative instrument was recognized. |
| A derivative instrument, held by a transferor, that relates to financial assets transferred in a transaction that it accounted for as a secured borrowing in accordance with ASC 860, but which does not itself serve as an impediment to sale accounting. | In accordance with ASC 815-10-15-64, a derivative instrument should not be accounted for as a derivative instrument if recognizing both the derivative instrument and either the transferred asset or liability that arose from the transfer would result in the transferor accounting for the same item twice. |

An illustration of the application of this scope exception is provided in ASC 815-10-55-41.

### 3.3.7 Investments in life insurance

Pursuant to ASC 815-10-15-67, a policyholder's investment in a life insurance contract (e.g., corporate- or bank-owned life insurance) accounted for in accordance with ASC 325-30 is not accounted for as a derivative instrument. This scope exception only applies to the holder of the life insurance contract.

### 3.3.8 Certain investment contracts

ASC 960 addresses the accounting for certain investment contracts. For practical reasons, the FASB excluded these investment contracts from ASC 815 and, thus, from being accounted for as derivative instruments. As explained in ASC 815-10-15-68, this scope exception applies only to:

- Plan investments accounted for under ASC 960-325-35-1 and
- Insurance contracts accounted for under ASC 960-325-35-3

The investment contract scope exception applies only to the holder of the investment contract, not the issuer of the investment contract.

#### 3.3.8.1 Synthetic guaranteed investment contracts

A synthetic guaranteed investment contract is a financial instrument that simulates the performance of a guaranteed investment contract. ASC 815-10-05-8 through 05-15 provides a discussion on these contracts, and an illustration of their contractual terms is included beginning in ASC 815-10-55-169. ASC 815-10-55-63 indicates that an issuer of a synthetic guaranteed investment contract is required to account for it as a derivative instrument. However, as noted in ASC 815-10-15-68A, the wrapper of a synthetic guaranteed investment contract that meets the definition of a fully benefit-responsive investment contract that is held by an employee benefit plan is exempt from ASC 815.

### 3.3.9 Certain loan commitments

Loan commitments may meet the definition of a derivative instrument. However, the FASB did not intend for all loan commitments to be accounted for as derivative instruments.

As explained in ASC 815-10-15-69, neither a lender nor a borrower accounts for a loan commitment as a derivative instrument. One exception is that lenders are required to account for loan commitments to originate mortgage loans that it will hold for sale, as derivative instruments.

SEC Staff Guidance incorporated in ASC 815-10-S99-1 provides the SEC staff's views on certain questions related to measuring the fair value of derivative loan commitments. That is, the staff believes that the fair value measurement of the derivative loan commitment should include the expected net future cash flows associated with servicing the related loan, but not the expected net future cash flows related to internally-developed intangible assets.

As noted in ASC 815-10-15-70, the loan commitment scope exception does not apply to a commitment to purchase or sell loans at a future date. An entity must evaluate such a commitment to determine if it meets the definition of a derivative instrument. This type of commitment often meets the definition of a derivative instrument if it may be net settled (e.g., if the loans that are subject to the commitment can be readily converted to cash).

### 3.3.10 Certain interest- and principal-only strips

Interest-only strips (I/Os) and principal-only strips (P/Os) result from separating a debt instrument into:

- **A P/O:** An instrument that is entitled to receive payments associated with the repayment of the principal of the debt instrument.
- **An I/O:** An instrument that is entitled to receive payments associated with the payments of interest on the principal balance of the debt instrument.

ASC 815 provides a narrow scope exception for simple I/Os and P/Os. According to ASC 815-10-15-72, an I/O or P/O is not accounted for as a derivative instrument if it:

- Represents the right to receive only a specified proportion of the contractual interest cash flows of a specific debt instrument or a specified proportion of the contractual principal cash flows of that debt instrument
- Does not incorporate any terms not present in the original debt instrument

I/Os and P/Os can be forms of compensation to a servicer as discussed in ASC 860. As ASC 815-15-55-154 illustrates, both servicing fees in excess of adequate compensation and guarantee fees are examples of circumstances that cause an I/O or P/O to not qualify for this scope exception. This, as well as the guidance in ASC 815-10-15-73, are discussed in the following table.

| Description of I/O or P/O | Applicability of the I/O and P/O scope exception |
|---|---|
| A portion of the interest or principal cash flows of a specific debt instrument as reasonable compensation for stripping the debt instrument. | Applies |
| A portion of the interest or principal cash flows of a specific debt instrument as adequate compensation to a servicer (as defined in ASC 860). | Applies |
| A portion of the interest or principal cash flows of a specific debt instrument to provide for a guarantee of payments. | Does not apply |
| A portion of the interest or principal cash flows of a specific debt instrument as compensation to a servicer that is more than adequate. | Does not apply |

| Description of I/O or P/O | Applicability of the I/O and P/O scope exception |
|---|---|
| A portion of the interest or principal cash flows of a specific debt instrument for any other purpose. | Does not apply |

### 3.3.11 Certain contracts involving an entity's own equity

A basic principle of ASC 815 is that a derivative instrument represents rights or obligations that meet the definitions of assets or liabilities. As a result, derivative accounting does not apply to items classified as equity. The guidance for this scope exception is in ASC 815-10-15-74 through 15-78. ASC 815-10-15-74 outlines, for certain contracts involving an entity's own equity, the types of contracts that qualify for the scope exception.

**ASC 815-10-15-74**

Notwithstanding the conditions of paragraphs 815-10-15-13 through 15-139, the reporting entity shall not consider the following contracts to be derivative instruments for purposes of this Subtopic:[4]

a. Contracts issued or held by that reporting entity that are both:
   1. Indexed to its own stock (see Section 815-40-15)
   2. Classified in stockholders' equity in its statement of financial position (see Section 815-40-25)

b. Contracts issued by the entity that are subject to Topic 718. If any such contract ceases to be subject to Topic 718 in accordance with paragraphs 718-10-35-9 through 35–14, the terms of that contract shall then be analyzed to determine whether the contract is subject to this Subtopic. An award that ceases to be subject to Topic 718 in accordance with those paragraphs shall be analyzed to determine whether it is subject to this Subtopic.

c. Any of the following contracts:
   1. A contract between an acquirer and a seller to enter into a business combination
   2. A contract to enter into an acquisition by a not-for-profit entity
   3. A contract between one or more NFPs to enter into a merger of not-for-profit entities
   4. In a joint venture's separate financial statements, a contract between a joint venture and its venturer related to the formation of the joint venture accounted for in accordance with Subtopic 805-60.

d. Forward contracts that require settlement by the reporting entity's delivery of cash in exchange for the acquisition of a fixed number of its equity shares (forward purchase contracts for the reporting entity's shares that require physical settlement) that are accounted for under paragraphs 480-10-30-3 through 30-5, 480-10-35-3, and 480-10-45-3.

[4] Following the adoption of ASU 2025-07, this sentence will be replaced with "Notwithstanding the conditions of paragraphs 815-10-15-13 through 15-60 and 815-10-15-62 through 15-139, the reporting entity shall not consider the following contracts to be derivative instruments for purposes of this Subtopic." Refer to the ASU for effective date and transition requirements.

As explained in ASC 815-10-15-75, the scope exceptions in ASC 815-10-15-74 do not apply to either the counterparty in those contracts or to a contract that an entity can or must settle by issuing its own equity instruments but that is indexed in part or in full to something other than its own stock.

**ASC 815-10-15-75**

The scope exceptions in paragraph 815-10-15-74 do not apply to either of the following:

a. The counterparty in those contracts. For example, the scope exception in (b) in the preceding paragraph[5] related to stock-based compensation arrangements does not apply to equity instruments (including stock options) received by nonemployees as compensation for goods and services.

b. A contract that an entity either can or must settle by issuing its own equity instruments but that is indexed in part or in full to something other than its own stock. That contract can be a derivative instrument for the issuer under paragraphs 815-10-15-13 through 15-139,[6] in which case it would be accounted for as a liability or an asset in accordance with the requirements of this Subtopic. For example, a forward contract that is indexed to both an entity's own stock and currency exchange rates does not qualify for the exception in (a) in the preceding paragraph[7] with respect to that entity's accounting because the forward contract is indexed in part to something other than that entity's own stock (namely, currency exchange rates).

The remainder of this section discusses the own equity scope exception as it relates to:

- Contracts that are indexed to an entity's own stock and are classified in stockholders' equity
- Contracts subject to ASC 718
- Contracts to facilitate a business combination
- Fixed-for-fixed forward contracts

### 3.3.11.1 Contracts that are indexed to an entity's own stock and are classified in stockholders' equity

In accordance with ASC 815-10-15-74(a), a contract that an entity issued or holds that is indexed to its own stock and is required to be presented in stockholders' equity (whether permanent or temporary) is exempt from ASC 815. Refer to RSM's A guide to accounting for debt and equity instruments in financing transactions for determining whether a contract is both:

- Indexed to the issuer's own stock
- Classified in stockholders' equity in the issuer's balance sheet

### 3.3.11.2 Contracts subject to ASC 718

In accordance with ASC 815-10-15-74(b), a stock-based compensation arrangement that is within the scope of ASC 718 is not accounted for as a derivative instrument. As a result, an entity that issues share-based payment awards that are within the scope of ASC 718, including stock options, stock warrants and restricted stock to employees or nonemployees (including customers) in exchange for goods or services does not account for those awards as derivative instruments. However, such an award would be

[5] Following the adoption of ASU 2025-07, the reference to "preceding paragraph" will be replaced with "paragraph 815-10-15-74." Refer to the ASU for effective date and transition requirements.
[6] Following the adoption of ASU 2025-07, the reference will be replaced with "paragraphs 815-10-15-13 through 15-60 and 815-10-15-62 through 15-139." Refer to the ASU for effective date and transition requirements.
[7] Following the adoption of ASU 2025-07, the reference to "preceding paragraph" will be replaced with "paragraph 815-10-15-74." Refer to the ASU for effective date and transition requirements.

accounted for as a derivative instrument by the recipient if it possesses all of the characteristics of a derivative instrument because this scope exception applies only to the employer and not the recipient.

As noted in ASC 815-10-55-46 through 55-48, stock awards that relate to the stock of an unrelated entity are not within the scope of ASC 718 even if the vesting of the awards is subject to continued employment and, therefore, do not qualify for this scope exception to ASC 815.

In accordance with ASC 718-10-35-10 through 35-12, a freestanding financial instrument issued to a grantee that is originally subject to ASC 718 may become subject to other accounting guidance, including ASC 815, if the terms of that instrument are modified after the grantee is no longer an employee or after the grantee vests in the award and is no longer providing goods or services or is no longer a customer. In circumstances like this, an entity should consider whether the modified instrument is a derivative instrument and if so, whether it meets the scope exception in ASC 815-10-15-74(a) for contracts that are indexed to an entity's own stock and are classified within stockholders' equity.

### 3.3.11.3 Contracts to facilitate a business combination

In accordance with ASC 815-10-15-74(c), the parties to certain contracts do not account for them as derivative instruments.

**ASC 815-10-15-74**

Notwithstanding the conditions of paragraphs 815-10-15-13 through 15-139,[8] the reporting entity shall not consider the following contracts to be derivative instruments for purposes of this Subtopic:

...

c. Any of the following contracts:

1. A contract between an acquirer and a seller to enter into a business combination
2. A contract to enter into an acquisition by a not-for-profit entity
3. A contract between one or more NFPs to enter into a merger of not-for-profit entities
4. In a joint venture's separate financial statements, a contract between a joint venture and its venturers related to the formation of the joint venture accounted for in accordance with Subtopic 805-60.

While contracts to enter into a business combination or certain acquisitions or mergers are excluded from the scope of ASC 815, an entity should evaluate contracts or instruments that it issues or acquires in conjunction with the acquisition or merger to determine whether they are derivative instruments in their entirety or contain embedded derivatives that it should account for as derivative instruments in accordance with ASC 815. This evaluation includes considering whether the contracts or instruments meet the definition of a derivative instrument and if any of the scope exceptions discussed in this section apply. An entity should determine this based on the facts and circumstances that exist at the date of the acquisition.

As part of this evaluation, an entity should analyze any contingent consideration feature in a business combination to determine whether it meets the definition of a derivative instrument. An entity should also consider the scope exception for certain contracts involving an entity's own equity for any share-based consideration. For further information on accounting for contingent consideration in a business combination, refer to RSM's A guide to accounting for business combinations.

[8] Following the adoption of ASU 2025-07, the reference will be replaced with "paragraphs 815-10-15-13 through 15-60 and 815-10-15-62 through 15-139." Refer to the ASU for effective date and transition requirements.

#### 3.3.11.4 Fixed-for-fixed forward contracts

In accordance with ASC 815-10-15-74(d), a forward contract that requires settlement in which the reporting entity will deliver cash in exchange for a fixed number of its equity shares that is accounted for under ASC 480-10-30-3 through 30-5 is not accounted for as a derivative instrument. For further information on accounting for such forward contracts refer to RSM's A guide to accounting for debt and equity instruments in financing transactions.

### 3.3.12 Leases

In accordance with ASC 815-10-15-79, the lessor and lessee of a lease that is within the scope of ASC 842 for the reporting entity do not account for the lease as a derivative instrument. However, the lease may contain features that are embedded derivatives and require separate accounting as required by ASC 815-15-25-1. Refer to Chapter 4 for further information on embedded derivatives.

### 3.3.13 Residual value guarantees

To protect their economic interest in a leased asset, lessors commonly require lessees to guarantee that the value of the leased asset will be at least a certain amount at the end of the lease term when the lessee returns the asset to the lessor. Such guarantees are referred to as residual value guarantees. In accordance with ASC 815-10-15-80, a residual value guarantee that is within the scope of ASC 842 is not accounted for as a derivative instrument.

Sometimes a third-party (e.g., an insurance company) may provide a residual guarantee to a lessor on behalf of the lessee. As discussed in ASC 815-10-15-81, the third-party guarantor considers the guidance in ASC 815 for any residual value guarantee that it provides to determine whether the guarantee meets the definition of a derivative instrument, and if so, whether it meets the residual value guarantee scope exception in ASC 815. If the residual value guarantee is not accounted for as a derivative instrument, the guarantor should consider whether the guarantee falls within the scope of ASC 460.

### 3.3.14 Registration payment arrangements

Registration rights or registration payment arrangements entitle the holder (e.g., investor or lender) to require an entity to file a registration statement for the resale of its equity instruments. A lender may receive registration rights in conjunction with the issuance of a loan agreement that can be settled in shares. Registration rights may also be granted in conjunction with the issuance or sale of equity, a warrant agreement, or convertible debt agreement. These registration rights may entitle the holder to an additional interest or payment if the entity does not file a registration statement by a certain date or allows it to lapse.

Guidance is provided in ASC 825-20 for issuers of registration payment arrangements. This guidance requires separate recognition and measurement under ASC 450 of the contingent obligation to make future payments (or transfer consideration) under a registration payment arrangement. This is the case regardless of whether the obligation arises from a separate agreement or is included as a feature of the debt or equity instrument. In accordance with ASC 815-10-15-82, neither the issuer nor its counterparty (e.g., investor or lender) of a registration payment arrangement that is within the scope of ASC 825-20 would account for it as a derivative instrument.

### 3.3.15 Certain fixed-odds wagering contracts

In accordance with ASC 815-10-15-82A, a fixed-odds wagering contract for an entity operating as a casino and for the casino operations of other entities are within the scope of ASC 606 and, therefore, is not accounted for as a derivative instrument.

# 4 Embedded derivatives

## 4.1 Overview

As noted in ASC 815-15-05-1, contracts such as bonds, insurance policies, leases and preferred stock may contain embedded derivatives. In other words, an instrument or contract that is not a derivative instrument in its entirety may contain a feature that has the same or similar economic effects as a derivative instrument. Assuming a scope exception does not apply, an entity may be required to bifurcate an embedded derivative from the instrument in which it is contained and account for it separately unless the entity elects to account for the entire instrument under the fair value option. The FASB's rationale for issuing guidance on embedded derivatives is to prevent an entity from avoiding the derivative accounting requirements of ASC 815 by inserting a derivative feature in a nonderivative instrument or another contract.

Although the concepts in the preceding paragraph are not difficult to understand, in practice, an entity is often presented with one or more challenges in applying the accounting guidance for embedded derivatives. These challenges essentially stem from the fact that an embedded derivative is an accounting construct. That is, whereas a freestanding interest rate swap or forward contract is itself a contractual agreement with specified terms, an embedded derivative is not. Rather, for lack of a better term, it is *embedded* in another instrument or contract. This means that an embedded derivative will not always be apparent. ASC 815 defines an embedded derivative as "Implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by a contract in a manner similar to a derivative instrument." Analyzing whether an embedded derivative exists requires judgment. In addition, once an entity identifies that an instrument or contract contains an embedded derivative, the terms of the embedded derivative may not always be obvious. Moreover, not only is an entity required to evaluate the terms of its instruments or contracts to identify embedded derivatives, it must also determine whether any embedded derivative that it identified is required to be accounted for as a separate derivative instrument. Making these determinations requires careful analysis and judgment. The process to determine if an embedded derivative requires separate accounting is multi-faceted. An embedded derivative is not accounted for separately as a derivative instrument unless it meets certain conditions, including the definition of a derivative instrument and does not meet any of the ASC 815 scope exceptions. Also, if the instrument or contract that contains the embedded derivative is accounted for at fair value with the changes in its fair value reported in earnings, the embedded derivative is not separated because essentially it is already receiving the accounting treatment that would be required if it was accounted for separately. This is because the terms that comprise the embedded derivative would need to be considered when determining the fair value of the instrument or contract in which the embedded derivative is contained. Finally, an embedded derivative is not accounted for separately unless its economic characteristics and risks are not clearly and closely related to the economic characteristics and risks of its host contract.

Comparing the economic characteristics and risks of the embedded derivative to those of the host contract requires not only identifying and understanding the nature of the embedded derivative, but also understanding the nature of the host contract. Determining the nature of the host contract is often subjective. Consider an instrument that has been determined to contain an equity-like embedded derivative. If the host contract is more akin to equity, the economic characteristics and risks of the equity-like embedded derivative would be clearly and closely related to those of the host contract, and the embedded derivative would not be accounted for separately. Conversely, if the host contract is more akin to debt, the economic characteristics and risks of an embedded equity-like derivative would not be considered clearly and closely related to those of the host contract, and if the other conditions required by ASC 815-15-25-1 are met, the embedded feature would be accounted for separately as a derivative instrument. This chapter discusses these concepts in more depth.

**RSM COMMENTARY: Accounting for embedded derivatives**

If an embedded derivative requires separate accounting, it is accounted for as if it is a freestanding derivative instrument. That is, the embedded derivative is initially and subsequently reported and measured on the balance sheet at fair value as determined pursuant to ASC 820. The change in the fair value of the embedded derivative is reported in earnings unless the derivative instrument is designated as a hedging instrument in a cash flow or net investment hedge. (For guidance on accounting for cash flow or net investment hedges, refer to Chapter 10 or Section 8.4, respectively.)

### 4.1.1 Embedded derivative terminology

When determining whether an embedded derivative must be accounted for as a derivative instrument, it is important to understand the following terms:

| Term | Description |
|---|---|
| Hybrid instrument | A contract that embodies both an embedded derivative and a host contract. |
| Embedded derivative | "Implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by a contract in a manner similar to a derivative instrument." As explained by ASC 815-15-25-2, embedded derivative refers to provisions noted in a single contract and not to provisions within separate contracts between different counterparties.<br>**Note:** Confusion exists in practice, as some believe that the term "embedded derivative" denotes an embedded feature that requires separate accounting as a derivative instrument. However, embedded derivatives do not necessarily require separate accounting. An embedded derivative is a feature that meets the description above, which then should be assessed to determine whether it requires separate accounting as a derivative instrument. See "Embedded derivative that requires separate accounting" below in this table.<br>Throughout the rest of this guide, the term "embedded derivative" is used to refer to a feature that meets the ASC Master Glossary definition provided above (i.e., a feature of an instrument or contract that must be analyzed to determine whether it must be accounted for separately as a derivative instrument). |
| Host contract | A hybrid instrument exclusive of the embedded derivative. |
| Embedded derivative that requires separate accounting | An embedded derivative that requires bifurcation from the host contract and is accounted for as a separate derivative instrument because it meets the conditions in ASC 815-15-25-1, which are discussed later in this chapter. One of the conditions is that a separate instrument with the same terms as the embedded derivative would be a derivative instrument subject to the requirements of ASC 815. |

The following table illustrates how this guidance is applied to similar instruments, namely, a warrant to purchase shares and an option to obtain shares by converting debt or preferred stock. If facts and circumstances differ from those described, a different conclusion may be reached.

| | |
|---|---|
| Stock purchase warrants | Warrants are generally considered freestanding, even if issued with another financial instrument, such as debt or stock. This is because warrants are typically separately exercisable (i.e., the exercise of the warrants would not result in the termination of the debt or stock the warrants may have been issued with). |
| Conversion options in debt or preferred stock agreements | Conversion options are typically viewed as embedded in the convertible debt or preferred stock because the conversion option generally cannot be detached and separately exercised (i.e., the exercise of the conversion option would result in the termination of the debt or preferred stock that is converted). |

### 4.1.2 Scope exceptions

In addition to the general scope exceptions summarized in ASC 815-10-15-13 and discussed in Chapter 3 that may be relevant to embedded derivatives, ASC 815-15 provides for certain scope exceptions that are specific to embedded derivatives. The circumstances under which embedded derivatives would not require separate accounting are outlined in ASC 815-15-15-4 through 15-21 and summarized in the following table.

| Contract, transaction or feature | Conditions that must be met to be exempt from the guidance on embedded derivatives |
|---|---|
| Normal purchases and normal sales contracts (ASC 815-15-15-4) | A contract that qualifies for the normal purchases and normal sales scope exception discussed at Section 3.3.2 is not considered to contain an embedded derivative. |
| Unsettled foreign currency transactions (ASC 815-15-15-5 through 15-6) | Unsettled foreign currency transactions, including financial instruments, do not contain embedded foreign currency derivatives if the transactions:<br>• Are monetary items<br>• Have principal or interest payments denominated in a foreign currency<br>• Are subject to the requirement in Subtopic 830-20 to recognize any foreign currency transaction gain or loss in earnings<br>ASC 815-15-15-6 clarifies that this exception applies to foreign-currency denominated trading and available-for-sale securities. We believe that this exception also applies to financial instruments that are not securities, such as a financial asset that can be prepaid or otherwise settled in a way such that the holder would not recover substantially all of its recorded investment (e.g., certain I/Os that are not securities). |
| Plain-vanilla servicing rights (ASC 815-15-15-7) | Plain-vanilla servicing rights, which involve the obligation to service assets and the right to receive fees for that servicing, do not contain an embedded derivative requiring separate accounting. |
| Features involving certain aspects of credit risk (ASC 815-15-15-9) | The transfer of credit risk that is created by the subordination of one financial instrument or tranche to another financial instrument or tranche potentially creates an embedded derivative. This scope exception from derivative treatment applies only to an embedded credit derivative created by subordination. Other embedded credit derivatives, such as credit default swaps on a referenced credit exposure, are potentially subject to separate derivative accounting even if their effects are allocated across various |

| Contract, transaction or feature | Conditions that must be met to be exempt from the guidance on embedded derivatives |
|---|---|
| | tranches of securitized financial instruments for subordination purposes. Consequently, certain circumstances would not qualify for this scope exception and would potentially be subject to separate derivative accounting. For example:<br>• An embedded derivative feature that relates to another type of risk, including another type of credit risk, is present in the securitized financial instruments.<br>• The holder of an interest in a tranche of a securitized financial instrument is exposed to the possibility of being required to make potential future payments because the possibility of those future payments is not created by subordination. The securitized financial instrument may involve other tranches that are not exposed to potential future payments; those other tranches might qualify for the scope exception.<br>• A holder owns an interest in a single-tranche securitization vehicle; the subordination of one tranche to another is therefore not relevant. |
| Features involving certain currencies (ASC 815-15-15-10 through 15-21) | An embedded foreign currency derivative is not separated from its host contract and accounted for separately as a derivative instrument if the conditions in ASC 815-15-15-10 are met. Under these conditions, the host contract:<br>• Is not a financial instrument<br>• Requires payment denominated in any of the following:<br>- The functional currency of any substantial party to the contract<br>- The local currency of any substantial party to the contract<br>- The currency the price of the related good or service is routinely denominated in for international commerce (e.g., U.S. dollars for crude oil transactions)<br>- The currency a substantial party to the contract uses as if it were the functional currency because the primary economic environment in which the party operates is highly inflationary (discussed in paragraph 830-10-45-11)<br>• Is clearly and closely related to other aspects of the embedded foreign currency derivative<br>The evaluation of whether a contract qualifies for this scope exception should only be performed at the inception of the contract.<br>While this scope exception does not apply to financial instruments, it does apply to a normal insurance contract that involves payment in the functional currency of either of the two parties to the contract. In addition, it applies to a normal insurance contract that involves payment in the local currency of the country in which the loss is incurred, regardless of the functional currencies of the parties to a particular transaction.<br>Refer to ASC 815-15-55-1 through 55-4 for implementation guidance on the application of this scope exception to insurance contracts.<br>As explained in ASC 815-15-15-11, an entity determines a counterparty's primary economic environment based on available information and reasonable assumptions (i.e., representations need not be obtained from the |

| Contract, transaction or feature | Conditions that must be met to be exempt from the guidance on embedded derivatives |
|---|---|
| | counterparty). An illustration regarding this determination is provided in ASC 815-15-55-213 through 55-215. Refer to ASC 830-10-55-5 for guidance on the economic factors that should be considered in determining an entity's functional currency.<br>The following expands on two of the key concepts in this embedded foreign currency derivative scope exception.<br>**Substantial party to a contract (ASC 815-15-15-12)**<br>When determining who is a substantial party to the contract:<br>a. Consider all facts and circumstances related to the contract (e.g., whether a party has the knowledge, resources and technology to fulfill its contractual obligations without relying on related parties).<br>b. Look through the legal form of the contract to analyze the substance of the underlying relationships.<br>The implementation guidance in ASC 815-15-55-84 through 55-95 provides useful illustrations to determine if a party to a contract is substantial and if a highly inflationary economy exists for a substantial party.<br>**Routinely denominated in international commerce (ASC 815-15-15-14)**<br>The application of the phrase "routinely denominated in international commerce" should be based on the currency in which transactions for similar products or services are routinely denominated around the world, rather than in a local area. In other words, if transactions for a particular product or service are routinely denominated in various currencies around the world, the embedded foreign currency derivative scope exception in ASC 815-15-15-10 does not apply to those transactions. This is illustrated through Example 2 that begins at ASC 815-15-55-96.<br>**Foreign currency caps and floors**<br>ASC 815-15-15-15 through 15-19 should be considered when determining if the scope exception applies to foreign currency caps and floors within a nonfinancial contract. |

### 4.1.3 Identifying embedded derivatives

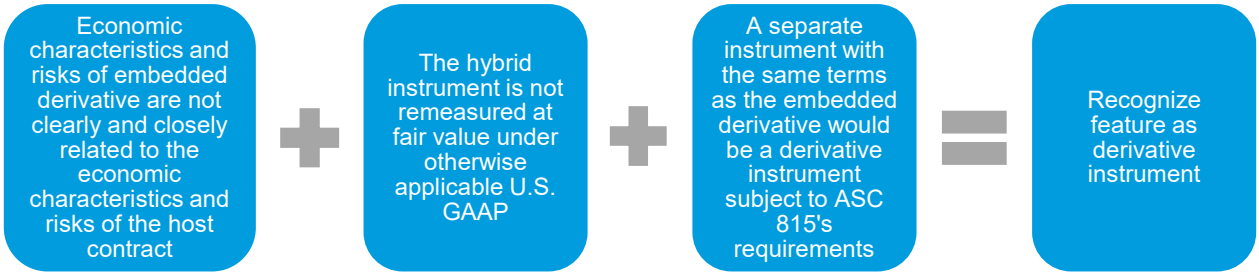
An instrument that has terms that are not found in the most simple and basic instrument of its type may contain one or more embedded derivatives. For example, a bond that is convertible by the holder and callable by the issuer may contain embedded derivatives in the form of a redemption feature (i.e., a call option) and a conversion option because an early redemption feature and a conversion option are not part of a plain-vanilla bond. Because an embedded derivative is "implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by a contract in a manner similar to a derivative instrument," it is helpful to focus on features that can alter the amount or timing of cash flows or the manner or amount in which the contract can otherwise be settled (e.g., in shares rather than cash) when determining what features within a contract may be embedded derivatives. The following table aids in this determination by providing examples of terminology that may be found in a contract that could indicate the existence of one or more embedded derivatives. The table is not intended to be all inclusive and contracts may not use identical terms to describe similar features.

| Embedded derivative | Key terminology to watch for |
|---|---|
| Conversion options (commonly found in debt instruments and preferred stock) | • Convert, convertible, upon conversion<br>• Exchange, exchangeable |
| Redemption features (commonly found in debt instruments and preferred stock) | • Accelerated repayment, prepay, repay<br>• Call, callable, put, puttable<br>• Upon the occurrence of certain contingent events (e.g., deemed liquidation, liquidation, change in control), the instrument will be paid off, redeemed<br>• Redeem, redeemable, upon redemption<br>• Repurchase<br>• Return |
| Interest rate features or indexation | • The rate will be adjusted, increased, decreased<br>• Ceilings, caps, floors, formula<br>• The rate will be determined by<br>• Index, indexed to, referenced |
| Credit indexation | • Amount or timing of cash flows will be adjusted upon:<br>- Bankruptcy<br>- Default<br>- Credit rating change |
| Foreign exchange indexation | • Exchange rate<br>• A specific currency that is not the currency of the parties to the transaction<br>• Index, indexed to, referenced |
| Equity or earnings indexation | • Amount or timing of cash flows will be adjusted based on:<br>- Equity index<br>- Earnings metrics (e.g., EBITDA, EPS, gains, losses, net income, profit, revenue)<br>- Formula |
| Commodity price indexation | • Index, indexed to, referenced to a particular commodity price<br>• Ceilings, caps, floors, formula refencing a commodity index<br>• Price, pricing |
| Other | • Cancel<br>• Choice, choose among, choose between<br>• Condition, conditional, contingency, contingent<br>• Elect<br>• Entitle<br>• Exercise<br>• Extend, extension<br>• Option<br>• Right |

## 4.2 Derivative analysis of embedded derivatives

Determining whether an embedded derivative must be separately recognized as a derivative instrument can be complex. Specifically, ASC 815-15-25-1 requires derivative recognition for embedded derivatives if three conditions are met:

1. The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.
2. The hybrid instrument is not remeasured at fair value under otherwise applicable U.S. GAAP.
3. A separate instrument with the same terms as the embedded derivative would be a derivative instrument subject to the requirements of ASC 815 (i.e., it meets the definition of a derivative instrument and does not qualify for one of the scope exceptions outlined in ASC 815-10-15-13 or ASC 815-15-15).




An entity would account for an embedded derivative separately as a derivative instrument "if and only if" all the preceding conditions are met. If the determination is made that one condition is not met for a particular embedded derivative, it would not be accounted for as a derivative instrument and there is no need to consider if the other requirements are met.

An integral part of analyzing an embedded derivative to determine if it requires separate accounting is determining the level of granularity to which the analysis applies.

**RSM COMMENTARY: Level of analysis**

ASC 815 does not specify the level at which the features of a financial instrument or contract need to be assessed to determine whether they represent embedded derivatives that require separate accounting. Questions have arisen as to whether each embedded derivative should be analyzed separately or combined with similar features that may exist within the same instrument or contract. A different conclusion may be reached as to whether an embedded derivative requires separate accounting as a derivative instrument depending on the approach taken.

For example, if a convertible debt instrument can be converted into equity shares contingent upon the occurrence of two separate events, such as a change in control or an IPO, the debt instrument could potentially be viewed as containing either:

- One conversion option (the combined approach)
- Two separate conversion options (the separate approach)

Suppose in this example there are different formulas for how the number of shares would be determined upon conversion, based on whether the event is a change in control or IPO, and the conversion feature upon a change in control meets all the requirements for the derivative scope exception for contracts involving an entity's own equity, but the conversion feature upon an IPO does not qualify for this scope exception. In this case, if the entity applied the combined approach, it would account for the entire conversion option separately as a derivative

instrument. However, if the entity applied the separate approach, it would only account for the conversion feature upon an IPO as a derivative instrument.

The level upon which the analysis should be applied requires judgment, and many factors should be considered, including:

- The party that can trigger the exercise of the feature (for options)
- Likeness of the underlyings
- How the settlement amounts are determined
- Situations that would trigger settlement

Because judgment is required, we believe that a reporting entity should document its justification for the approach taken and apply it consistently over time.

It should be noted that while a separate approach may be appropriate when analyzing embedded derivatives within a nonderivative host contract to determine which embedded derivatives should be accounted for as derivative instruments, it would not be appropriate to apply a separate approach to a freestanding derivative instrument because the entire instrument is a derivative that is required to be accounted for at fair value. To illustrate, if the instrument in question is a freestanding warrant derivative that is exercisable upon a change in control or IPO (rather than being convertible debt whereby the holder can convert upon a change in control or IPO) and either exercise feature (or, for that matter, any terms within the instrument) cause it to not qualify for the derivative scope exception for contracts involving an entity's own equity, the warrant in its entirety would be accounted for as a derivative instrument.

### 4.2.1 Clearly and closely related to the host contract

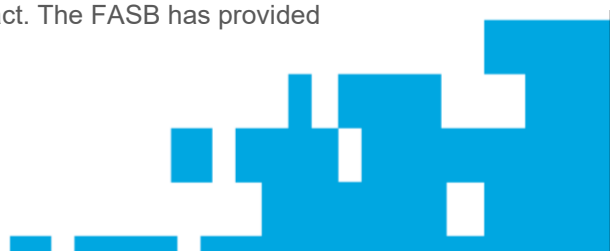
An entity considers whether the economic characteristics and risks of the embedded derivative are clearly and closely related to the economic characteristics and risks of the host contract as part of the embedded derivative analysis. If an entity determines that the economic characteristics and risks of the embedded derivative are clearly and closely related to those of the host contract, the entity would not account for the embedded derivative separately as a derivative instrument. However, if the entity determines that the economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract, the entity would account for the embedded derivative separately as a derivative instrument if the other two conditions in ASC 815-15-25-1 are met.

Determining the nature of the host contract is integral to assessing this condition. Sometimes, this determination is straightforward (e.g., the host contract of a convertible bond would be a plain-vanilla-nonconvertible bond, and therefore a debt host contract). In other cases, identifying the nature of the host contract can be challenging, particularly when the hybrid instrument is in the form of a share. It is not uncommon for instruments like preferred stock to have both debt- and equity-like characteristics, in which case subjective conclusions need to be reached about whether the host contract is more like debt or equity. (Refer to Section 4.2.1.1 for guidance on analyzing instruments in the form of a share).

To illustrate the significance of this determination, if an entity has determined that an instrument contains an equity-like embedded derivative and the host contract is akin to equity, the economic characteristics and risks of the embedded derivative would be clearly and closely related to those of the host contract and the embedded derivative would not be accounted for separately as a derivative instrument. Conversely, if the host contract is akin to debt, the economic characteristics and risks of the equity-like embedded derivative would be considered not clearly and closely related to those of the host contract. In this latter case, if the other two conditions in ASC 815-15-25-1 are met, the embedded derivative would be accounted for as a derivative instrument.

Although economic characteristics and risks sound technical, an entity can simply think of this as the nature of the embedded derivative versus the nature of the host contract. The FASB has provided





application guidance and examples in ASC 815-15-25-16 through 25-51A to help an entity assess this condition. (Refer also to Section 4.3 for a more in-depth discussion of embedded derivative considerations organized by type of host contract).

If the economic characteristics and risks of the embedded derivative are clearly and closely related to those of the host contract, there is no need to perform the rest of the analysis, as the embedded derivative would not meet the requirement for separation as a derivative instrument.

#### 4.2.1.1 Hybrid instruments in the form of a share that have characteristics of both debt and equity

Certain equity instruments (most commonly, preferred stock) tend to have a mix of debt- and equity-like characteristics. In these cases, an evaluation needs to be performed, in accordance with the guidance that begins at ASC 815-15-25-17A, to determine if the host contract is more akin to debt or equity. This determination is not based on the classification of the instrument on the balance sheet, but rather a subjective evaluation and weighting of all relevant terms and features of the instrument. It would be rare for an instrument that is required to be classified as a liability to be considered more akin to equity. The significance of this determination is that if the instrument is overall deemed more debt-like, equity-like features such as a conversion option would have economic characteristics and risks that are not clearly and closely related to the debt host contract. Conversely, if the instrument is overall deemed more equity-like, debt-like features such as a redemption option would have economic characteristics and risks that are not clearly and closely related to the equity host contract. The conclusion on whether a host contract contained within a hybrid instrument that is in the form of a share is more equity-like or debt-like can also impact conclusions reached on whether an embedded put, call or redemption option is a derivative instrument. This is because the net settlement characteristic of a derivative instrument is deemed to exist under ASC 815-10-15-107 for a put or call option embedded in a debt instrument. However, as noted in ASC 815-10-15-109, ASC 815-10-15-107 does not apply to hybrid instruments that do not contain a debt host contract. As a result, a put, call or redemption option that is embedded in an equity host contract would not be a derivative instrument unless the net settlement characteristic of a derivative instrument otherwise exists (e.g., contractually or because the underlying shares can be readily converted to cash).

The analysis of the nature of a hybrid instrument in the form of a share should be based on all stated and implied substantive terms and features, with each term and feature evaluated to determine if its host contract is more debt- or equity-like and weighted based on relevant facts and circumstances in existence at the date of issuance. The following template is a tool for evaluating and weighting features commonly associated with preferred stock to determine if the host contract is more debt- or equity-like.

| Factors to consider | Views on weighting certain factors | Analysis |
|---|---|---|
| **Redemption rights (generally debt-like characteristic)** | | |
| Is redemption mandatory or contingent? | A mandatory redemption right would be given more weight. The weight placed on a contingent redemption right would be commensurate with the likelihood of redemption being triggered. | |
| Who holds the redemption right? | A redemption right held by an investor would be given more weight than if held by the issuer. | |

| Factors to consider | Views on weighting certain factors | Analysis |
|---|---|---|
| Is the redemption right in-the-money or out-of-the-money? | An in-the-money right would be given more weight. | |
| If a conversion option is also provided, how favorable is this option in comparison to the redemption right? | Less weight would be placed on a redemption right if the conversion option was more favorable. | |
| Are there legal restrictions or solvency factors that would prohibit the issuer from redeeming the instrument? | Such restrictions and factors would reduce the weight placed on the redemption right. | |
| Are there issuer-specific considerations that make redemption unlikely (e.g., is the issuer thinly capitalized or unprofitable)? | Such considerations would reduce the weight placed on the redemption right. | |
| **Conversion rights (generally equity-like characteristic unless settlement will be in a variable number of shares designed to result in a fixed amount of value)** | | |
| Who holds the conversion right? | A conversion right held by an investor would be given more weight than if held by the issuer. | |
| Is conversion mandatory? | More weight would be placed on a mandatory conversion right. | |
| Is the conversion right contingent? | Less weight would be placed on a contingent conversion right, commensurate with the likelihood of it not being triggered. | |
| Is the conversion right in-the-money or out-of-the-money? | An in-the-money conversion right would be given more weight. | |
| If the instrument is also redeemable, what is more likely to occur first, conversion or redemption? | Less weight would be placed on the conversion right if redemption was more likely to occur first. | |
| **Rights upon liquidation** | | |
| Is there a stated liquidation preference? | If so, the liquidation right is a debt-like characteristic. | |
| Does the holder participate in the residual value of the entity? | If so, the liquidation right is an equity-like characteristic. | |

| Factors to consider | Views on weighting certain factors | Analysis |
|---|---|---|
| **Voting rights** | | |
| Does the holder have voting rights and if so, are they entitled to vote on all or limited matters? | If so, the voting right is an equity-like characteristic and is weighted commensurately with the level of influence the rights provide. | |
| How much influence can the holder's class of stock exercise based on its voting rights? | The degree of influence is equity-like to the extent it has the same degree of influence common shareholders have. | |
| **Dividend rights** | | |
| Are the dividends mandatory or discretionary? | Mandatory dividends are a debt-like characteristic, while discretionary dividends are an equity-like characteristic. | |
| Are the dividends stated or participating? | Stated dividends are a debt-like characteristic, while participating dividends are an equity-like characteristic. | |
| Are the dividends cumulative or noncumulative? | Cumulative dividends are a debt-like characteristic, while noncumulative dividends are an equity-like characteristic. | |
| **Protective covenants (debt-like characteristic weighted commensurately with the level of protection the covenants provide)** | | |
| Are there collateral requirements akin to collateralized debt? | If so, this is a debt-like characteristic. | |
| If the instrument contains a redemption option held by the investor or holder, is the issuer's performance upon redemption guaranteed by the parent of the issuer or otherwise? | If so, this is a debt-like characteristic. | |
| Does the instrument provide the holder with certain rights akin to creditor rights (e.g., the ability to force bankruptcy or a preference in liquidation)? | If so, this is a debt-like characteristic and is weighted commensurately with the level of influence the rights provide. | |

| Factors to consider | Views on weighting certain factors | Analysis |
|---|---|---|
| **Conclusion:** Based on the factors to consider, the weight placed on them and the most likely outcome of the instrument, conclude as to whether the nature of the preferred stock host contract is more debt- or equity-like. | | |

If the conclusion is that the nature of the host contract is more debt-like, refer to Section 4.3.1 for discussion on hybrid instruments with a debt host contract. If the conclusion is that the nature of the host contract is more equity-like, refer to Section 4.3.2 for discussion on hybrid instruments with an equity host contract.

#### 4.2.1.2 Hybrid instruments that are not in the form of a share

While there is extensive guidance beginning at ASC 815-15-25-17A to determine the nature of the host contract for hybrid financial instruments that are in the form of a share, this guidance does not apply to instruments that are not in the form of a share. The nature of the host contract for non-share instruments is generally determined by excluding the embedded derivatives and focusing on the remaining host contract. Therefore, the nature of the host contract for a hybrid instrument in the form of debt is generally always debt, even if the debt is convertible into equity.

### 4.2.2 Instrument is not remeasured at fair value

The second condition that an entity must assess when determining whether it should account for an embedded derivative separately as a derivative instrument is whether the hybrid instrument would not otherwise be measured at fair value with changes in fair value reported in earnings. The reason for this condition is that if the hybrid instrument containing the embedded derivative is accounted for at fair value with the changes in its fair value reported in earnings, the embedded derivative would essentially already be receiving the accounting treatment that would be required if it were accounted for separately as a derivative instrument. This criterion simplifies the accounting analysis for industries that account for substantially all investments at fair value through earnings (or the change in net assets), such as broker-dealers, investment companies, health and welfare plans, and postretirement plans.

Available-for-sale debt securities fail to meet this condition because the changes in fair value are reported in OCI, not earnings.

If the hybrid instrument would not otherwise be measured at fair value with changes in fair value reported in earnings, an entity would account for the embedded derivative separately as a derivative instrument if the other two conditions in ASC 815-15-25-1 are met. Otherwise, the embedded derivative would not be accounted for separately.

**RSM COMMENTARY: Fair value option (FVO)**

The complexity of reporting an embedded derivative separate from its host contract may be avoided by electing to measure the entire hybrid instrument using the FVO provided by either ASC 825-10 or ASC 815-15. Additional considerations apply when the FVO is applied to a liability instrument because changes in fair value that are attributable to changes in the credit risk of that instrument are reported through OCI instead of earnings.

Refer to ASC 815-15-25-4 through 25-6 and ASC 825-10 for further guidance on the application of the FVO to hybrid financial instruments.

The FVO pursuant to ASC 825-10 has fewer restrictions on its use compared to the FVO pursuant to ASC 815. For example, ASC 825-10 allows the FVO to be applied to qualifying financial instruments regardless of whether an instrument contains an embedded derivative that requires separate accounting.

### 4.2.3 Embedded component would be accounted for as a derivative

An entity does not account for an embedded derivative separately as a derivative instrument if a separate instrument with the same terms as the embedded derivative does not meet the definition of a derivative instrument or if it qualifies for one of the scope exceptions in ASC 815. Refer to Chapter 3 for the definition of a derivative instrument and the general scope exceptions in ASC 815, as well as Section 4.1.2 for scope exceptions specific to embedded derivatives.

ASC 815-15-25-1(c) states that the initial net investment for the hybrid instrument should not be considered the initial net investment for the embedded derivative. The initial net investment of an embedded derivative can be viewed in different ways. An example follows.

**Example 4-1: Determining the initial net investment for an embedded derivative**

If a convertible bond is issued for $10 million, the $10 million is the initial net investment for the hybrid instrument and not the initial net investment for the embedded conversion option. Hypothetically, the initial net investment for the conversion option would be the amount one would pay to obtain the conversion option (i.e., its fair value at the time of the transaction). Generally, an investor economically pays for the conversion option by receiving a lower interest rate on a convertible bond than it would otherwise find acceptable for the same bond absent the conversion option. Assume that the bond can convert into one million shares ($10 per share conversion price) and each share was worth $12 at the time the bond was issued. In this case, the fair value of the conversion option (its initial net investment) would be less by more than a nominal amount than the initial net investment that would need to be made to acquire the underlying shares ($12 each). In other words, the value of the conversion option would be significantly less than the value of the shares because there is a $10 per share cost to exercise that conversion option.

Although an entity generally performs the analysis in ASC 815-15-25-1(c) as if the embedded derivative was a freestanding instrument, there is one exception to this approach. As explained in ASC 815-15-25-14, the guidance in ASC 480-10-25-4 through 25-14 for distinguishing liabilities from equity is not considered when determining whether the embedded derivative should be equity classified for purposes of applying the own-equity scope exception in ASC 815-10-15-74(a). The reason for this is that ASC 480 only applies to freestanding instruments.

## 4.3 Application of the embedded derivative guidance to various types of host contracts

This section addresses how the guidance on embedded derivatives applies to hybrid instruments with debt, equity, lease, insurance and executory host contracts.

### 4.3.1 Hybrid instruments with a debt host contract

It is common for debt instruments or host contracts to have embedded derivatives that may require separate recognition as derivative instruments, including:

- Conversion options
- Early redemption features (such as put and call options that can accelerate payoff)
- Additional payments if a contingent event, such as a change in control, occurs
- Interest that is indexed to something other than interest rates

When determining if there are features within a debt host contract that may require separate recognition as a derivative instrument, the focus should be on features that can alter the amount or timing of cash flows or the way the contract can be settled (e.g., in shares rather than cash).

Pursuant to ASC 815-15-25-25, it would be inappropriate for an entity to express the characteristics of a debt host contract in a way that would result in it identifying an embedded derivative that is not clearly present in the hybrid instrument.

For example, suppose an entity issues fixed-rate debt that is convertible into equity and separately enters into an interest rate swap, the economic effects of which are to essentially convert the fixed-rate on the debt into a variable rate. It would be appropriate to deconstruct that bond into a fixed-rate debt host contract and an embedded equity conversion feature, but it would not be appropriate to view that bond as a variable-rate debt host contract because the variable rate is a characteristic that is not present in the host contract.

#### 4.3.1.1 Interest rate features, including leverage factors

A hybrid instrument with a debt host contract may contain embedded derivatives that affect the interest rate or otherwise impact the interest payments on the instrument. Although interest is central to a debt host contract, not every embedded interest rate derivative will have economic characteristics and risks that are clearly and closely related to its debt host contract. For example, a debt instrument may contain an embedded interest rate derivative that leverages the interest rate on the instrument to such a great degree that the economic characteristics and risks of the embedded interest rate derivative are not clearly and closely related to the host contract.

Pursuant to ASC 815-15-25-26, an embedded derivative in which the only underlying is an interest rate or interest rate index (e.g., an interest rate cap, floor or collar) that alters the net interest payments that otherwise would be paid or received on an interest-bearing debt host contract is considered clearly and closely related to the host contract unless either of the following conditions exists:

- There is a possible situation (no matter how remote) in which the creditor or investor could be forced by the terms of the instrument to accept settlement in such a way that it would not recover substantially all of its initial recorded investment (ASC 815-15-25-26(a)). In making this determination, an entity should consider the undiscounted net cash flows that the creditor or investor would receive if the embedded derivative was triggered in comparison to its initial recorded investment. In practice, “substantially all” has generally been interpreted to mean at least 90% of the initial recorded investment will be recovered. An example of when this condition would exist is a situation in which debt is issued at a premium greater than 10% and gives the debtor the option of prepaying at par. Conversely, this condition would not exist if the instrument could be put by the investor or creditor, because it only applies when the issuer has the contractual right to demand settlement in this manner. Refer to Example 10 beginning at ASC 815-15-55-128 for further guidance.

- There is a possible future interest rate scenario under which the embedded derivative could at least double the creditor or investor's initial rate of return (IRR) on the debt host contract and result in a rate of return that would be at least twice the then-current market rate of return (based on the possible future interest rate scenario) for a contract with the same terms involving a debtor with similar credit quality to the actual debtor's credit quality at the inception of the contract (ASC 815-15-25-26(b)). This condition does not apply if the right to accelerate the payment of the debt can only be exercised by the debtor. This condition is referred to as the double-double test.

There are some important considerations to keep in mind when applying this guidance in ASC 815-15-25-26, including:

- This guidance does not apply if the embedded derivative has an underlying that is not an interest rate or interest rate index. Examples include embedded derivatives that tie interest payments to a stock or commodity price or index. Such embedded derivatives do not have economic characteristics and risks that are clearly and closely related to a debt host contract.
- While this guidance generally applies to call or put options or other embedded derivatives that can accelerate the repayment of principal, it does not apply if the acceleration is contingent on the occurrence or non-occurrence of a certain event because such a contingency is a non-interest rate underlying. (ASC 815-15-25-42, which is discussed in Section 4.3.1.5 is applicable to contingent features that can accelerate repayment). The analysis for determining whether either of the two conditions exists should be performed after allocating the issuance proceeds to freestanding financial instruments that may have been issued together in the same transaction, such as warrants and debt.
- As noted in ASC 815-15-25-27, while the focus of this guidance is on the investor's return and recovery of investment, the existence of either of the two conditions would result in a conclusion for both parties that the embedded derivative is not clearly and closely related to the host contract. Because this analysis should be performed when the instrument is issued or acquired by the reporting entity, an entity that acquires the instrument after its initial issuance date could reach a different conclusion than the issuer did because they are applying the guidance at different points in time and potentially different circumstances (e.g., the issuer may have issued the instrument at face, but a subsequent acquirer may have paid a premium or discount on the secondary market).
- I/Os and P/Os may qualify for the derivative scope exception described in ASC 815-10-15-72 through 15-73.
- ASC 815-15-25-33 through 25-36 addresses the application of this guidance to derivatives that are embedded in securitized interests in prepayable financial assets.

The following excerpt from ASC 815-15-55-25 illustrates application of the requirements in ASC 815-15-25-26(b) to various instruments.

| Instrument | Paragraph 815-15-25-26(b) Applicable to the Embedded Call Option? | Comments |
|---|---|---|
| 1. An unsecured commercial loan that includes a prepayment option that permits the loan to be prepaid by the borrower at a fixed amount at any time at a specified premium over the initial principal amount of the loan. | No. | The commercial loan is prepayable only at the option of the borrower. |
| 2. A fixed-rate debt instrument issued at a discount that is | No. | The fixed-rate debt instrument is callable at par value only by the issuer. |

| Instrument | Paragraph 815-15-25-26(b) Applicable to the Embedded Call Option? | Comments |
|---|---|---|
| callable at par value at any time during its 10-year term. | | |
| 3. A fixed-rate 10-year bond that contains a call option that permits the issuer to prepay the bond at any time after issuance by paying the investor an amount equal to all the future contractual cash flows discounted at the then-current Treasury rate plus 45 basis points. The spread over the Treasury rate for the borrower at the issuance of the bond was 300 basis points. | No. | The fixed-rate 10-year bond is callable only at the option of the issuer. |
| 4. A 5-year debt instrument issued at par that has a quarterly coupon equal to 15 percent minus 3 times 3-month LIBOR and that includes a call provision that allows the issuer to call the debt at any time at a specified premium over par. | No. | The instrument is callable only by the issuer, so the embedded call option feature will not be subject to the conditions in paragraph 815-15-25-26(b). However, the conditions in that paragraph are still applicable to the levered index feature of the debt. |
| 5. A fixed rate debt instrument is issued at par and is callable at any time during its 10-year term. If the debt is called, the investor receives the greater of the par value of the debt or the market value of 100,000 shares of XYZ common stock (an unrelated entity). | No. | The instrument is callable only by the issuer, so the embedded call option feature will not be subject to the conditions in paragraph 815-15-25-26(b). However, the embedded call option is not considered clearly and closely related to the debt host contract because the payoff is based on an equity price. |
| 6. A mortgage-backed security is issued, whereby cash flows associated with principal payments (including full or partial prepayments and related penalties) received on the related mortgage loans are passed through to the mortgage-backed security investors. | Not applicable (see comments). | Although the related mortgage loans are prepayable, and thus each contain a separate embedded call option, the mortgage-backed security itself does not contain an embedded call option. While the mortgage-backed security investor is subject to prepayment risk, the mortgage-backed security issuer has the obligation (not the option) to pass through cash flows from the related mortgage loans to the |

| Instrument | Paragraph 815-15-25-26(b) Applicable to the Embedded Call Option? | Comments |
|---|---|---|
| | | mortgage-backed security investors. Therefore, mortgage-backed securities are not within the scope of this guidance. Paragraphs 815-15-25-33 through 25-36 address the application of paragraph 815-15-25-26(b) to securitized interests in prepayable financial assets. |

## Doubling the initial and market rate of return

A debt instrument may contain an embedded interest rate derivative that positively leverages the interest rate of the instrument to such a great degree that the return on the debt instrument is no longer indicative of a debt instrument. ASC 815-15-25-26(b) provides guidance on how to assess if an interest rate leveraging feature is clearly and closely related to its debt host contract. This assessment is commonly called the double-double test.

The following table explains how to address certain items when performing the double-double test.

| | Commentary |
|---|---|
| IRR | An entity should use the IRR on the debt host contract (i.e., not the hybrid instrument) without the embedded derivative in the double-double test. The IRR on the debt host contract may differ from the stated yield of the hybrid instrument for this reason, as well as other factors such as the debt being issued or acquired at a premium or discount. An entity should perform this analysis regardless of the probability of the event that would leverage the interest occurring. |
| Transactions with multiple elements | When considering transactions with multiple elements (e.g., debt issued with warrants), an entity should perform the double-double test after the proceeds have been allocated to the separate transactions. |

Interest rate provisions within a debt host contract that superficially appear to be unproblematic can meet the double-double test in ASC 815-15-25-26(b) and therefore result in an embedded derivative that should be accounted for separately. Consideration should be given to an inconsistency between how the variable interest rate is determined and how frequently the interest rate resets. Consider the following example.

**Example 4-2: Double-double test – Debt host contract**

A financial instrument pays an interest rate that is based on the rolling average of a variable rate. Assume that:

- Interest is based on the 12-month rolling average of one-month SOFR.
- The interest rate resets monthly.
- Interest is paid monthly.

- One-month SOFR is 1% at the initial recognition of the instrument.
- The 12-month rolling average of one-month SOFR interest rates is 1.2% at the initial recognition of the instrument.

Based on these assumptions, an entity would view this instrument as having a debt host contract, which pays interest based on one-month SOFR that resets every month, and an embedded derivative that adjusts the interest rate from one-month SOFR to the 12-month rolling average of one-month SOFR.

Continuing this example, consider the following scenario that, while remote, is possible:

- One-month SOFR moves up to 4% and remains at 4% for 11 months.
- In the twelfth month, one-month SOFR drops to 1.5%.

After SOFR was 1.5% for one month, the interest rate on the instrument would be approximately 3.79% ((4% x 11) + 1.5%)/12), which would be more than twice the IRR of the host contract of 1% while also being more than twice the then current one-month SOFR market rate of 1.5%. In this case, the embedded derivative that adjusts the interest rate from one-month SOFR to the 12-month rolling average of one-month SOFR would not be considered clearly and closely related to the host contract. As a result, the embedded derivative would be accounted for separately as a derivative instrument unless the hybrid instrument is accounted for in its entirety at fair value through earnings. In other words, once the interest rate on the instrument adjusts to an amount that is more than twice the IRR of the host contract while also being more than twice the then-current one-month SOFR, the embedded derivative would have to be accounted for separately from the host contract unless the reporting entity decides to account for the entire hybrid financial instrument at fair value with changes in unrealized gains and losses recognized through earnings.

Example 13 that begins at ASC 815-15-55-165 includes various cases that illustrate the application of the embedded derivative guidance to debt host contracts.

The table in Section 4.3.1.1 provides application of the guidance in ASC 815-15-25-37 through 25-39 to specific debt instruments.

### Interest rate reset features related to the elimination of LIBOR

**RSM COMMENTARY: Hedges involving LIBOR or other discontinued rates**

Reference rate reform has resulted in the elimination of LIBOR after June 30, 2023, and the elimination of other interbank offered rates around the world. More interbank offered rates may be eliminated in the future. In the U.S., the Alternative Reference Rates Committee convened by the Federal Reserve Board has recommended SOFR as the preferred alternative to LIBOR. The replacement of LIBOR with an alternative rate has had broad-reaching effects on entities that have assets, debt instruments, interest rate swap agreements or other contracts that reference LIBOR.

At a conference in December 2020, the SEC staff discussed a fact pattern related to evaluating whether certain SOFR-based interest rate reset features are embedded derivatives that require separate accounting[9]. The fact pattern discussed the following interest rate reset conventions:

- Term SOFR
- Compounded SOFR in-arrears
- Compounded SOFR in-advance
- Average SOFR in-advance

[9] A script of the remarks is available at https://www.sec.gov/news/speech/pearce-remarks-aicpa-2020.

In this fact pattern, an entity needed to assess whether these features should be considered terms of the debt host contract. If the entity cannot conclude that these features are terms of the debt host contract, they would be considered embedded derivatives and require further analysis to determine if separate accounting as a derivative instrument is required (e.g., because the double-double test discussed at Section 4.3.1.1 is met). However, the entity determined that these features should be considered terms of the debt host contract because:

- The SOFR interest-rate features were meant to provide a "market-based solution" to LIBOR elimination.
- The purpose of the features is not to leverage the investor's returns.
- Counterparties were not looking to add complex basis swaps.
- Consumer protection laws require certain of these reset features for specific lending products.

The SEC staff did not object to the entity's view that these four SOFR-based interest rate features are terms of the host contract rather than embedded derivatives that could potentially require separate accounting.

### Interest rate caps and floors

Pursuant to ASC 815-15-25-32, interest rate caps and floors (including collars, which are combinations of caps and floors) are considered clearly and closely related to their debt host contract, unless either of the conditions in ASC 815-15-25-26 are met. As those conditions are typically not met, embedded interest rate caps or floors are generally not accounted for as a derivative instrument.

### Inflation-linked bonds

An inflation-linked bond is a debt instrument that pays an interest rate on an amount of principal that is adjusted for the rate of inflation as measured by an inflation index. Treasury Inflation-Protected Securities (TIPS) and inflation-indexed savings bonds are tied to the value of the Consumer Price Index (CPI). Generally, the outstanding principal, and therefore interest paid on an inflation-linked bond, rises with inflation. As a result, inflation-linked bonds can mitigate the impact of inflation on the investors of these TIPS.

As indicated in ASC 815-15-25-50, the interest rate and the inflation rate in the economic environment for the currency in which a debt instrument is denominated are considered clearly and closely related. Thus, an entity would not separate an inflation-related embedded derivative from its debt host contract unless the embedded derivative creates significant leverage. A leveraged inflation feature would not be considered clearly and closely related to a debt host contract and would need to be separately recognized as a derivative instrument if it has all the characteristics of a derivative instrument and the debt is not accounted for at fair value through earnings in its entirety. An example of a leveraged inflation feature is a bond where the principal on the bond is adjusted by a multiple of CPI, rather than CPI by itself.

### Default interest

Many debt instruments contain a feature that requires the issuer or borrower to pay additional interest to the investor or holder based on the occurrence of certain credit events (e.g., covenant violation, failure to make a payment when due, other events of default).

ASC 815-15-25-46 provides guidance on embedded derivatives that adjust the interest rate on an instrument based on the issuer's or borrower's creditworthiness.

**ASC 815-15-25-46**

The creditworthiness of the debtor and the interest rate on a debt instrument shall be considered to be clearly and closely related. Thus, for debt instruments that have the

interest rate reset in the event of any of the following conditions, the related embedded derivative shall not be separated from the host contract:

a. Default (such as violation of a credit-risk-related covenant)

b. A change in the debtor's published credit rating

c. A change in the debtor's creditworthiness indicated by a change in its spread over U.S. Treasury bonds

The preceding guidance illustrates default by mentioning a credit-risk-related covenant violation. It is not uncommon for default provisions that adjust the interest rate on an instrument to encompass circumstances such as a change in control of the entity that are not directly tied to the debtor's credit risk; in this case, the feature may require separate accounting as a derivative instrument if the requirements of ASC 815-15-25-1 are otherwise met.

Certain debt instruments that are convertible into the issuer's common shares express the trigger for contingent interest in terms of the market price or fair market value of the instrument. Although changes in interest rates and credit risk affect the market price or fair market value of a hybrid convertible debt instrument, the issuer's common stock price is often the prevalent underlying. Therefore, as indicated in ASC 815-15-25-49, such contingent interest provisions likely would be considered not clearly and closely related to a debt host contract.

As explained in ASC 815-15-25-47, a debt instrument that incorporates a credit risk of a party other than the issuer (e.g., payments required by the debt instrument can be impacted by an event of default or a change in creditworthiness of an entity other than the issuer) contains an embedded credit derivative that could require separate derivative accounting if the requirements of ASC 815-15-25-1 are met. In this case, the host contract and embedded derivative both have the economic characteristics and risks of debt. However, the host contract has the economic characteristics and risks of debt issued by the issuer, while the embedded derivative has the economic characteristics and risks of debt issued by another party. Therefore, the host contract and embedded derivative are not clearly and closely related. This guidance does not affect the accounting for nonrecourse debt; if the debtor does not make the payments due under the instrument, the creditor's recourse is limited to the collateral pledged under the debt instrument.

#### 4.3.1.2 Beneficial interests in securitizations

In a securitization transaction, a transferor transfers financial assets into another legal entity that creates ownership interests backed by the transferred assets and issues those interests to third-party investors. The process of creating these asset-backed interests is referred to as "securitization" and the interests themselves are commonly referred to as "beneficial interests."

Beneficial interests are defined in the ASC Master Glossary.

**Master Glossary – Beneficial Interests**

Rights to receive all or portions of specified cash inflows received by a trust or other entity, including, but not limited to, all of the following:

a. Senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through

b. Premiums due to guarantors

c. Commercial paper obligations

d. Residual interests, whether in the form of debt or equity.

Examples of beneficial interests include mortgage-backed securities, asset-backed securities, collateralized debt obligations, collateralized loan obligations, I/Os and P/Os.

Beneficial interests that can contractually be prepaid or otherwise settled in such a way that the beneficial interest holder would not recover substantially all of its recorded investment would be accounted for as available-for-sale or trading securities under ASC 320. If the beneficial interest is not accounted for at fair value through earnings or does not meet the scope exception for certain I/Os and P/Os (see ASC 815-10-15-72 through 15-73 and Case B that begins at ASC 815-15-55-153), the holder should analyze the beneficial interest to determine if it requires derivative recognition in its entirety or if it contains any embedded derivatives that are required to be accounted for separately. As discussed in ASC 815-15-25-12, an entity should base this determination on the contractual terms of the beneficial interest. This requires the entity to understand the nature and amount of assets, liabilities and other financial instruments (e.g., options, guarantees) involved in the entire securitization transaction. In addition, the entity must understand the payment priority and payoff structure of the beneficial interest.

As part of the determination of whether the beneficial interest is a derivative instrument in its entirety or contains an embedded derivative, an entity will have to assess whether the initial net investment characteristic of a derivative instrument is present. That characteristic is present when the initial net investment "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." Refer to Section 3.2.1.3 for more discussion on the initial net investment characteristic of a derivative instrument.

Various examples of the application of the embedded derivative analysis to beneficial interests and securitization structures are provided in ASC 815-15-55-222 through 55-226D. The following is a summary of select features that generally warrant further assessment to determine whether derivative recognition is necessary:

- Prepayment features embedded in the financial assets that underly the beneficial interests
- Put or call options embedded in the beneficial interest
- Clean-up call held by the servicer or options of one of the parties to the transfer to purchase financial assets from the securitization vehicle (including removal of accounts provisions)
- Credit default swaps, interest rate swaps, cross-currency swaps and other derivative instruments that an entity enters into as part of the securitization structure—particularly when the notional amount of the derivative instrument does not match the securitized assets or may not match the securitized assets as prepayments occur (refer to ASC 815-15-55-144, ASC 815-15-55-223 and ASC 815-15-55-226B through 55-226D)
- Any transfer of credit risk that does not solely arise from subordination of one financial instrument to another (refer to ASC 815-15-15-9)
- Payments are denominated in a different currency than the underlying assets (refer to Case V that begins at ASC 815-15-55-222)
- Interest rate features that are inconsistent with the underlying assets (e.g., the underlying assets and the beneficial interest are indexed to different variable rate indices, or the underlying assets have a fixed rate and the beneficial interest has a variable rate) (refer to Case X that begins at ASC 815-15-55-224)
- A feature that may require the beneficial interest holder to make future payments rather than just receive reduced cash inflows, regardless of how unlikely it is that the holder will be required to make payments (refer to ASC 815-15-25-51A and ASC 815-15-55-226B)
- Features that could otherwise result in the holder not recovering substantially all of its initial recorded investment or meeting the double-double test described at Section 4.3.1.1

Refer to ASC 815-15-25-33 through 25-36, ASC 815-15-25-51A and Example 11 that begins at ASC 815-15-55-137 for further guidance on the embedded derivative analysis associated with beneficial interests and securitized financial assets.

A common structure that typically contains an embedded credit derivative is a collateralized debt obligation (CDO). A CDO is a structured financial product that pools together cash flow-generating assets that are in the form of debt obligations and repackages them into various tranches of investments to be sold to investors. The debt obligations serve as the collateral for the investment tranches. That is, the cash flows received from the debt obligations are used to fund the payments to be made on the investment tranches. Each tranche has a different priority in terms of the cash flows from the debt obligations. As a result, each tranche has a different risk and reward profile. In addition, the various tranches may have different principal balances, coupon rates, prepayment risk and maturity dates. These CDOs are also referred to as cash collateralized CDOs because the tranches sold to investors are backed by actual debt obligations (i.e., cash instruments).

ASC 815-15-15-9 indicates the transfer of credit risk that is only in the form of subordination of one financial instrument to another, thereby redistributing credit risk, does not create an embedded derivative that is accounted for separately. This element of a CDO does not result in an embedded derivative that should be accounted for separately. However, an entity should analyze the specific facts and circumstances regarding a securitization structure to determine whether it contains an embedded credit derivative that does require separate accounting. Other embedded credit derivatives (e.g., those related to credit default swaps on a referenced credit) may require separate accounting. In addition, an entity should assess whether such structures contain other types of embedded derivatives (e.g., embedded interest rate, prepayment derivatives).

In contrast to the previously discussed cash collateralized instrument, synthetic instruments also exist in the marketplace. Rather than being backed by cash instruments, synthetic instruments are backed by derivative instruments designed to replicate the effect of investing in cash instruments. For example, the effect of investing in a 30-year debt obligation issued by ABC Corp. can be replicated by investing in a 30-year U.S. Treasury obligation and simultaneously entering into a credit default swap that references the ABC Corp. debt obligation. A synthetic CDO of multiple obligors could be created by investing in a U.S. Treasury obligation and entering into an array of credit default swaps. Because the exception in ASC 815-15-15-9 only applies to the transfer of credit risk in the form of subordination of one financial instrument to another (e.g., the subordination of one beneficial interest to another tranche of a securitization), the credit default swaps would have to be accounted for as derivative instruments.

#### 4.3.1.3 Commodity indexed payments

A debt instrument or loan may contain an embedded derivative that causes the loan payments to be impacted by the price of a commodity. For example, consider a loan that a bank makes to a gas producer. The bank and the gas producer may agree that when gas prices are high, the gas producer will pay a greater rate of interest than it otherwise would; in exchange, the gas producer will pay a lesser rate of interest when gas prices are low. Because the interest rate in this loan agreement is tied to the price of gas, the loan contains an embedded gas price derivative. This hybrid instrument could be viewed as being comprised of a debt host contract that pays a rate of interest that is typical for the particular borrower and an embedded gas indexation derivative. The economic characteristics and risks of the host contract are that of debt and the economic characteristics and risks of the embedded derivative are that of a commodity. Therefore, the embedded derivative is not clearly and closely related to the host contract. As a result, assuming the hybrid instrument is not measured at fair value with changes in fair value reported in earnings, the embedded derivative would be accounted for separately.

#### 4.3.1.4 Loans that enable the lender or investor to participate in the appreciation of the financed property, expected residual profit or a share of net earnings or operating cash flows

The following excerpts illustrate the application of the derivative scope exceptions for non-exchange traded contracts that are discussed in Section 3.3.5 to certain derivative instruments that may be embedded in debt host contracts.

**ASC 815-15-55-8**

Under an example participating mortgage, the investor receives a below-market interest rate and is entitled to participate in the appreciation in the fair value of the project that is financed by the mortgage upon sale of the project, at a deemed sale date, or at the maturity or refinancing of the loan. The mortgagor must continue to own the project over the term of the mortgage.

**ASC 815-15-55-9**

The instrument has a provision that entitles the investor to participate in the appreciation of the referenced real estate (the project). However, a separate contract with the same terms would be excluded by the exception in paragraph 815-10-15-59(b) because settlement is based on the value of a nonfinancial asset of one of the parties that is not readily convertible to cash. (This Subtopic does not modify the guidance in Subtopic 470-30).

**ASC 815-15-55-10**

Paragraph 310-10-05-9 explains that loans granted to acquire operating properties sometimes grant the lender a right to participate in expected residual profit from the sale or refinancing of the property. An equity kicker (or expected residual profit) would typically not be separated from the host contract and accounted for as an embedded derivative because paragraph 815-15-25-1(c) exempts a hybrid contract from bifurcation if a separate instrument with the same terms as the embedded equity kicker is not a derivative instrument subject to the requirements of this Subtopic. Under paragraph 815-10-15-59(b), an embedded equity kicker would typically not be subject to the requirements of this Subtopic because the separate instrument with the same terms is not exchange traded and is indexed to nonfinancial assets that are not readily convertible to cash. Similarly, if an equity kicker is based on a share in net earnings or operating cash flows, it would also typically qualify for the scope exception in paragraph 815-10-15-59(d). If the embedded derivative does not need to be accounted for separately under this Subtopic, the Acquisition, Development, and Construction Arrangements Subsections of Subtopic 310-10 shall be applied.

**ASC 815-15-55-11**

A loan with an equity kicker of more than 50 percent of net earnings that is considered an investment in real estate under the Acquisition, Development, and Construction Arrangements Subsections of Subtopic 310-10 would not be analyzed under this Subtopic as a host loan contract and an embedded equity kicker derivative.

### 4.3.1.5 Redemption options and other features that can accelerate payoff

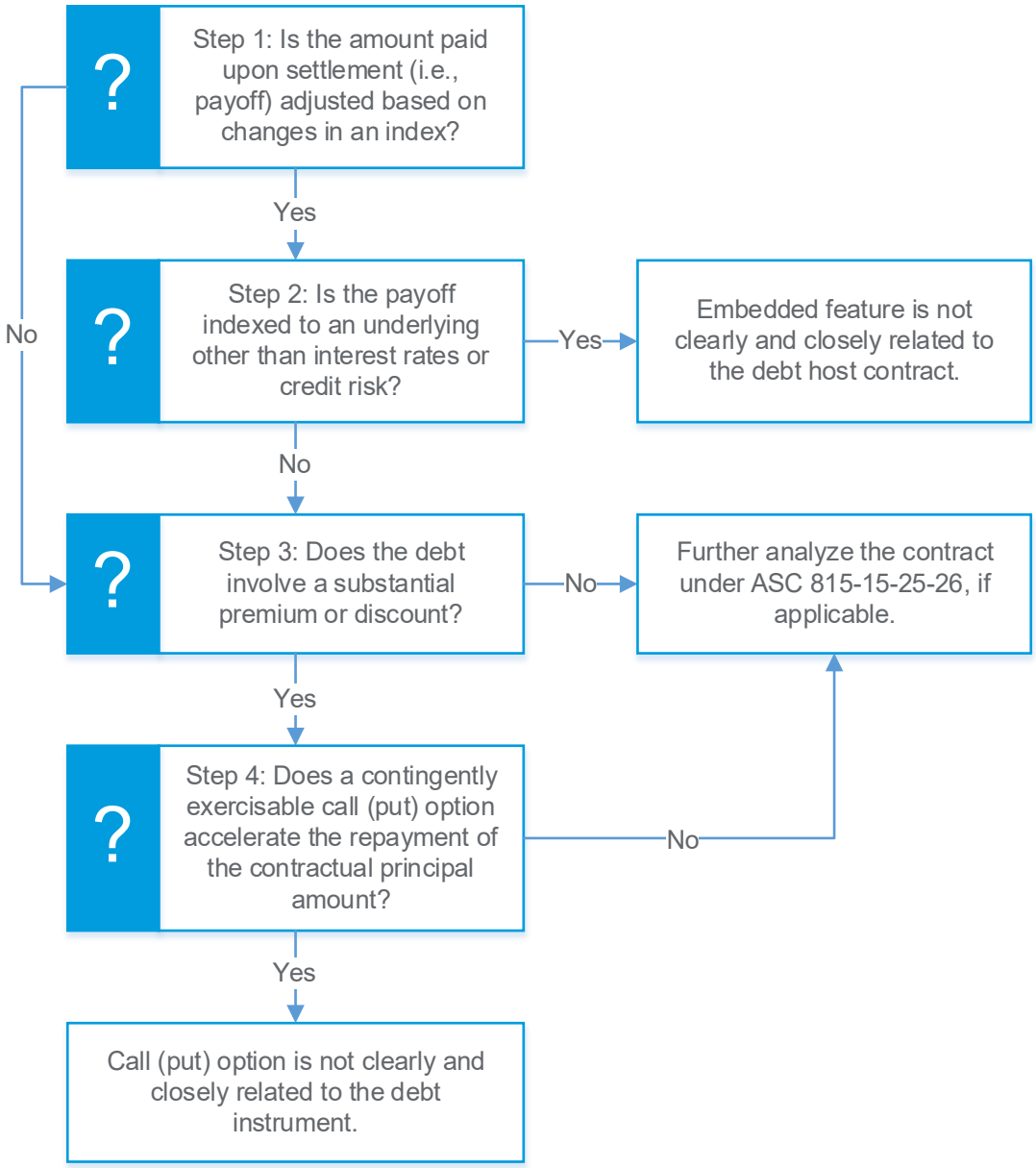
Redemption options can be thought of as put options or call options.

| Option type | Description |
|---|---|
| Put | Allows the investor to demand repayment prior to its maturity |
| Call | Allows the issuer or borrower to pay off the debt or loan prior to its scheduled repayment terms |

Pursuant to ASC 815-15-25-41, a put or call option that does not accelerate debt repayment, but rather requires cash settlement in an amount equal to the price of the option on the date of exercise, would be considered not clearly and closely related to the debt host contract. As a result, such a put or call option would be accounted for separately as a derivative instrument if it met all the characteristics of a derivative instrument.

A put or call option that accelerates the repayment of principal on a debt instrument requires further analysis to determine whether the option is clearly and closely related to its debt host contract.

The guidance beginning at ASC 815-15-25-42 outlines the following decision sequence that should be followed in determining whether an option that can accelerate the settlement of a debt instrument is clearly and closely related to the debt host contract.




This decision sequence results in a conclusion that put and call options are not clearly and closely related to a debt host contract under any of the following circumstances:

- Rather than being the repayment of principal at par, the payoff amount is indexed to something other than interest rates or credit risk.
- The debt involves a substantial premium or discount, and the option is contingently exercisable.

- One of the two conditions outlined in ASC 815-15-25-26 is met (refer to Section 4.3.1.1).

A common type of put or call option that is not clearly and closely related to the debt host contract is a feature that will result in repayment of the debt at a significant premium upon the occurrence of a contingent event, such as a change in control. When considering Steps 1 and 2 of the decision sequence, we believe repayments that are based on either a fixed premium to par or a premium that changes due to the passage of time would not be considered indexed to something other than interest rates or credit risk.

In evaluating the significance of a premium or discount in Step 3, premiums or discounts of 10% or more are generally viewed as substantial. However, consideration should be given to the specific facts and circumstances. Generally, a put or call option would not be considered to involve a substantial discount or premium if it required a debt instrument to be paid off at its accreted value. Additionally, we believe that when determining if the debt involves a substantial premium or discount, an entity should consider not only the relationship of the par amount to the issuance proceeds attributable to the debt, but also the relationship of the payoff amount to the issuance proceeds attributable to the debt. Even when debt is issued at par, but a portion of the proceeds is allocated to other freestanding instruments (such as warrants), the debt could be deemed to involve a substantial discount. Generally, it would not be appropriate to consider discounts created by separately recognizing a conversion option associated with the debt, given that the holder would typically not benefit from the conversion option if the instrument is redeemed. However, it may be necessary to consider premiums or discounts created from bifurcating other embedded derivatives from the debt that could result in payments that are incremental to the redemption feature and can be triggered prior to or on the redemption date. Additionally, while fees paid to the creditor can create a discount that would be considered in this analysis, discounts related to issuance costs paid to third parties would be ignored.

If the only underlying in the embedded derivative is an interest rate or interest rate index, the guidance in ASC 815-15-25-26, discussed at Section 4.3.1.1, should be considered before concluding that noncontingent puts and calls and other features in a debt instrument that can alter the interest payments are clearly and closely related to a debt host contract. If exercise of a put or call option is contingent on the occurrence of a certain event, like a change in control, this would constitute a non-interest rate underlying. As a result, ASC 815-15-25-26 would not be relevant to the analysis for that option. The following table, reproduced from ASC 815-15-55-13, demonstrates the application of the four-step decision sequence in ASC 815-15-25-42 for determining whether call options and put options that can accelerate the settlement of a debt instrument should be considered clearly and closely related to the debt host contract under the criterion in ASC 815-15-25-1(a).

| Instrument | Indexed Payoff? (Steps 1 and 2) | Substantial Discount or Premium? (Step 3) | Contingently Exercisable? (Step 4) | Embedded Option Clearly and Closely Related? |
|---|---|---|---|---|
| 1. Debt that is issued at a substantial discount is callable at any time during its 10-year term. If the debt is called, the investor receives the par value of the debt plus any unpaid and accrued interest. | No. | Yes. | No. | The embedded call option is clearly and closely related to the debt host contract because the payoff is not indexed, and the call option is not contingently exercisable. |

| Instrument | Indexed Payoff? (Steps 1 and 2) | Substantial Discount or Premium? (Step 3) | Contingently Exercisable? (Step 4) | Embedded Option Clearly and Closely Related? |
|---|---|---|---|---|
| 2. Debt that is issued at par is callable at any time during its term. If the debt is called, the investor receives the greater of the par value of the debt or the market value of 100,000 shares of XYZ common stock (an unrelated entity)? | Yes, based on an equity price. | N/A. Analysis not required. | N/A. Analysis not required. | The embedded call option is not clearly and closely related to the debt host contract because the payoff is indexed to an equity price. |
| 3. Debt that is issued at par is puttable if the S&P 500 Index increases by at least 20 percent. If the debt is put, the investor receives the par amount of the debt adjusted for the percentage increase in the S&P 500. | Yes, based on an equity index (S&P 500). | N/A. Analysis not required. | N/A. Analysis not required. | The embedded put option is not clearly and closely related to the debt host contract because the payoff is indexed to an equity price. |
| 4. Debt that is issued at a substantial discount is puttable at par if London Interbank Offered Rate (LIBOR) either increases or decreases by 150 basis points. | No. | Yes. | Yes, contingent on a movement of LIBOR of at least 150 basis points. | The put option is not clearly and closely related to the debt host contract because the debt was issued at a substantial discount and the put option is contingently exercisable. |
| 5. Debt that is issued at a substantial discount is puttable at par in the event of a change in control. | No. | Yes. | Yes, contingent on a change in control. | The put option is not clearly and closely related to the debt host contract because the debt was issued at a |

| Instrument | Indexed Payoff? (Steps 1 and 2) | Substantial Discount or Premium? (Step 3) | Contingently Exercisable? (Step 4) | Embedded Option Clearly and Closely Related? |
|---|---|---|---|---|
| | | | | substantial discount and the put option is contingently exercisable. |
| 6. Zero coupon debt is issued at a substantial discount and is callable in the event of a change in control. If the debt is called, the issuer pays the accreted value (calculated per amortization table based on the effective interest rate method). | No. | Yes. | Yes, contingent on a change in control, but since the debt is callable at the accreted value, the call option does not accelerate the repayment of principal. | The call option is clearly and closely related to the debt host contract. Although the debt was issued at a substantial discount and the call option is contingently exercisable, the call option does not accelerate the repayment of principal because the debt is callable at the accreted value. |
| 7. Debt that is issued at par is puttable at par in the event that the issuer has an initial public offering. | No. | No. | N/A. Analysis not required. | The embedded put option is clearly and closely related to the debt host contract because the debt was issued at par (not at a substantial discount) and is puttable at par. Paragraph 815-15-25-26 does not apply. |
| 8. Debt that is issued at par is puttable if the price of the common stock of Entity XYZ (an entity unrelated to the issuer or investor) changes by 20 percent. If the debt is put, the | Yes, based on an equity price (price of Entity XYZ's common stock). | N/A. Analysis not required. | N/A. Analysis not required. | The embedded put option is not clearly and closely related to the debt host contract because the payoff is indexed to an equity price. |

| Instrument | Indexed Payoff? (Steps 1 and 2) | Substantial Discount or Premium? (Step 3) | Contingently Exercisable? (Step 4) | Embedded Option Clearly and Closely Related? |
|---|---|---|---|---|
| investor will be repaid based on the value of Entity XYZ's common stock. | | | | |
| 9. Debt is issued at a slight discount and is puttable if interest rates move 200 basis points. If the debt is put, the investor will be repaid based on the S&P 500. | Yes, based on an equity index (S&P 500). | N/A. Analysis not required. | N/A. Analysis not required. | The embedded put option is not clearly and closely related to the debt host contract because the payoff is based on an equity index. |

**RSM COMMENTARY: Distinguishing between conversion and redemption options**

Standard conversion options allow for conversion of a debt instrument into a fixed or substantially fixed number of shares. Standard redemption features, such as put and call options, give the holder the right to put the debt to the issuer (or the issuer the right to call the debt from the holder) at a stated amount to be paid in cash or shares. Some instruments provide for conversion into a variable number of shares, with the number of shares determined at the time of conversion based on the fair value or price of the shares at the conversion date. Such a feature is designed to ensure that the holder receives a predetermined amount of value paid in whatever number of shares it takes to arrive at that value. In other words, the value that the holder is expected to receive upon conversion is not expected to vary based on changes in the value of the underlying shares. We believe it would be appropriate to analyze such a feature as a redemption option rather than a conversion option when performing the embedded derivative analysis. This can have significant ramifications to the analysis because although options to convert to shares are not clearly and closely related to a debt host contract, redemption options may be.

#### 4.3.1.6 Conversion options

A convertible debt instrument is one of the most common hybrid instruments. Convertible debt is debt containing a conversion feature that allows the investor or holder to convert the debt into the equity shares of the issuer rather than receive repayment of the debt principal in cash.

As noted in ASC 815-15-25-51, equity conversion options are not clearly and closely related to a debt host contract because the underlying value of an equity conversion option is dependent upon the value of an equity interest.

As part of the analysis to determine if a conversion option should be separately recognized as a derivative instrument, an entity must determine whether the conversion option would meet the definition of a derivative instrument if it was a freestanding instrument. This often hinges on whether the net settlement characteristic of a derivative instrument is met (because the other characteristics typically are), and, for the issuer of the convertible instrument, whether the conversion option qualifies for a derivative scope exception. To determine whether the net settlement characteristic of a derivative instrument is met, an entity should consider if the convertible instrument has any provisions whereby the holder can get the

as-converted value in cash. For example, contractual net settlement may exist in the form of a put or redemption option that allows the holder to receive the greater of face or the as-converted value in cash.

If there are no contractual provisions for net settlement, an entity would next generally consider whether the shares that will be delivered upon conversion are readily convertible to cash.

The determination of whether the shares are readily convertible to cash needs to be considered on an ongoing basis throughout the life of a contract. Delisting an IPO or significant changes in the level of trading activity are examples of factors that could influence the conclusion. An entity should consider whether the smallest increment of shares that would be delivered in accordance with each individual contract is small relative to the daily transaction volume. Assume, for example, that a debt instrument can be converted at a conversion price that would result in the issuance of 100,000 shares of publicly traded common stock. The average daily trading volume associated with the common stock is 50,000 shares. If the debt instrument could only be converted in total, the 100,000 shares into which it would be converted is large relative to the daily transaction volume, and the common shares would not be considered readily convertible to cash. Many instruments permit conversion in whole or in part (i.e., in whatever increment the holder elects), in which case, generally, the common shares would be considered readily convertible to cash if they are actively traded. Refer to the guidance beginning at ASC 815-10-15-130 and Example 7 beginning at ASC 815-10-55-99 for additional information.

In contrast to the example, if the shares to be delivered upon conversion were those of a private company, those shares would not be considered readily convertible to cash.

If an equity conversion option contained in a hybrid instrument that has a debt host contract is determined to meet the definition of a derivative instrument, the issuer would need to determine whether the conversion option meets the scope exception for certain contracts involving an entity's own equity in ASC 815-10-15-74(a). Refer to A guide to accounting for debt and equity instruments in financing transactions for further information on the embedded conversion option analysis and this scope exception from the perspective of the issuer. The investor or holder cannot qualify for this scope exception.

#### 4.3.1.7 Term extension feature

A term extension feature is defined in ASC 815-15-25-44 as an embedded derivative that either:

- Unilaterally enables one party to significantly extend the remaining term to maturity of an instrument
- Automatically significantly extends the remaining term of an instrument upon the occurrence of specific events or conditions

ASC 815-15-25-44 also states that a term extension feature "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." As a result, if an embedded term extension feature does not reset the interest rate on an instrument, it is not clearly and closely related to the debt host contract. Additionally, a term-extension feature that could prevent an investor from recovering substantially all its initial recorded investment is also not clearly and closely related to the debt host contract, consistent with the guidance in ASC 815-15-25-26.

Term extension features that are not clearly and closely related to the host contract may require separate recognition as a derivative instrument if all the characteristics of a derivative instrument are present, including net settlement. Term-extension features that are exercisable at the option of the borrower may meet the loan commitment scope exception in ASC 815-10-15-69 through 15-71.

#### 4.3.1.8 Equity indexed payments

As explained in ASC 815-15-25-49, in the context of interest payments that are indexed to equity, an equity-related derivative embedded in a debt instrument is required to be separated from the host contract and accounted for as a derivative instrument. This would be the case whether the equity indexed payments are based on the price of a specific common stock or on a basket of equity instruments

because the changes in fair value of an equity interest and the interest yield on a debt instrument are not clearly and closely related.

#### 4.3.1.9 Illustrative examples of applying the embedded derivative guidance to common features within hybrid instruments that contain a debt host contract

The table below provides RSM's views on whether the first and third criterion in ASC 815-15-25-1 are met for common embedded derivatives found in hybrid contracts that contain a debt host contract, including preferred shares that are more akin to debt. Criterion one is that the economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract, and criterion three is that the embedded derivative meets the definition of a derivative instrument and is not eligible for a derivative scope exception. If both criteria are met and the hybrid instrument is not accounted for at fair value through earnings in its entirety, the embedded derivative would require separate recognition as a derivative instrument.

| | **Are the economic characteristics and risks of the embedded derivative not clearly and closely related to the host contract?** | **Does the embedded derivative meet the definition of a derivative instrument, and is it not eligible for a scope exception?** |
|---|---|---|
| Conversion options[(a)] | Yes, the economic characteristics and risks of an option to convert a debt instrument into equity shares are not clearly and closely related to a debt host contract. | Possibly. A conversion option would generally meet the definition of a derivative instrument if net settlement exists (e.g., contractually or because the conversion shares are actively traded). The price of the shares is an underlying, the number of shares it can convert into is a notional amount and there is generally little or no initial net investment associated with the conversion option.<br>From the issuer's perspective, it may qualify for the scope exception for certain contracts involving an entity's own equity (Refer to ASC 815-10-15-74 through 15-78). |
| Redemption or other features that can accelerate payoff including put, call and prepayment options or requirements | An entity should consider ASC 815-15-25-40 through 25-42, as well as ASC 815-15-25-26 and 25-37 (as relevant) to determine if the economic characteristics and risks of the feature are not clearly and closely related to a debt host contract. | Embedded derivatives within a hybrid instrument that can accelerate the maturity typically meet the definition of a derivative instrument. Interest rates and, for contingent features, the occurrence of the contingency are underlyings. The face amount of the debt (or face plus a premium) is generally the notional amount. There is generally little or no initial net investment associated with the feature. The net settlement characteristic is present for features that can accelerate the maturity of a hybrid instrument that contains debt host contract due to ASC 815-10-15-107. Generally, embedded derivatives require no or minimal initial net investment. |

| | Are the economic characteristics and risks of the embedded derivative not clearly and closely related to the host contract? | Does the embedded derivative meet the definition of a derivative instrument, and is it not eligible for a scope exception? |
|---|---|---|
| Interest rate floors, caps, collars | The economic characteristics and risks of interest rate floors, caps and collars are often considered clearly and closely related to a debt host contract. As a result, this criterion would not be met. However, an entity should carefully consider the guidance that begins at ASC 815-15-25-26 in making this determination. | Interest rate floors, caps and collars typically meet the definition of a derivative instrument. These embedded derivatives have an underlying (i.e., an interest rate or index) and have a notional amount (i.e., the face amount). Further, these embedded derivatives typically require little or no initial net investment and net settle as described in ASC 815-10-15-100 through a one-way transfer of cash (when making the interest payments, neither party is required to deliver an asset with a principal amount equal to the notional amount). |
| Default interest and other credit-sensitive payments | Default interest and other credit-sensitive payments are considered clearly and closely related to a debt host contract such that this criterion would not be met if the default interest or payments are based on the default or change in credit worthiness of the obligor (ASC 815-15-25-46 and 25-47). | Embedded derivatives that provide for default interest and other credit sensitive payments typically meet the definition of a derivative instrument. These embedded derivatives have an underlying because they provide for a payment based on an occurrence or nonoccurrence of an event (e.g., a change in credit rating or an event of default). Further, they typically have a payment provision or notional amount (e.g., face amount of the debt to which a default rate of interest will be applied). In addition, they typically require little or no initial net investment and net settle as described in ASC 815-10-15-100 through a one-way transfer of cash (when making the interest or other credit-sensitive payments, neither party is required to deliver an asset with a principal amount equal to the notional amount). |
| Term-extending options | An entity should consider ASC 815-15-25-44 to determine if the economic characteristics and risks of the feature are not clearly and closely related to a debt host contract. | Term-extending options typically do not meet the definition of a derivative instrument unless net settlement exists. Further, a term-extending option would not be accounted for as a derivative instrument if meets the loan commitment scope exception. |
| Commodity- or equity-indexed payments | Yes, the economic characteristics and risks of a commodity or equity index are not clearly and closely related to a debt host contract. | Features embedded in a debt instrument with payments that are based on a commodity or equity price or index typically meet the definition of a derivative instrument. The commodity or equity price |

| | Are the economic characteristics and risks of the embedded derivative not clearly and closely related to the host contract? | Does the embedded derivative meet the definition of a derivative instrument, and is it not eligible for a scope exception? |
|---|---|---|
| | | or index is considered an underlying. Further, these embedded derivatives typically have a payment provision or notional amount to which the index is applied and require little or no initial net investment. Typically, these embedded derivatives net settle as described in ASC 815-10-15-100 because they are settled by a one-way transfer of cash (neither party is required to deliver an asset (e.g., commodity or equity security) that is associated with the underlying). |
| Inflation-indexed payments | Generally, no. Inflation-indexed payments are considered clearly and closely related to a debt host contract unless a significant leverage factor is involved or the inflation rate is not a relevant rate in the economic environment for the currency in which the debt instrument is denominated (ASC 815-15-25-50). | The definition of a derivative instrument typically would be met because the embedded derivatives that provide for inflation-indexed payments have an underlying (i.e., inflation index), usually have a notional amount (the payment amount to which the index is applied), require little or no initial net investment, and net settle under ASC 815-10-15-100 in the form of a one-way transfer of cash (neither party is required to deliver an asset that is associated with the underlying [i.e., an inflation-sensitive asset] and has a denomination equal to the notional amount). |

(a) Some instruments provide for conversion into a variable number of shares, with the number of shares determined at the time of conversion based on the fair value or price of the shares at the conversion date. Such a feature is designed to ensure that the holder receives a predetermined amount of value paid in whatever number of shares it takes to arrive at that value. In other words, the value that the holder is expected to receive upon conversion is not expected to vary based on changes in the value of the underlying shares. For these reasons, features such as this are evaluated as redemption features rather than conversion options.

### 4.3.2 Hybrid instruments with an equity host contract

This section generally applies to hybrid instruments in the form of a share when the nature of the host contract is determined to be more equity-like than debt-like. Refer to Section 4.2.1.1 for additional guidance on determining the nature of a hybrid instrument in the form of a share that has characteristics of both debt and equity.

As explained in ASC 815-15-25-16, if the host contract contains a residual interest in an entity, its economic characteristics and risks are considered akin to an equity instrument. As a result, an embedded derivative would need to possess mostly equity characteristics and risks (related to the same entity) for it to be considered clearly and closely related to the host contract.

#### 4.3.2.1 Redemption options (put or call options)

It is not uncommon for preferred or similar shares to have embedded redemption or put options that allow the holder to return (put) the shares to the issuer in exchange for cash or other assets, either on or after a specified date, or upon the occurrence of a contingent event such as a change in control. Issuer call options are also prevalent in preferred or similar shares, whereby the issuer decides if it wants to pay cash or other assets in exchange for a return of the shares. As explained in ASC 815-15-25-20, embedded put and call options are not clearly and closely related to equity host contracts. As a result, when these features are present in a hybrid instrument with an equity host contract that is not accounted for at fair value through earnings and meet the definition of a derivative instrument, they generally require separate recognition as a derivative instrument. (The issuer would not account for embedded put and call options as derivative instruments if all the requirements for the scope exception in ASC 815-10-15-74(a) are met. Refer to Section 3.3.11.1 for further discussion on this scope exception).

#### 4.3.2.2 Conversion options

An equity instrument may contain an option whereby it will automatically, contingently or at the holder's option convert from one class of the issuer's shares to another (most commonly, from preferred stock to common). An embedded option to convert from one form of equity to another generally has economic characteristics and risks that are clearly and closely related to an equity host contract (e.g., ASC 815-15-25-17D(b) notes that the ability for an investor to convert a preferred share into a fixed number of common shares generally is viewed as an equity-like characteristic and would therefore not be accounted for separately as a derivative instrument).

#### 4.3.2.3 Rights-offering features

Rights-offering features may provide the holders of equity shares with the right to purchase more of the issuer's shares and are often granted in conjunction with an initial offering. These rights may either be freestanding or embedded in the outstanding equity shares issued at the time the rights are granted. Generally, embedded rights-offering features to purchase additional shares have economic characteristics and risks that are clearly and closely related to an equity host contract and therefore do not require separate recognition as a derivative instrument. Refer to the discussion of "Delayed issuance of preferred or other stock" in our publication, A guide to accounting for debt and equity instruments in financing transactions, for guidance in determining if the rights are embedded or freestanding and the accounting ramifications of that determination.

#### 4.3.2.4 Illustrative examples of applying the embedded derivative guidance to common features within hybrid instruments that contain an equity host contract

The table below provides RSM's views on whether the first and third criterion in ASC 815-15-25-1 are met for common embedded derivatives found in hybrid instruments that contain an equity host contracts. (Refer to the table in Section 4.3.1.9 if the host contract was deemed more debt-like.) Criterion one is that the economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract, and criterion three is that the embedded derivative meets the definition of a derivative instrument and is not eligible for a derivative scope exception. If both criteria are met and the hybrid instrument is not accounted for at fair value through earnings in its entirety, the embedded derivative would require separate recognition as a derivative instrument.

| | Are the economic characteristics and risks of the embedded derivative not clearly and closely related to the host contract? | Does the embedded derivative meet the definition of a derivative instrument, and is it not eligible for a scope exception? |
|---|---|---|
| Option to convert to another class of equity[(a)] | No, the economic characteristics and risks of an option to convert a particular class of equity shares into another class of equity shares are clearly and closely related to an equity host contract. | Possibly. A conversion option would generally meet the definition of a derivative instrument if net settlement exists (e.g., contractually or because the conversion shares are actively traded). Whether the conversion option within a hybrid instrument that contains an equity host contract meets the definition of a derivative instrument is generally irrelevant because the economic characteristics and risks of such options are clearly and closely related to their equity host contract such that separate derivative accounting is not required or appropriate. |
| Redemption features put or call options | Yes, the economic characteristics and risks of a redemption option are not clearly and closely related to an equity host contract. | Possibly. Redemption features embedded in an equity host contract typically meet the definition of a derivative instrument if net settlement exists. Most redemption features are settled gross in that an asset that is associated with the underlying (price of the shares) and notional (e.g., redemption amount) exchanges hands. ASC 815-10-15-107 does not apply to embedded derivatives in a hybrid instrument that contains an equity host contract. However net settlement may exist if contractually provided for (e.g., in the certificate of designation) or if the shares to be redeemed are actively traded).<br>From the issuer's perspective, redemption options in an equity host contract may qualify for the scope exception for certain contracts involving an entity's own equity (refer to ASC 815-10-15-74 through 15-78). |

(a) Some instruments provide for conversion into a variable number of shares, with the number of shares determined at the time of conversion based on the fair value of the shares at that time or the price at which shares were issued in a qualified financing event. Such a feature is designed to ensure that the holder receives a predetermined amount of value paid in whatever number of shares it takes to arrive at that value. In other words, the value that the holder is expected to receive upon conversion is not expected to vary based on changes in the value of the underlying shares. For these reasons, features such as this are evaluated as redemption features rather than conversion options.

### 4.3.3 Hybrid instruments with a lease host contract

Determining whether an embedded derivative in a lease contract is clearly and closely related to the lease host contract involves a thought process similar to that used for a debt host contract. In other words, the nature of the host contract is generally determined by excluding the embedded derivative and focusing on the remaining host contract. Therefore, the nature of the host contract for a hybrid instrument in the form of a lease is typically a lease and any embedded derivatives that do not have economic characteristics and risks that are clearly and closely related to a lease would require further analysis to determine if separate recognition as a derivative instrument is required.

#### 4.3.3.1 Illustrative examples of applying the embedded derivative guidance to common features within hybrid instruments that contain a lease host contract

The table below provides RSM's views on whether the first and third criterion in ASC 815-15-25-1 are met for common embedded derivatives found in hybrid instruments that contain a lease host contract. Criterion one is that the economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract, and criterion three is that the embedded derivative meets the definition of a derivative instrument and is not eligible for a derivative scope exception. If both criteria are met and the hybrid instrument is not accounted for at fair value through earnings in its entirety, the embedded derivative would require separate recognition as a derivative instrument.

| | **Are the economic characteristics and risks of the embedded derivative not clearly and closely related to the host contract?** | **Does the embedded derivative meet the definition of a derivative instrument, and is it not eligible for a scope exception?** |
|---|---|---|
| Inflation-indexed rentals | No, rental payments for the use of leased assets and adjustments for inflation are considered to have economic characteristics and risks that are clearly and closely related to a lease host contract unless a significant leverage factor is involved. (ASC 815-15-25-21). | Generally, the derivative analysis is not relevant because the economic characteristics and risks of inflation indexed rentals are clearly and closely related to their lease host contract unless a significant leverage factor is involved. However, if a significant leverage factor is involved, the derivative analysis is relevant. The definition of a derivative instrument would typically be met because the embedded derivatives that provide for inflation-indexed rentals have an underlying (i.e., inflation index), usually have a notional amount (the payment amount to which the index is applied), require little or no initial net investment, and net settle under ASC 815-10-15-100 in the form of a one-way transfer of cash (neither party is required to deliver an asset that is associated with the underlying [i.e., an inflation-sensitive asset] and has a denomination equal to the notional amount). |
| Interest-rate-adjusted rentals | No, interest-rate-adjusted rentals are considered to have economic characteristics and risks that are clearly and closely | Because the economic characteristics and risks of interest-rate-adjusted rentals are considered clearly and closely related to a lease host contract, the derivative analysis is not relevant. |

| | Are the economic characteristics and risks of the embedded derivative not clearly and closely related to the host contract? | Does the embedded derivative meet the definition of a derivative instrument, and is it not eligible for a scope exception? |
|---|---|---|
| | related to a lease host contract under ASC 815-15-25-22. | |
| Feature that adjusts lease payments based on the lessee's sales (e.g., monthly rent payable of $15,000, plus 2% of the lessee's monthly gross sales) | Both the clearly and closely related criterion and whether the feature meets the definition of a derivative instrument are irrelevant; the embedded derivative would qualify for the scope exception in ASC 815-10-15-59(d) because the underlying on which settlement is based is the sales of one of the parties to the contract. | |
| Purchase option at the end of the lease term | Both the clearly and closely related criterion and whether the feature meets the definition of a derivative instrument are generally irrelevant; an option to purchase a leased asset would typically qualify for the scope exception in ASC 815-10-15-59(b) if the underlying leased asset on which settlement is based is a nonfinancial asset that is unique, not readily convertible to cash and owned by the party that would not benefit under the option from an increase in the fair value of the leased asset. | |

### 4.3.4 Hybrid instruments with an insurance host contract

An entity will need to assess its insurance contracts to determine whether any contain an embedded derivative that must be accounted for separately. ASC 815-15-55 provides implementation guidance for the following types of insurance contracts:

- Dual-trigger insurance contracts (ASC 815-15-55-12)
- Variable annuities contracts (ASC 815-15-55-54 through 55-56)
- Payment options for variable annuity contracts (ASC 815-15-55-58)
- Equity-indexed annuity contracts (ASC 815-15-55-62 through 55-72)
- Equity-indexed life insurance contracts (ASC 815-15-55-73 through 55-76)
- Modified coinsurance arrangements (ASC 815-15-55-107 through 55-109)

#### 4.3.4.1 Dual-trigger insurance contracts

Dual-trigger insurance contracts are policies that pay the holder benefits only if two events occur. Although the contracts or embedded derivatives within them often qualify for a derivative scope exception, ASC 815-15-55-12 explains that if an insurance entity issues a contract that "involves essentially assured amounts of cash flows" based on insurable events that are highly probable of occurring, the entity should separate an embedded derivative related to changes in the separate pre-identified variable for that portion of the contract and account for it as a derivative instrument. Refer to Example 3-13 for an illustration of the concept of essentially assured.

### 4.3.4.2 Variable annuities in general

As noted in ASC 815-15-55-54, variable annuities are similar to variable life insurance contracts in that they enable the policyholder to direct the asset mix of its investment account among a variety of mutual funds, which are typically comprised of equities and bonds. The policyholder may be able to elect from various payment options at the end of the accumulation period (i.e., the period during which the policyholder pays premiums).

These variable annuity contracts typically provide that upon the death of the policyholder, the beneficiary will receive the greater of the value of the investment account or a minimum death benefit guarantee. The minimum death benefit guarantee is usually limited to premiums paid plus a minimum stated return on those premiums (e.g., 3 or 4%).

While variable annuities generally do not fall within the scope of ASC 815, certain components require further consideration. The following table compiled from the guidance that begins at ASC 815-15-55-55 discusses various components (including payment options) of variable annuities, whether each component should be accounted for separately as a derivative instrument and the basis for that conclusion.

| Component | Accounted for separately? | Basis for conclusion |
|---|---|---|
| Death benefit component (i.e., the minimum death benefit guarantee, to the extent it exceeds the fair value of the account) | No | ASC 815-10-15-53(a) excludes this component from the scope of ASC 815 because the payment of the death benefit results from an identifiable insurable event rather than the changes in an underlying as discussed in ASC 815-15-55-55(a). Additionally, death benefits that meet the criteria of market risk benefits are excluded from the scope of ASC 815. |
| Investment component (i.e., the investment account of traditional annuities) | No | As discussed in ASC 815-15-55-55(b), the investment component of a traditional variable annuity is not considered a derivative instrument subject to ASC 815.<br>In accordance with ASC 815-15-55-56, this guidance should not be applied to other seemingly similar structures by analogy. |
| Investment component consisting of an equity-index-based interest annuity | Sometimes | In accordance with ASC 815-15-55-55(b), such an investment component would be accounted for separately as a derivative instrument if it meets all the conditions in ASC 815-15-25-1. ASC 815-15-55-55(b) goes on to state that, “Before concluding that the investment component contains an embedded derivative, the insurance entity should first evaluate whether the equity-index-based interest annuity contains a market risk benefit (see paragraph 944-40-25-25C).”<br>Additionally, market risk benefits are excluded from the scope of ASC 815. |
| Investment account surrender right at fair value | No | In accordance with ASC 815-15-55-55(c), an investment account surrender right at fair value is not within the scope of ASC 815 because it is exercised only at the fund fair value and relates to a traditional variable annuity. |

| Component | Accounted for separately? | Basis for conclusion |
|---|---|---|
| | | In accordance with ASC 815-15-55-56, this guidance should not be applied to other seemingly similar structures by analogy. |
| Payment options at the end of the accumulation period | Sometimes | In accordance with ASC 815-15-55-55(d), payment options are not subject to ASC 815 if the payment is a market risk benefit within the scope of ASC 944. |
| A guarantee of a minimum interest rate that is used to compute periodic annuity payments if and when the policyholder chooses to annuitize | No | The net settlement characteristic of a derivative instrument is not met because settlement can be achieved only by the investment of the account balance in lieu of an immediate payout. Refer to ASC 815-10-15-99 and 815-15-55-58 for further information.<br>The embedded derivative would not be subject to ASC 815 if it is considered a market risk benefit, given the scope exception that begins at ASC 815-10-15-52. |
| A guaranteed minimum account value to annuitize if and when a policyholder chooses to annuitize | Generally, no | The net settlement characteristic of a derivative instrument is not met during the accumulation phase because the policyholder would only realize the benefit of the guaranteed minimum account value by annuitizing, and therefore receiving, the benefit over the payout period. However, the net settlement characteristic of a derivative instrument would be considered to exist, and an embedded derivative recognized during the accumulation phase, if either the policyholder can withdraw all or part of the guaranteed account balance during the payout period or the payout period is unrealistically short (e.g., one year). |
| A guaranteed minimum level of periodic annuity payments during the payout phase if and when a policyholder chooses to annuitize | No | The net settlement characteristic of a derivative instrument is not met during the accumulation phase because the policyholder would only realize the benefit of the guaranteed minimum level of periodic annuity payments by annuitizing, and therefore receiving, the benefit over the payout period. This assumes that the contract is annuitized at its contract value and does not have a minimum guaranteed account value as described in the preceding row. |

#### 4.3.4.3 Equity-indexed annuities

An equity-indexed annuity is a deferred fixed annuity that has a guaranteed minimum interest rate plus a contingent return that is based on an internal or external equity index (e.g., the S&P 500 Index). The guaranteed contract value is typically designed to meet certain regulatory requirements. Equity-indexed annuities usually have minimal mortality risk and as a result are classified as investment contracts pursuant to ASC 944. Because equity-indexed annuities often do not have specified maturity dates, these contracts remain in the accumulation phase until the customer surrenders the contract or chooses to annuitize. Generally, a customer can surrender their contract at any time and receive the account value less any surrender charges.

ASC 815-15-55-63 explains the two basic designs of equity-indexed annuities:

- The periodic ratchet design, where, in the annual version, the customer receives the greater of the appreciation in the equity index during a series of one-year periods (ending on each policy anniversary date) or the guaranteed minimum fixed rate of return over that period
- The point-to-point design, where the customer receives the greater of the appreciation in the equity index during a specified period (for example, five or seven years, starting on the policy issue date) or the guaranteed minimum fixed rate of return over that period

Refer to ASC 815-15-55-64 through 55-72 for further explanation of, and accounting guidance relevant to, equity-indexed annuities. Example 14 that begins at ASC 815-15-55-227 illustrates accounting and valuation issues associated with an equity-indexed annuity that has a minimum account value and participates in equity returns.

#### 4.3.4.4 Equity-indexed life insurance contracts

An equity-indexed life insurance contract combines term life insurance with an investment feature. The death benefit amount of an equity-indexed life insurance contract is based on the amount chosen by the policyholder plus the account value. The policyholder's account value is based on the cumulative deposits plus the positive returns based on an equity index (e.g., the S&P 500 Index). The cash surrender value of the contract is also linked to the equity index. In some contracts, the death benefit amount is dependent on the overall return on the index.

The economic characteristics and risks of the equity-indexed components of these arrangements are not considered clearly and closely related to the economic characteristics and risks of an insurance contract. Therefore, an entity should consider whether any equity-indexed components require separate accounting as a derivative instrument under ASC 815-15-25-1. As indicated in ASC 815-10-15-67, if the policyholder accounts for its equity-indexed life insurance contract in accordance with ASC 325-30, the insurance contract is not subject to ASC 815. As a result, the policyholder would not account for the embedded derivative separately from the insurance contract.

Refer to ASC 815-15-55-73 through 55-76 for accounting guidance on equity-indexed life insurance contracts.

### 4.3.5 Hybrid instruments with an executory host contract

Executory contracts often do not contain the net settlement characteristic of a derivative instrument. As a result, such a contract generally does not meet the definition of a derivative instrument in its entirety, but should be evaluated to assess whether it contains any embedded derivatives (e.g., caps and floors) that may be required to be accounted for separately. If an executory contract does meet the definition of a derivative instrument in its entirety, the entity may elect to apply the normal purchases and normal sales scope exception discussed in Section 3.3.2, if the contract qualifies.

The following is a list of examples of embedded derivatives that may be found in an executory contract for the purchase or sale of raw materials, supplies or services:

- Price caps and floors
- Price adjustments
- Foreign-currency swaps or options
- Commodity forwards
- Commodity options

#### 4.3.5.1 Caps and floors embedded in purchase contracts

Guidance on caps and floors that are embedded in purchase contracts is provided in ASC 815-15-25-19.

> **ASC 815-15-25-19**
>
> The economic characteristics and risks of a floor and cap on the price of an asset embedded in a contract to purchase that asset are clearly and closely related to the purchase contract, because the options are indexed to the purchase price of the asset that is the subject of the purchase contract. See Example 6 (paragraph 815-15-55-114) for an illustration of such options.

Example 6 that begins at ASC 815-15-55-114 is helpful in understanding why the purchase contract in its entirety does not meet all the characteristics of a derivative instrument, but the embedded cap and floor do.

## 4.4 Accounting for hybrid instruments

Pursuant to ASC 815-15-25-4 and 25-5, an entity may elect to account for an entire hybrid instrument at fair value, with changes in fair value reported in earnings (except as noted in ASC 825-10-45-5[10]), if the hybrid instrument has an embedded derivative that requires bifurcation. If an entity does not make that election, any embedded derivatives that meet the conditions in ASC 815-15-25-1 should be accounted for as derivative instruments separately from the host contract. (Refer to Section 11.1.3 for a discussion of the presentation of derivative instruments that have been separated from the host contract in the balance sheet).

The following is a summary of the accounting treatment that an entity would apply when ASC 815 would otherwise require separating the embedded derivatives from a host contract.

| Accounting component | Accounting treatment |
|---|---|
| Embedded derivative (ASC 815-10-35) | The embedded derivative is reported on the balance sheet at fair value and changes in its fair value are generally reported in earnings. If the embedded derivative is designated as a hedging instrument in a cash flow hedge, changes in its fair value would be recognized in accordance with ASC 815-30-35. However, it is not common in our experience for an embedded derivative to be designated as a hedging instrument. |
| Host contract (ASC 815-15-25-54) | The host contract that remains after separating an embedded derivative is accounted for based on the accounting guidance applicable to similar contracts that do not contain an embedded derivative. For example, assume a conversion option embedded in a hybrid convertible debt instrument requires separate recognition as a derivative instrument. The convertible debt was issued for proceeds of $10 million and the fair value of the conversion option derivative was $1 million at the issuance date. The host contract that remains after separately recognizing the conversion option at its $1 million fair value is accounted for like a debt instrument without a conversion option. The debt host contract will have an initial carrying amount of $9 million with the $1 million discount created through the recognition of the conversion option accounted for through the application of the interest method described in ASC 835-30. |

[10] ASC 825-10-45-5 requires changes in the fair value of a financial liability accounted for at fair value that are attributable to a change in instrument-specific credit risk to be recognized separately in other comprehensive income.

| Accounting component | Accounting treatment |
|---|---|
| Hybrid instrument if embedded derivative cannot be reliably identified and measured (ASC 815-15-25-52 and 25-53) | The entire hybrid instrument would be accounted for at fair value with changes in fair value reported in earnings (except as noted in ASC 825-10-45-5) if an embedded derivative that requires separate recognition under ASC 815-15-25-1 cannot be reliably identified or measured. This circumstance is expected to be unusual. A hybrid instrument that is accounted for at fair value through earnings cannot be designated as a hedging instrument. |

### 4.4.1 Allocating basis

In accordance with ASC 815-15-30-2, the basis of a hybrid instrument (generally the proceeds associated with it) is allocated between the embedded derivative and the host contract to determine each of their carrying values. The amount allocated to the embedded derivative upon its initial recognition is its fair value at that time. The remainder is allocated to the host contract. This is illustrated with a convertible debt instrument in the preceding table.

The nuances of determining the fair value of a separated embedded derivative are summarized in the following table.

| Type of embedded derivative | Determination of fair value |
|---|---|
| Non-option based (ASC 815-15-30-4 through 30-5) | Generally, for initial and ongoing valuation purposes, an entity should establish the terms of a non-option embedded derivative (e.g., forward contract) such that its fair value will equal zero upon its initial recognition. This means that an entity would have to adjust the explicit terms of an off-market embedded derivative (generally its forward price) to be reflective of market terms at the time of initial recognition to result in the initial zero fair value. Refer to Example 12 beginning at ASC 815-15-55-160 for an illustration. |
| Option based (ASC 815-15-30-6) | Unlike a non-option embedded derivative, an option-based embedded derivative can have a value other than zero upon its initial recognition. In other words, the contractual terms of the embedded option are used in determining the fair value of the option, even if those terms (e.g., strike price) are off market. |

**Note:** When estimating the fair value of embedded derivatives separately from the fair value of the non-derivative portions of a contract, it is important to ensure that all relevant features are considered but not double-counted in the analysis. Consider for example a debt instrument that has two embedded derivatives that require recognition as a derivative instrument; namely a conversion option, whereby the holder can convert the debt into a stated number of the issuer's common stock, and an option for the holder to put the debt back to the issuer for 1.5 times face value if there is a change in control. The debt also contains an option for the issuer to prepay. However, that option does not meet all the requirements in ASC 815-15-25-1 and therefore is not required to be recognized as a derivative instrument. Determining the fair value of the embedded derivatives is complex in that it is not as simple as determining the value of the conversion option in isolation and adding that to the value of the change in control put option (also determined in isolation). Such an approach would overstate the value of the derivative instruments in that the holder cannot exercise both the put option and the conversion option. In addition, the fact that the issuer can prepay the debt adds an additional valuation complexity because if the issuer does prepay, the period of time during which the put or conversion option can be exercised will be reduced, a fact that also impacts the value of the embedded derivatives. As a result, complex valuation models such as Monte Carlo simulations are often necessary when valuing embedded derivatives and may require the use of a third-party valuation specialist.

In accordance with ASC 815-15-25-7 through 25-10, if a hybrid instrument contains more than one embedded derivative that requires separate accounting, an entity should bundle those embedded derivatives together as a single, compound embedded derivative and report the compound derivative as a single unit of account. However, that compound embedded derivative should not include any features that are clearly and closely related to the host contract as those features would not require derivative recognition under ASC 815-15-25-1.

### 4.4.2 Asymmetry amongst counterparties

The guidance in ASC 815-15 on embedded derivatives generally applies to both parties to the contract. However, it is possible that the two parties could reach different conclusions as to whether an embedded derivative should be accounted for separately. For example, certain derivative scope exceptions only apply to one party to the transaction. An example includes the scope exception in ASC 815-10-15-74 for certain contracts involving an entity's own equity. It is also possible that an investor that acquires a debt instrument as part of a business acquisition or in the secondary market could reach a different conclusion than the original investor or issuer as to whether an embedded interest rate derivative or put or call option requires separate accounting. This is because the analysis to determine if an embedded derivative has characteristics and risks that are clearly and closely related to the host contract should be performed at the time the instrument is issued or acquired by the reporting entity. Thus, an entity that acquires the instrument after its initial issuance date would generally be acquiring it and applying the guidance at different points in time and potentially different circumstances (e.g., the issuer may have issued the instrument at face, while a subsequent acquirer may have paid a premium or discount on the secondary market, which could impact conclusions reached under ASC 815-15-25-26 and 25-42).

### 4.4.3 Timing and frequency of the embedded derivative assessment

The analysis to determine whether an embedded derivative is required to be accounted for separately should be performed upon entering into the contract or financial instrument. Although the analysis to determine if an embedded derivative meets the clearly and closely related condition in ASC 815-15-25-1(a) and the embedded foreign currency derivative scope exception in ASC 815-15-15-10 are generally one-time assessments, it may be necessary to reassess the determination of whether the embedded derivative:

- Meets the definition of a derivative instrument
- Qualifies for a derivative scope exception
- Must be bifurcated when a hybrid instrument containing an embedded feature or host contract is modified

The table below provides examples of why the accounting treatment for an embedded derivative may change, therefore emphasizing the importance of reassessing conclusions on whether a derivative that is embedded in a hybrid instrument requires separate recognition.

| Situation | Accounting ramifications |
|---|---|
| **Definition of a derivative instrument:** Changes in the trading volume of an issuer's shares or the existence of a market mechanism | Factors such as an IPO, sustained changes in daily trading volume, and listing or delisting of the shares on a national stock exchange can impact the determination of whether the shares underlying an embedded conversion option are readily convertible to cash and, as such, whether the net settlement characteristic of a derivative instrument in ASC 815-10-15-119 through 15-124 is met. Similarly, as new markets develop or contract, conclusions reached about whether a market mechanism exists may change.<br>As another example, the common shares of a public company that trade at a low volume may not be considered readily convertible to cash. However, that conclusion would change if significant trading volume developed in the future. |
| **Definition of a derivative instrument:** Existence of a market mechanism | A contract that is or is not contractually net settleable will likely remain as such through its entire term. However, a market mechanism to facilitate net settlement may emerge or disappear over the life of the contract. Refer to ASC 815-10-15-118. |
| **Scope exception:** Change in whether the criteria to apply the scope exception for certain contracts involving an entity's own equity are met | A change in circumstance may cause a feature that qualified for the derivative scope exception in ASC 815-10-15-74(a) to no longer qualify or, conversely, cause a feature that initially did not qualify for the scope exception to newly qualify. This could be the case, for example, as the number of authorized shares are increased or as outstanding shares and commitments to issue shares change, impacting conclusions on whether the condition in 815-40-25-20 to apply the scope exception are met. |
| **Instrument modification:** Change in a way that triggers a remeasurement event | A hybrid instrument may be modified in a way that triggers a remeasurement event such that it has a new basis. This would be the case if, for example, there is an extinguishment of the hybrid instrument. To illustrate, if modified debt is considered extinguished, its carrying value is adjusted to fair value, which is likely at a premium or discount to the face amount. While conclusions reached on whether an embedded derivative has characteristics and risks that are clearly and closely related to the host contract are generally not reassessed, because the debt was extinguished, this would be viewed as though new debt was issued. In light of the debt likely being "issued" at a premium or discount, the conclusions reached on whether an embedded redemption feature or interest rate feature is clearly and closely related to the host contract when applying the guidance in ASC 815-15-25-26 and 25-42 may be impacted. Additionally, changes to the terms may impact conclusions reached on whether an embedded derivative is a derivative instrument and, if so, whether it qualifies for a scope exception. |

# 5 Overview of hedge accounting and the requirements to apply it

## 5.1 Overview

Many entities who enter into derivative transactions to economically hedge their exposure to various risks have the desire to elect hedge accounting. ASC 815 requires derivative instruments within its scope to be recognized on the balance sheet, generally at fair value.[11] Absent an election to apply hedge accounting, changes in the fair value of derivative instruments are recognized through earnings and can therefore cause significant earnings volatility from one period to the next. Earnings volatility can be minimized if an entity elects and qualifies for hedge accounting in the form of a cash flow hedge, fair value hedge or hedge of a net investment in a foreign operation. An election to apply hedge accounting is transaction based, and an entity may elect to use hedge accounting for some qualifying derivative transactions and not for others. There are stringent requirements that must be met in accordance with prescribed timeframes to elect and qualify for hedge accounting, including designating and documenting the hedge in a very prescriptive manner, as well as demonstrating at the inception of a hedge, and on an ongoing basis, that the hedge is highly effective.

Electing and qualifying for hedge accounting can be a frustrating and time-consuming process due to these complex and stringent requirements. As a result, many entities rely on external specialists to help them navigate through and comply with the requirements. Some entities decide they would rather live with the period-to-period earnings volatility rather than put forth the time and effort necessary to comply with the requirements of ASC 815. In making such a decision, the chief financial officer (CFO) or treasurer may want to consider various factors, including the expectations of the users of the financial statements, the duration of the derivative instruments and their potential significance, as well as the specific facts and circumstances of the proposed hedging relationship and resultant degree of complexity to qualify for hedge accounting.

There are three major types of hedges: cash flow hedges, fair value hedges and net investment hedges.

**RSM COMMENTARY: Understanding the terminology**

A cash flow hedge is defined as a hedge of the exposure to variability in the cash flows of a recognized asset or liability, or of a forecasted transaction, that is attributable to a particular risk. Exposure to variability in cash flows typically results from an interest rate that is not fixed (i.e., variable-rate debt), forecasted purchases or sales of commodities at prices that are not fixed or locked in, or forecasted purchases or sales transactions that will be settled in a nonfunctional currency.

A fair value hedge is defined as a hedge of the exposure to changes in the fair value of a recognized asset or liability, or of an unrecognized firm commitment, that are attributable to a particular risk. Exposure to changes in fair value typically results from holding or issuing a debt instrument that has a fixed interest rate or that is denominated in a nonfunctional currency, holding an asset that is exposed to fluctuations in fair value as market prices change, or commitments to buy or sell an asset at a fixed price. Unlike a cash flow hedge, where variability in an interest or exchange rate or price causes variability in cash flows, commodities inventory, fixed-rate debt instruments and firm commitments are examples of items that can present exposure to changes in fair value.

A net investment hedge is a hedge of the foreign currency exposure of a net investment in a foreign operation.

[11] As discussed in Section "Simplified hedge accounting approach for a cash flow hedge of a variable-rate borrowing with a receive-variable, pay-fixed interest rate swap," private companies that elect and qualify for the simplified hedge accounting approach for an interest rate swap can elect to account for the swap at settlement value rather than fair value.

**Pending change: ASU 2025-09, *Hedge accounting improvements***

On November 25, 2025, the FASB issued ASU 2025-09, *Derivatives and Hedging (Topic 815): Hedge Accounting Improvements* (ASU 2025-09), to align hedge accounting more closely with the economics of an entity's risk management activities.

Stakeholders noted to the FASB that, in certain instances, it is challenging to apply hedge accounting for otherwise highly effective hedging relationships. This has resulted in less decision-useful information for investors. Stakeholders also identified areas of hedge accounting guidance that required updating to address the impact of reference rate reform.

ASU 2025-09 addresses five issues intended to enable financial statements to better reflect certain hedging strategies by allowing entities to achieve and maintain hedge accounting for a greater number of highly effective economic hedges. The objective of ASU 2025-09 is to more closely align hedge accounting with the economics of an entity's risk management activities. The FASB believes that the changes set forth in this ASU will improve the decision usefulness of information provided to investors.

ASU 2025-09 affects the following types of hedges:

- A cash flow hedge of a group of forecasted transactions where the individual forecasted transactions within the group share a similar or the same hedged risk. Refer to the "Pending change: ASU 2025-09, *Hedge accounting improvements*" box in Section 5.2.2.2.
- A cash flow hedge of forecasted interest payments on a variable-rate debt instrument with contractual terms that permit the borrower to change the interest rate index or interest rate tenor (i.e., reset frequency) of the debt instrument. Refer to the "RSM Commentary" and "Pending change: ASU 2025-09, *Hedge accounting improvements*" boxes in Section 5.2.2.
- A cash flow hedge of a variable price component of a forecasted purchase or sale of a nonfinancial asset. Refer to the "RSM Commentary" and "Pending change: ASU 2025-09, *Hedge accounting improvements*" boxes in Section 6.2.
- A cash flow hedge or fair value hedge where the hedging instrument is a compound derivative composed of a written option and a non-option derivative (e.g., an interest rate swap that contains a written cap or floor on the variable rate). Refer to the "RSM Commentary" and "Pending change: ASU 2025-09, *Hedge accounting improvements*" boxes in Section 7.2.
- A dual hedge (i.e., a hedge for which a foreign-currency-denominated debt instrument is both designated as the hedging instrument in a net investment hedge of a foreign operation and designated as the hedged item in a fair value hedge of interest rate risk). Refer to the "Pending change: ASU 2025-09, *Hedge accounting improvements*" box in Section 8.5.

For public business entities (PBEs), ASU 2025-09 is effective for annual reporting periods beginning after December 15, 2026, and interim periods within those annual reporting periods. For entities other than PBEs, the ASU is effective for annual reporting periods beginning after December 15, 2027, and interim periods within those annual reporting periods. Early adoption is permitted on any date on or after its issuance.

### 5.1.1 Accounting for cash flow hedges

The accounting for cash flow hedges is significantly different than the accounting for fair value hedges. The application of cash flow hedge accounting, which is the subject of Chapter 10, minimizes earnings volatility because changes in the fair value of the derivative instrument are recognized through other comprehensive income and generally do not impact the income statement until the hedged transaction impacts earnings. In other words, changes in the fair value of a derivative instrument are accumulated in other comprehensive income and subsequently reclassified into earnings in the same period or periods in which the hedged forecasted transaction affects earnings.

### 5.1.2 Accounting for fair value hedges

Fair value hedge accounting minimizes earnings volatility because both changes in the fair value of the derivative instrument and changes in the fair value of the hedged item that are attributable to the hedged risk are recognized on the income statement and offset one another, as is elaborated on in Chapter 9.

### 5.1.3 Accounting for net investment hedges

The accounting for net investment hedges, which is addressed in Section 8.4, minimizes earnings volatility because changes in the fair value of the derivative instrument or other hedging instrument are recognized through other comprehensive income as part of the cumulative translation adjustment.

## 5.2 Requirements to qualify for hedge accounting

ASC 815-20-25 outlines the general requirements that must be met to qualify for hedge accounting. In short, hedge accounting must be elected through formal designation and documentation of the hedging relationship. Additionally, an eligible hedging instrument needs to be highly effective at addressing a permissible hedged risk associated with an eligible hedged item or transaction. These requirements are discussed in the following sections:

- Formal designation and documentation (Section 5.2.1)
- Eligibility of hedged items and transactions (Section 5.2.2)
- Eligible hedging instruments (Section 5.2.3)
- Hedge effectiveness (Section 5.2.4)

Careful attention should be given to these requirements to ensure that hedge accounting can be applied. There are key dates, which vary by type of entity, by which the designation and documentation requirements need to be met, as well as by which hedge effectiveness needs to be assessed and documented. As the following table demonstrates, some of these requirements need to be met as early as the inception of the hedge, which is generally when the derivative instrument is executed.

| Summary of key requirements and timing | | |
|---|---|---|
| **Type of entity** | **Designation and documentation (Section 5.2.1)** | **Effectiveness assessment (Section 5.2.4)** |
| PBEs, financial institutions (as described in ASC 942-320-50-1) and not-for-profit entities that have issued, or are a conduit bond obligor for, securities that are traded, listed or quoted on an exchange or an over-the-counter market | The documentation requirements in ASC 815-20-25-3 must be met at the inception of the hedge. | The initial prospective quantitative hedge effectiveness assessment (using information applicable as of the date of hedge inception) must be performed by the earliest of:<br>• The first quarterly hedge effectiveness assessment date<br>• The date that financial statements that include the hedged |

| Summary of key requirements and timing | | |
|---|---|---|
| | | transaction are available to be issued<br>• The date that any criterion to apply hedge accounting is no longer met<br>• The date of expiration, sale, termination or exercise of the hedging instrument<br>• The date of dedesignation of the hedging relationship<br>• For a cash flow hedge of a forecasted transaction, the date that the forecasted transaction occurs[(a)]<br>Subsequent assessments of effectiveness must be performed and documented whenever financial statements or earnings are reported and at least every three months. |
| Private company (excluding financial institutions) applying the simplified hedge accounting approach for qualifying interest rate swaps in accordance with ASC 815-20-25-135 | The documentation requirements in ASC 815-20-25-3 must be met by the date the first annual financial statements are available to be issued after hedge inception. | There is no requirement to assess the effectiveness of the hedge, and hedge accounting can continue if the requirements to apply this method continue to be met. Ongoing consideration needs to be given to the possibility of default by the counterparty to the swap. If the likelihood that the counterparty will not default ceases to be probable, hedge accounting should be discontinued. |
| Other entities | The documentation requirements in ASC 815-20-25-139 must be met at the inception of the hedge. The method of assessing hedge effectiveness must be documented by the date on which the next interim (if applicable) or annual financial statements (including footnotes) are available to be issued. | The hedge effectiveness must be assessed by the date on which the next interim (if applicable) or annual financial statements (including footnotes) are available to be issued, using information applicable as of hedge inception and each subsequent quarterly assessment date. |

(a) As part of the meeting materials for its September 5, 2018, meeting, the FASB staff indicated that when hedging a group of forecasted transactions, the initial prospective quantitative assessment of hedge effectiveness should be completed before the first forecasted transaction occurs. As noted in ASC 815-20-25-14, forecasted transactions include not only forecasted sales or purchases, but also cash flows related to a recognized asset or liability (e.g., interest payments).

### 5.2.1 Formal designation and documentation

There are stringent documentation requirements that must be met in accordance with the preceding time frames to apply hedge accounting. These requirements were designed to prevent an entity from basing a decision on whether to elect hedge accounting on the derivative gain or loss that occurred during the period. Careful attention should be given to these requirements, as it is important that all required documentation is in place within the required time frame and that each requirement is fully and clearly addressed. Management may want to seek external assistance with the documentation and other requirements associated with hedge accounting to not only ensure that all requirements are met, but also to benefit from the expertise of others in designing and documenting the hedge in a manner that will result in high effectiveness and minimize the ongoing compliance burden. For example, the effectiveness of a hedge is often impacted by how the hedged item or transaction and the nature of the risk being hedged are defined, as well as the methods the entity selects to assess the effectiveness of the hedging relationship.

The formal documentation requirements are outlined in ASC 815-20-25-3 and summarized in the following table with comments that may be useful in understanding the requirements.

| Documentation requirements | Comments |
|---|---|
| **Applicable to all hedges** | |
| Hedging relationship | |
| Risk management objective and strategy, including identification of: | |
| • Hedging instrument (e.g., derivative) | Refer to Section 5.2.3 for a discussion of eligible and ineligible hedging instruments. |
| • Hedged item or transaction | Refer to Section 5.2.2 for a discussion of eligible hedged items and transactions. |
| • Nature of risk being hedged | Refer to the table in Section 5.2.2. |
| • The methods that will be used to retrospectively and prospectively measure effectiveness (e.g., dollar-offset test, regression analysis, qualitative approach) | Refer to Section 5.2.4 for additional guidance on assessing effectiveness. In those circumstances outlined in Section 5.2.4.1, for which no quantitative analysis is necessary, the documentation should demonstrate how the relevant criteria are met. We believe it is also prudent in these circumstances to document the method that will be used to assess the effectiveness if the criteria to assume perfect effectiveness are no longer met. In other words, the entity should indicate whether it intends to assess the ongoing effectiveness qualitatively (as discussed in the Section "Hedges that were initially assessed quantitatively") after performing an initial quantitative assessment and, if so, how it intends to carry out that qualitative assessment and the quantitative method it will use in the event facts and circumstances change such that the entity can no longer assert qualitatively that the hedging relationship was and continues to be |

| Documentation requirements | Comments |
|---|---|
| | highly effective. (Refer to the RSM Commentary that follows Example 5-1.)<br>The quantitative method that is selected (either as the ongoing method that will be used to assess the effectiveness of the hedge, or as the method used if the entity can no longer assert qualitatively that the hedging relationship was and continues to be highly effective) should be described with sufficient specificity that an uninvolved person could perform the analysis and get the same results. The parameters that will be deemed highly effective should also be defined. The quantitative method used for any initial assessment of effectiveness should be used for prospective quantitative assessments.<br>The documentation should also indicate if all of the gain or loss on the hedging instrument will be included in the assessment of effectiveness and, if not, how the excluded component will be recognized in earnings. |
| • The statement that the entity is hedging foreign currency risk on an after-tax basis rather than on a pretax basis, if applicable | |
| **Applicable to fair value hedges** | |
| For a fair value hedge of a firm commitment, a reasonable method for recognizing in earnings the asset or liability representing the gain or loss on the hedged firm commitment | |
| For a hedging relationship designated under the portfolio layer method, an analysis to support the entity's expectation that the hedged item is anticipated to be outstanding as of the hedged item's assumed maturity date | Refer to Section "Portfolio layer method" for additional guidance. |
| **Applicable to cash flow hedges** | |
| For a cash flow hedge of a forecasted transaction: | |
| • The date on or period within which the forecasted transaction is expected to occur | Refer to relevant discussion in Section "Probability of the hedged forecasted transaction" for guidance. |
| • The specific nature of asset or liability involved (if any) | |

| Documentation requirements | Comments |
|---|---|
| • Either:<br>– The exact amount of foreign currency being hedged for hedges of foreign currency exchange risk<br>– The number of items or unit of measure encompassed by the hedged forecasted transaction for hedges of other risks | |
| • If a forecasted sale or purchase is being hedged for price risk, the hedged transaction should not be specified solely in terms of expected currency amounts or as a percentage of sales or purchases during a period | |
| • The current price of a forecasted transaction (to satisfy the criterion in ASC 815-20-25-75(b) for offsetting cash flows) | This amount is used to determine the offsetting cash flows during the term of the hedge to determine if the hedge is highly effective. |
| • The hedged forecasted transaction, described with sufficient specificity so that when a transaction occurs, it is clear whether the transaction is or is not the hedged transaction | Careful consideration should be given to defining the hedged forecasted transaction in a manner that meets this requirement without being overly specific. Examples include:<br>• For a commodities hedge of a contractually specified component: The hedged transaction is the first previously undesignated sales (or purchases) of a stated product with prices based on the contractually specified component occurring in the month the derivative instrument matures, equal to the derivative instrument's notional amount.<br>• For a foreign currency hedge: The hedged transaction is the first previously undesignated sales (or purchases) in the hedged currency occurring in the month the derivative instrument matures, equal to the derivative instrument's notional amount.<br>These examples are included for illustrative purposes and need to be tailored for the specific facts and circumstances. For example, when there are multiple derivative instruments hedging the same pool of forecasted transactions that are designated on the same date, it is important to further differentiate the transactions that are being hedged with each derivative instrument.<br>Assume, for example, that an entity has two interest rate swaps, each with a $25 million notional amount, that are intended to hedge the forecasted interest payments on $50 million of the entity's variable-rate borrowings. The entity may |

| Documentation requirements | Comments |
|---|---|
| | want to indicate that swap 1 is hedging the first interest payments made each month on an amount of variable-rate borrowings indexed to the contractually stated interest rate equal to its notional amount ($25 million) through its maturity date, and swap 2 is hedging the first previously undesignated interest payments made each month on an amount of variable-rate borrowings indexed to the contractually stated interest rate equal to its notional amount ($25 million) through its maturity date.<br><br>By defining hedged forecasted transactions generically rather than associating them with a specific customer (in the case of hedged sales), vendor (in the case of hedged purchases) or debt instrument (in the case of hedged interest payments), the documentation will allow for any transactions that occur in the designated time frame and share the same risk exposure to serve as the hedged transactions, making it less likely that a shortfall will occur. Example 7-3 further illustrates this concept. Additionally, Example 6-2 and Example 7-6 demonstrate the benefit of not describing the hedged forecasted transactions in a manner that limits them to one specific contractually specified index. |
| • Identification of the contractually specified component if hedging this risk in a forecasted purchase or sale of a nonfinancial asset[12] | Refer to Section 6.2 for additional information. |
| • Identification of the contractually specified interest rate if hedging this risk for forecasted interest receipts or payments on a variable-rate financial asset or liability[13] | Refer to Section 7.2 for additional information. |

[12] Following the adoption of ASU 2025-09, this requirement is amended to: Identification of the component or subcomponent if hedging this risk in a forecasted purchase or sale of a nonfinancial asset that meets the criterion in ASC 815-20-25-15(i)(3).” Refer to the ASU for effective date and transition requirements.

[13] Following the adoption of ASU 2025-09, guidance was added to assist with the application of this requirement: “See paragraphs 815-30-35-37B through 35-37M for guidance on changing the contractually specified interest rate for a hedge of forecasted interest payments on a variable-rate debt instrument that permits the borrower to select at each reset period the interest rate index from a list of contractual options (including the interest rate tenor) upon which interest is accrued (this debt instrument is referred to throughout Topic 815 as “choose-your-rate” debt).” Refer to the ASU for effective date and transition requirements.

| Documentation requirements | Comments |
|---|---|
| • *Following the adoption of ASU 2025-09* – For a cash flow hedge of a group of forecasted transactions, the method used to determine if the forecasted transactions have similar risk exposure as determined per ASC 815-20-55-23A | Refer to Section 5.2.2.2 for additional information. |

### 5.2.1.1 Illustrative documentation example

**Example 5-1: Documentation when the critical terms of the hedging instrument and hedged forecasted transaction match (ASC 815-20-55-80A)**

This Example illustrates the documentation requirements in paragraph 815-20-25-3 when the critical terms of the hedging instrument and hedged forecasted transaction match in accordance with paragraphs 815-20-25-84 through 25-85. On January 1, 20X1, Entity A, a U.S. dollar (USD) functional currency entity, executes a forward contract to hedge a portion of its exposure to Canadian Dollar- (CAD-) denominated forecasted sales expected to occur in December 20X1. Entity A determines that all the critical terms of the hedging instrument and hedged forecasted transaction match. It documents the hedging relationship concurrently with the execution of the forward contract in accordance with paragraph 815-20-25-3 as follows:

a. Risk management objective: To hedge against movements in the USD/CAD exchange rate that will affect the USD value of future CAD sales.

b. Hedged forecasted transaction: The first CAD 500,000 sales in December 20X1.

c. Hedging instrument: Foreign exchange forward contract to sell CAD 500,000 and receive USD 400,000 on December 31, 20X1. The fair value of the forward contract at hedge inception is zero.

Method of assessing hedge effectiveness: Entity A will assess the effectiveness on a qualitative basis at hedge inception. The critical terms of the hedging instrument and hedged forecasted transaction can be considered to match because the notional amounts and underlyings of the hedging instrument and hedged forecasted transaction are the same and the forecasted sales are expected to occur in the same fiscal month as the maturity date of the hedging instrument. Therefore, the hedge is expected to be perfectly effective. Subsequent assessments of effectiveness will be performed by verifying and documenting whether the critical terms of the hedging instrument and hedged forecasted transaction have changed during the period in review and whether it remains probable that the counterparty to the hedged item and hedged forecasted transactions will not default. If there are no such changes in critical terms or counterparty credit risk, Entity A will continue to conclude that the hedging relationship is perfectly effective.

**RSM COMMENTARY:** It should be noted that this example illustrates one of the circumstances outlined in ASC 815-20-25-3(b)(2)(iv)(01) for which no quantitative assessment of effectiveness is required. When a quantitative assessment is required or desired, the method that will be used to assess the effectiveness prospectively, as well as the method that will be used to assess the effectiveness retrospectively (which may or may not be the same method), should be described in sufficient detail that an uninvolved third party could perform the effectiveness assessment and get the same results. Even in those circumstances, such as this example in which no quantitative assessment of effectiveness is required, we believe it is prudent to document the method that will be used to assess effectiveness on an ongoing basis. To illustrate using this example, Entity A could expand paragraph (d) to indicate that in the event they can no longer conclude the hedging relationship is perfectly effective, effectiveness will be

assessed using the hypothetical-derivative method,[14] which, while it is outlined in the context of an interest rate swap beginning at ASC 815-30-35-25 (and included herein in Section "Hypothetical-derivative method"), it is commonly applied to other hedges. If a quantitative method for assessing effectiveness was not documented and the critical terms no longer match, hedge accounting may need to be discontinued. Conversely, if a quantitative method was documented and upon the terms no longer matching that method demonstrates the hedge remains highly effective, hedge accounting could continue uninterrupted.

### 5.2.2 Eligibility of hedged items and transactions

ASC 815-20-25-4 through 25-44 outlines the criteria that need to be met for hedged items and transactions to be designated in a hedge. The following table summarizes the risks that are eligible for hedging, with references to the section in this guide for additional information for some commonly observed hedges.

| Type of hedge | Eligible risks to hedge | Guide section |
|---|---|---|
| Fair value hedge of nonfinancial asset (e.g., commodity) or liability (excluding loan servicing rights and nonfinancial firm commitments with financial components) (ASC 815-20-25-12e) | The risk of changes in the fair value of the entire hedged asset or liability (reflecting its actual location if a physical asset). In other words, the price risk of a similar asset in a different location or of a major ingredient cannot be the hedged risk. | 6.4 |
| Cash flow hedge of a forecasted purchase or sale of a nonfinancial asset (ASC 815-20-25-15i) | The risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates. | 8.2.1.1 |
| | The risk of changes in the cash flows relating to all changes in the purchase price or sales price of the asset reflecting its actual location if a physical asset (regardless of whether that price and the related cash flows are stated in the entity's functional currency or a foreign currency). In other words, the risk of changes in the cash flows relating to the purchase or sale of a similar asset in a different location cannot be the hedged risk. | 6.3 |
| | The risk of variability in cash flows attributable to changes in a contractually specified component.[15] | 6.2 |
| | Risk of changes in its fair value attributable to credit risk, foreign exchange risk or both. | |

[14] Entity A should describe specifically how the computation required by ASC 815-30-35-25 will be performed (e.g., a cumulative dollar-offset approach as described in Section "Assessing effectiveness using a dollar-offset approach," or through a regression analysis that compares the change in fair value of the actual derivative instrument to the change in fair value of the hypothetical derivative instrument for the 30 most recent monthly observations).

[15] Following the adoption of ASU 2025-09, this requirement is amended to the risk of changes in cash flows relating to a variable component or subcomponent of the purchase price or sales price of a nonfinancial asset. Refer to the ASU for effective date and transition requirements.

| Type of hedge | Eligible risks to hedge | Guide section |
|---|---|---|
| Fair value hedge of all or a portion of a held-to-maturity debt security (ASC 815-20-25-12d) | Risk of changes in the entire fair value of an option component that permits its prepayment. | |
| Cash flow hedge of variable cash flows related to a held-to-maturity debt security (ASC 815-20-25-15f) | Risk of changes in its cash flows attributable to credit risk. | |
| | Risk of changes in its cash flows attributable to foreign exchange risk. | |
| Fair value hedge of a financial asset or liability, a recognized loan servicing right or a nonfinancial firm commitment with financial components (ASC 815-20-25-12f) | The risk of changes in the overall fair value of the entire hedged item. | 7.1 |
| | The risk of changes in the entire fair value of an option component in a prepayable financial instrument. | Example 7-11 |
| | The risk of changes in its fair value attributable to changes in the designated benchmark interest rate (i.e., interest rate risk). | 7.2.2 |
| | The risk of changes in its fair value attributable to changes in the related foreign currency exchange rates (i.e., foreign exchange risk). | |
| | The risk (referred to as credit risk) of changes in its fair value attributable to both:<br>a. Changes in the obligor's creditworthiness<br>b. Changes in the spread over the benchmark interest rate with respect to the hedged item's credit sector at inception of the hedge | |
| | If the designated hedged risk is not the risk of changes in the overall fair value, two or more of the other risks (interest rate risk, foreign currency exchange risk and credit risk) may simultaneously be designated as being hedged. | |
| Cash flow hedge of forecasted purchase, issuance or sale of a financial asset or liability (or the interest payments on that financial asset or liability) or the variable cash inflow or outflow of an existing financial asset or liability (ASC 815-20-25-15j) | The risk of overall changes in the hedged cash flows related to the asset or liability, such as those relating to all changes in the purchase price or sales price (regardless of whether that price and the related cash flows are stated in the entity's functional currency or a foreign currency). | 7.1 |
| | For forecasted interest receipts or payments on an existing variable-rate financial instrument, risk of changes in its cash flows attributable to changes in the contractually specified interest rate (i.e., interest rate risk). | 7.2.1 |
| | For a forecasted issuance or purchase of a debt instrument (or the forecasted interest payments), the risk of changes in cash flows attributable to changes | 7.2.1.1 |

| Type of hedge | Eligible risks to hedge | Guide section |
|---|---|---|
| | in the benchmark interest rate (if the instrument is expected to have a fixed rate of interest) or the expected contractually specified interest rate (if the instrument is expected to have a variable rate of interest). If uncertain, the hedged risk should be designated as the variability in cash flows attributable to changes in a rate that would both qualify as a benchmark interest rate (e.g., SOFR) and as a contractually specified interest rate. | |
| | The risk of changes in the functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates (referred to as foreign exchange risk). | 8.2.1.2 |
| | The risk (referred to as credit risk) of changes in its cash flows attributable to all of the following:<br>• Default<br>• Changes in the obligor's creditworthiness<br>• Changes in the spread over the contractually specified interest rate or benchmark interest rate with respect to the related financial asset's or liability's credit sector at inception of the hedge. | |
| | If the designated hedged risk is not the risk of overall changes in the hedged cash flows related to the asset or liability, two or more of the other risks (interest rate risk, foreign exchange risk and credit risk) simultaneously may be designated as being hedged. | |
| Fair value hedge of foreign exchange risk (ASC 815-20-25-37) | Changes in the fair value of a recognized asset or liability (or a specific portion thereof) for which a foreign currency transaction gain or loss is recognized in earnings attributable to changes in foreign currency exchange rates | |
| | Changes in the fair value of an available-for-sale debt security (or a specific portion thereof) attributable to changes in foreign currency exchange rates | |
| | Changes in the fair value of an unrecognized firm commitment (or a specific portion thereof) attributable to foreign currency exchange rates | Example 8-5, Example 8-6 |
| Cash flow hedge of foreign exchange risk (ASC 815-20-25-34 and 25-38) | Changes in the functional-currency-equivalent cash flows associated with a forecasted transaction, including an intra-entity transaction | 8.2.1.1 |
| | Changes in the functional-currency-equivalent cash flows associated with a recognized asset or liability | 8.2.1.2 |

| Type of hedge | Eligible risks to hedge | Guide section |
|---|---|---|
| | Changes in the functional-currency-equivalent cash flows associated with an unrecognized firm commitment | 8.2.1.3 |
| | Changes in the functional-currency-equivalent cash flows related to the settlement of the foreign-currency-denominated receivable or payable that results from a forecasted purchase or sale on credit | 8.3 |
| Hedge of a net investment in a foreign operation | Exposure to changes in foreign currency exchange rates | 8.4 |

As noted in ASC 815-30-35-37A and illustrated through Example 6-2 and Example 7-6, it is permissible for the hedged risk to change during the life of the hedging relationship.

**RSM COMMENTARY:** ASC 815-30-35-37A specifies that if there is a change to the hedged risk in a cash flow hedge, an entity does not necessarily have to dedesignate the hedging relationship. Rather, it determines whether the hedging instrument continues to be highly effective at offsetting cash flows attributable to the revised forecasted transaction. We have observed that a common situation where there is a change to the hedged risk in a cash flow hedge is in the context of hedges of forecasted interest payments on variable-rate debt instruments that permit the borrower to change the interest rate index or interest rate tenor of the debt instrument (commonly referred to as "choose-your-rate" debt). However, when an entity does select a different interest rate, there is diversity in practice as to how to assess effectiveness and determine whether forecasted transactions should be considered likely to occur.

In ASU 2025-09, the FASB has superseded ASC 815-30-35-37A and added ASC 815-30-35-37B through 35-37M to provide guidance for changing the contractually specified interest rate for hedges of forecasted interest payments on choose-your-rate debt instruments. Refer to the following "Pending change: ASU 2025-09 *Hedge Accounting Improvements*" box.

**Pending change: ASU 2025-09, *Hedge accounting improvements***

On November 25, 2025, the FASB issued ASU 2025-09, *Derivatives and Hedging (Topic 815): Hedge Accounting Improvements* (ASU 2025-09 or the ASU), to align hedge accounting more closely with the economics of an entity's risk management activities.

ASU 2025-09 enables an entity to apply cash flow hedge accounting to forecasted interest payments on variable-rate borrowings whose contractual provisions permit the borrower to switch both the reference interest rate index and the interest rate tenor (i.e., the reset interval) on which interest is calculated. These arrangements are commonly described as "choose-your-rate" debt. Under this model, the debt agreement specifies the permissible alternative rate indexes and tenors that may be designated as the hedged risk throughout the hedge term without discontinuing hedge accounting. The ASU also allows entities to employ certain simplifying assumptions when evaluating the likelihood of the forecasted interest payments occurring and when performing hedge-effectiveness assessments. This guidance may be applied to existing, forecasted issuances of, and subsequent replacements of, choose-your-rate debt. The ASU explicitly prohibits extending this approach by analogy to other fact patterns.

For PBEs, ASU 2025-09 is effective for annual reporting periods beginning after December 15, 2026, and interim periods within those annual reporting periods. For entities other than PBEs,

the ASU is effective for annual reporting periods beginning after December 15, 2027, and interim periods within those annual reporting periods. Early adoption is permitted on any date on or after its issuance.

Entities should apply the guidance in ASU 2025-09 prospectively for all hedging relationships. An entity may elect to adopt the ASU for hedging relationships that exist as of the date of adoption.

Following the adoption of ASU 2025-09, as noted in ASC 815-20-25-79B, for a cash flow hedge of forecasted interest payments on a choose-your-rate debt for which an entity chooses to apply the guidance in ASC 815-30-35-37B through 35-37M, the quantitative prospective assessment of hedge effectiveness should consider all reasonably possible changes in cash flows of the forecasted transaction attributable to only the then-designated contractually specified interest rate. An entity should not consider possible changes in cash flows of the forecasted transaction attributable to a contractually specified interest rate that may be designated in the future. The quantitative prospective assessment of hedge effectiveness should consider all reasonably possible changes in cash flows of the derivative instrument in accordance with ASC 815-20-25-79(a).

#### 5.2.2.1 Hedged item criteria relevant to fair value hedges

ASC 815-20-25-11 and 25-12 outlines the primary hedged item criteria that are applicable only to fair value hedges. Additionally, ASC 815-20-25-43 contains a list of items (summarized in Section 5.2.2.3) that are specifically ineligible for designation as a hedged item. Assuming all relevant criteria are met, the following items are eligible to be designated as the hedged item in a fair value hedge:

- A recognized asset or liability in its entirety (e.g., a loan)
- A specific portion of a recognized asset or liability (e.g., 50% of a loan)
- All or a specific portion of an unrecognized firm commitment, such as a commitment to purchase an asset at a pre-established price (refer to glossary definition of firm commitment)
- All or a specific portion of a portfolio of similar assets or similar liabilities that share the same risk exposure (e.g., a portfolio of loans or pool of inventory)
- A specific layer or layers of a closed portfolio of similar financial assets (Refer to Section "Portfolio layer method" for further information)

The hedged item in a fair value hedge needs to present an exposure to changes in fair value attributable to the hedged risk that could affect reported earnings.[16] For example, assets such as inventory and a fixed-rate loan, as well as a firm commitment to buy something at a stated price, all present such exposure, given that the fair value of inventory and the firm commitment would be expected to change as market prices associated with the inventory or firm commitment change, and the fair value of a fixed-rate loan would be expected to change as market interest rates fluctuate.

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), it is required to be one of the following in accordance with ASC 815-20-25-12(b)(2):

- A percentage of the entire asset or liability (or of the entire portfolio)
- One or more selected contractual cash flows, including one or more individual interest payments during a selected portion of the term of a debt instrument
- A put or call option (including an interest rate cap or price cap or an interest rate floor or price floor) embedded in an existing asset or liability that is not separately recognized as a derivative instrument (Example 6-14 and Example 7-11 illustrate this concept)

[16] This requirement does not apply to entities that do not report earnings, such as not-for-profit entities.

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

A hedged item can be a layer of a closed portfolio of prepayable or nonprepayable financial assets or one or more beneficial interests secured by a portfolio of prepayable or nonprepayable financial instruments under a portfolio layer method. The portfolio layer method is discussed in Section 7.2.2.1. As previously mentioned, one of the requirements that must be met when hedging a portfolio of assets or liabilities is that the individual assets or liabilities need to share the same risk exposure for which they are designated as being hedged. ASC 815-20-55-14 sheds additional light on this concept by indicating that if the change in fair value of a hedged portfolio attributable to the hedged risk was 10% during a reporting period, the change in the fair value of each individual item within the portfolio attributable to the hedged risk should be expected to be within a fairly narrow range (e.g., 9% to 11%) for shared risk exposure to exist. Conversely, a range of 7% to 13% is noted as inconsistent with the requirement to share the same risk exposure. Loans are the type of assets that are most commonly hedged as a portfolio in practice. As noted in ASC 815-20-55-15, relevant characteristics to consider when aggregating loans in a portfolio to be hedged include (in part) loan, collateral and interest rate characteristics, as well as maturity and prepayment data.

If appropriate elections are made to hedge interest rate risk for a partial term and measure the change in fair value of the hedged item on the basis of the benchmark rate component of the contractual coupon cash flows under a portfolio layer method hedge (discussed more fully in Section "Portfolio layer method"), the analysis to determine if the risk exposure is shared can be performed qualitatively and only needs to be performed at hedge inception, given that the portfolio is closed. (The inference here is that in any other circumstance, this analysis is ongoing and typically needs to be quantitative.) For the purpose of this test and hedge accounting, all assets in the portfolio are considered nonamortizing and nonprepayable with the same maturity and coupon rate as elaborated on in BC112 of ASU 2017-12.

### 5.2.2.2 Hedged transaction criteria applicable to cash flow hedges only

ASC 815-20-25-13 permits hedging exposure to variability in expected future cash flows attributable to either existing recognized assets or liabilities, such as interest payments on variable-rate debt, or a forecasted transaction, such as a forecasted purchase or sale that will occur at the market price at the time of the transaction. Both the cash flows related to a recognized asset or liability and the cash flows related to a forecasted transaction are referred to as a forecasted transaction or hedged transaction.

#### Hedging forecasted transactions

ASC 815-20-25-15 outlines certain criteria that must all be met for a forecasted transaction to be eligible for designation as a hedged transaction in a cash flow hedge (criteria pertaining to risks that are eligible to be hedged are included in the table in Section 5.2.2 and omitted from here).

**ASC 815-20-25-15 [Partial Excerpt]**

A forecasted transaction is eligible for designation as a hedged transaction in a cash flow hedge if all of the following additional criteria are met:

a. The forecasted transaction is specifically identified as either of the following:
   1. A single transaction
   2. A group of individual transactions that share the same[17] risk exposure for which they are designated as being hedged. A forecasted purchase and a forecasted sale shall not both be included in the same group of individual transactions that constitute the hedged transaction.

b. The occurrence of the forecasted transaction is probable.

c. The forecasted transaction meets both of the following conditions:
   1. It is a transaction with a party external to the reporting entity (except as permitted by paragraphs 815-20-25-30 and 815-20-25-38 through 25-40).
   2. It presents an exposure to variations in cash flows for the hedged risk that could affect reported earnings.

d. The forecasted transaction is not the acquisition of an asset or incurrence of a liability that will subsequently be remeasured with changes in fair value attributable to the hedged risk reported currently in earnings. [**RSM commentary:** As noted at ASC 815-20-25-29, the recognition of foreign currency transaction gains or losses based on changes in the spot rate is not considered to constitute this form of remeasurement.]

e. If the forecasted transaction relates to a recognized asset or liability, the asset or liability is not remeasured with changes in fair value attributable to the hedged risk reported currently in earnings.[18]

f. [Omitted]

g. The forecasted transaction does not involve a business combination subject to the provisions of Topic 805 or a combination accounted for by an NFP that is subject to the provisions of Subtopic 958-805.

h. The forecasted transaction is not a transaction (such as a forecasted purchase, sale, or dividend) involving either of the following:
   1. A parent entity's interests in consolidated subsidiaries
   2. An entity's own equity instruments.

i. [Omitted]

j. [Omitted]

k. The item is not otherwise specifically ineligible for designation (see paragraph 815-20-25-43) [**RSM commentary:** This criterion is summarized in Section 5.2.2.3.]

As noted in ASC 815-20-25-15(a)(2) (see codification excerpt above) the shared risk exposure requirement relevant to fair value portfolio hedges is also relevant when hedging a group of forecasted

[17] Following the adoption of ASU 2025-09, the "share the same" risk exposure requirement is replaced with "have a similar" risk exposure. Refer to the ASU for effective date and transitions requirements.

[18] Following the adoption of ASU 2025-09, an example was added to this criterion: "For example, if the forecasted transaction relates to the purchase or sale of a nonfinancial item under a contract that is accounted for as a derivative under Topic 815 (that is, a recognized asset or liability), an entity may designate the variable price component (or subcomponent) in the contract as the hedged risk if all other hedge criteria are satisfied." Refer to the ASU for effective date and transition requirements.

transactions in a cash flow hedge. Example 6-9, as well as the following list, illustrate how shared risk exposure may exist in various circumstances associated with a cash flow hedge:

- Forecasted sales of the same product to various customers for a commodities hedge
- Forecasted purchases of the same product from various vendors for a commodities hedge
- Forecasted sales or purchases denominated in the same currency for a foreign currency hedge
- Forecasted interest payments on a pool of variable-rate debt that varies with the same index (e.g., SOFR) for a hedge of interest rate risk

As noted in ASC 815-20-25-22, forecasted purchases or sales can be designated as the hedged item through an all-in-one hedge, which is further illustrated beginning at ASC 815-20-55-111, using a fixed-price contract associated with the forecasted purchases or sales that meets the definition of a derivative instrument as the hedging instrument.

**Pending change: ASU 2025-09, *Hedge accounting improvements***

On November 25, 2025, the FASB issued ASU 2025-09, *Derivatives and Hedging (Topic 815): Hedge Accounting Improvements* (ASU 2025-09 or the ASU), to align hedge accounting more closely with the economics of an entity's risk management activities.

ASU 2025-09 expands the hedged risks that may be combined within a group of individual forecasted transactions in a cash flow hedge. Specifically, the ASU changes the requirement to designate a group of individual forecasted transactions from having a shared risk exposure to having a similar risk exposure. An entity must evaluate whether the risks are similar both when the hedge is initiated and throughout the life of the hedging relationship. The ASU further explains that individual forecasted transactions may be viewed as having a similar risk exposure when the designated hedging derivative is highly effective in offsetting each of the risks included in the group. Additionally, in certain circumstances, entities may use a qualitative approach on an ongoing basis to assess whether the group continues to meet the similar-risk criterion.

For PBEs, ASU 2025-09 is effective for annual reporting periods beginning after December 15, 2026, and interim periods within those annual reporting periods. For entities other than PBEs, the ASU is effective for annual reporting periods beginning after December 15, 2027, and interim periods within those annual reporting periods. Early adoption is permitted on any date on or after its issuance.

Entities should apply the guidance in ASU 2025-09 prospectively for all hedging relationships. An entity may elect to adopt the ASU for hedging relationships that exist as of the date of adoption.

### Probability of the hedged forecasted transaction

An important criterion that must be met to designate a forecasted transaction or group of transactions as the hedged item in a cash flow hedge is that the designated transaction or group of transactions must be probable of occurring. In part, this entails assessing the creditworthiness of the counterparty to a hedged forecasted transaction, particularly in those circumstances where the hedged transaction involves payments from the counterparty, (e.g., hedges of forecasted sales, interest to be received on a financial asset). ASC 815-20-55-24 specifically states that the assessment of whether transactions are probable should be supported by observable facts, with consideration given to the following circumstances in assessing the likelihood that a transaction will occur:

- The frequency of similar past transactions
- The financial and operational ability of the entity to carry out the transaction

- The substantial commitments of resources to a particular activity (for example, a manufacturing facility that can be used in the short run only to process a particular type of commodity)
- The extent of loss or disruption of operations that could result if the transaction does not occur
- The likelihood that transactions with substantially different characteristics might be used to achieve the same business purpose (for example, an entity that intends to raise cash may have several ways of doing so, ranging from a short-term bank loan to a common stock offering)

Consideration should be given to quantities of hedged forecasted transactions and the length of time until a forecasted transaction is projected to occur when determining the extent of evidence necessary to support an assertion that the transactions are probable.

One of the requirements in ASC 815-20-25-3 (included in Section 5.2.1) is to document the timing of the hedged forecasted transaction. In many cases, a range is used when documenting the timing, particularly when hedging forecasted purchases or sales, given the difficulty in knowing the precise day a transaction will occur. Care should be taken when establishing this date or range because if it becomes probable that a hedged forecasted transaction will not occur by the end of the originally specified time period documented at the inception of the hedge, hedge accounting should be discontinued. Additionally, if it is probable that the hedged forecasted transaction will not occur either by the end of the originally specified period or within an additional two-month period of time, the gain or loss in accumulated other comprehensive income associated with the hedge needs to be immediately recognized in earnings in accordance with ASC 815-30-40-5 unless there are rare, extenuating circumstances related to the nature of the forecasted transaction that are outside the control or influence of the reporting entity as noted in ASC 815-30-40-4. A pattern of hedged forecasted transactions not occurring within a two-month period of the originally specified time period calls into question the entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions. For this reason, it is generally beneficial to be conservative in estimating the timing of the hedged forecasted transactions. ASC 815-20-35 and ASC 815-20-25-75(b) require that the best estimate of the forecasted transaction's timing be both documented and used in assessing hedge effectiveness (i.e., the estimated timing may change, in which case the new best estimate as of each effectiveness assessment date would be used). Various examples within ASC 815 illustrate the ramifications of hedged forecasted transactions no longer being probable, including certain of the cash flow hedge examples incorporated in Chapter 6 and Chapter 7.

#### 5.2.2.3 Items specifically ineligible for designation as a hedged item or transaction

In addition to items or transactions that do not specifically meet the eligibility criteria described in the preceding subsections of Section 5.2.2, ASC 815-20-25-43 contains a list of items or transactions that are not eligible to be designated as a hedged item or transaction in the respective hedges.

**ASC 815-20-25-43**

Besides those hedged items and transactions that fail to meet the specified eligibility criteria, none of the following shall be designated as a hedged item or transaction in the respective hedges:

a. Subparagraph not used

b. With respect to both fair value hedges and cash flow hedges:

   1. An investment accounted for by the equity method in accordance with the requirements of Subtopic 323-10 or in accordance with the requirements of Topic 321

   2. A noncontrolling interest in one or more consolidated subsidiaries

3. Transactions with stockholders as stockholders, such as either of the following:
   i. Projected purchases of treasury stock
   ii. Payments of dividends.
4. Intra-entity transactions (except for foreign-currency-denominated forecasted intra-entity transactions) between entities included in consolidated financial statements
5. The price of stock expected to be issued pursuant to a stock option plan for which recognized compensation expense is not based on changes in stock prices after the date of grant.

c. With respect to fair value hedges only:
   1. If the entire asset or liability is an instrument with variable cash flows, an implicit fixed-to-variable swap (or similar instrument) perceived to be embedded in a host contract with fixed cash flows
   2. For a held-to-maturity debt security, the risk of changes in its fair value attributable to interest rate risk
   3. An asset or liability that is remeasured with the changes in fair value attributable to the hedged risk reported currently in earnings [**RSM commentary:** As noted in ASC 815-20-25-29, the recognition of foreign currency transaction gains or losses based on changes in the spot rate is not considered to constitute this form of remeasurement.]
   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 noncontrolling interest, or an equity method investee
   6. An equity instrument issued by the entity and classified in stockholders' equity in the statement of financial position
   7. A component of an embedded derivative in a hybrid instrument—for example, embedded options in a hybrid instrument that are required to be considered a single forward contract under paragraph 815-10-25-10 cannot be designated as items hedged individually in a fair value hedge in which the hedging instrument is a separate, unrelated freestanding option.

d. With respect to cash flow hedges only:
   1. Subparagraph not used
   2. If variable cash flows of the forecasted transaction relate to a debt security that is classified as held-to-maturity under Topic 320, the risk of changes in its cash flows attributable to interest rate risk

### 5.2.3 Eligible hedging instruments

The eligibility of hedging instruments is discussed beginning in ASC 815-20-25-4. In most cases, the hedging instrument in a hedging relationship is a derivative instrument, either in its entirety or a proportion thereof. Additionally, two or more derivative instruments can be jointly designated as the hedging instrument in a hedging relationship. Refer to Chapter 1 for an overview of what constitutes a derivative instrument.

As noted in ASC 815-20-25-22, a fixed-price contract associated with a forecasted purchase or sale that meets the definition of a derivative instrument can be designated as the hedging instrument in an all-in-one hedge. This is illustrated beginning at ASC 815-20-55-111.

| Additional criteria to be met for certain hedging instruments | |
|---|---|
| **Hedging instrument** | **Guidance** |
| Written option (i.e., an option for which the entity receives a premium in the form of cash, a favorable rate or another term) | Beginning at ASC 815-20-25-87, illustrated through Example 20 beginning at ASC 815-20-55-179 and the example incorporated Example 7-4 |
| Intra-entity derivative instruments for hedges of foreign exchange risk | Beginning at ASC 815-20-25-46A, as well as ASC 815-20-25-52 and ASC 815-20-25-61 through 25-64 |
| Instrument used to modify interest payments from one variable rate to another variable rate | Beginning at ASC 815-20-25-50 |
| Instrument in net investment hedges of foreign currency exposure | Beginning at ASC 815-20-25-66 |

In times of rising interest rates, an entity wishing to hedge interest rates may be more likely to purchase an interest rate cap by paying a premium to effectively limit interest rate payments. Sometimes, an entity that purchases an interest rate cap may wish to offset the premium on the cap by selling (i.e., writing) an interest rate floor. The written option guidance noted in the preceding table applies to the written interest rate floor.

In addition to derivative instruments, certain nonderivative financial instruments, including intra-entity loans that may give rise to foreign currency transaction gains or losses, are eligible to be designated as the hedged item in a foreign currency hedge, as is more fully elaborated on beginning at ASC 815-20-25-58 and illustrated in Example 8-5.

### 5.2.3.1 Ineligible hedging instruments

In addition to hedging instruments that do not meet the preceding eligibility criteria, ASC 815-20-25-71 contains a list of items that are specifically not eligible to be designated as hedging instruments.

**ASC 815-20-25-71**

Besides those hedging instruments that fail to meet the specified eligibility criteria, none of the following shall be designated as a hedging instrument for the respective hedges:

a. With respect to fair value hedges, cash flow hedges, and net investment hedges:
   1. A nonderivative instrument, such as a U.S. Treasury note, except as provided in paragraphs 815-20-25-58 through 25-59 and 815-20-25-66
   2. Components of a compound derivative instrument representing different risks
   3. A hybrid financial instrument that an entity irrevocably elects under paragraph 815-15-25-4 to initially and subsequently measure in its entirety at fair value (with changes in fair value recognized in earnings)
   4. A hybrid instrument for which an entity cannot reliably identify and measure the embedded derivative instrument that paragraph 815-15-25-1 requires be separated from the host contract
   5. Any of the individual components of a compound embedded derivative that is separated from the host contract.

b. With respect to fair value hedges only:

1. A nonderivative financial instrument as the hedging instrument in a fair value hedge of the foreign currency exposure of a recognized asset or liability.
2. A nonderivative financial instrument as the hedging instrument in a fair value hedge of the foreign currency exposure of an available-for-sale debt security.

c. With respect to cash flow hedges only:

1. A nonderivative financial instrument as a hedging instrument in a foreign currency cash flow hedge.

d. With respect to net investment hedges only:

1. A compound derivative instrument that has multiple underlyings—one based on foreign exchange risk and one or more not based on foreign exchange (for example, the price of gold or the price of an S&P 500 contract), except as indicated in paragraph 815-20-25-67 for certain cross-currency interest rate swaps
2. A derivative instrument and a cash instrument in combination as a single hedging instrument (that is, an entity shall not consider a separate derivative instrument and a cash instrument as a single synthetic instrument for accounting purposes)
3. Subparagraph not used

### 5.2.4 Hedge effectiveness

Effectiveness in the context of hedge accounting relates to the extent to which expected changes in fair value or cash flows associated with the hedging instrument are expected to offset expected changes in fair value or cash flows associated with the hedged item, which are attributable to the hedged risk, during the term of the hedge. A hedging relationship needs to be highly effective at its inception and on an ongoing basis for an entity to apply hedge accounting. Hence, ASC 815-20 requires hedge effectiveness to be assessed both prospectively and retrospectively as elaborated on through the discussion that follows. Mismatches between the hedging instrument and the item or transaction it is hedging cause a hedging relationship to not be perfectly effective. Examples are mentioned in ASC 815-20-25-77.

**ASC 815-20-25-77**

There would be a mismatch between the change in fair value or cash flows of the hedging instrument and the change in fair value or cash flows of the hedged item or hedged transaction in any of the following circumstances, among others:

a. A difference between the basis of the hedging instrument and the hedged item or hedged transaction, to the extent that those bases do not move in tandem

b. Differences in critical terms of the hedging instrument and hedged item or hedged transaction, such as differences in any of the following:

1. Notional amounts
2. Maturities
3. Quantity
4. Location (not applicable for hedging relationships in which the variability in cash flows attributable to changes in a contractually specified component is designated as the hedged risk) [*Following the adoption of ASU 2025-09* - Location (not applicable if the hedging instrument's underlying and the designated hedged risk are the same)]
5. Delivery dates.

c. A change in the counterparty's creditworthiness.

The following table contains some common mismatches that we observe in practice.

| Context | Mismatch |
|---|---|
| Hedging interest rate risk | • In a hedge of interest rate risk, a mismatch can arise when a variable-rate debt instrument has an interest rate floor hedged with an interest rate swap that does not contain a mirror of the floor.<br>• In a hedge of interest rate risk, a mismatch can arise when a variable-rate debt instrument is hedged with an interest rate swap that has a different reference rate tenor than the debt instrument (e.g., debt that has interest payments based on one-month SOFR hedged with an interest rate swap that has a variable leg based on overnight-SOFR). |
| | • In a fair value hedge of interest rate risk, a fair value mismatch can arise because the hedging instrument is measured at full fair value, reflecting all market factors (including counterparty credit risk and discounting effects), whereas the hedged item is remeasured only for changes in fair value attributable to the designated interest rate risk. This difference in measurement scope can result in hedge ineffectiveness when changes in factors excluded from the hedged risk affect the fair value of the derivative but not the hedged item. |
| Hedging commodities | • There may be a basis (e.g., location, type or quality) difference between the hedging instrument and hedged item or hedged forecasted transactions. For example, the quality (e.g., premium grade) of the commodity to be delivered in the hedged forecasted transaction may be different than the quality of the commodity referenced in the hedging derivative instruments (e.g., exchange grade). Some of these differences may be ignored in a hedge of a contractually specified component.<br>• The timing of hedged forecasted commodity transactions may not line up with the maturity date of the derivative instrument.[(a)] |
| Hedging foreign currency exposure | • The hedged item or transactions may be denominated in a different currency than the underlying currency of the derivative instrument. |

| Context | Mismatch |
|---|---|
| | • The timing of hedged forecasted transactions may not line up with the maturity date of the derivative instrument.[(a)] |

(a) As noted in ASC 815-20-25-84A, when hedging a group of forecasted transactions, the timing can be assumed to match if the forecasted transactions occur within the same 31-day period or fiscal month that the derivative instrument matures.

In certain cases, the effectiveness of a hedge can be assessed qualitatively, and in other cases, a quantitative analysis is required or desired. Certain examples in Chapter 6 through Chapter 8 illustrate reasons why certain hedges are not perfectly effective and mention approaches that may be taken to assess the effectiveness of the hedge. The two most common quantitative approaches used to assess the effectiveness of a hedge are a dollar-offset approach and regression analysis, both of which are discussed later in this chapter. *Highly effective* is not specifically defined in ASC 815; however, in practice, it has been interpreted to mean a cumulative dollar-offset ratio that ranges from 80 to 125% (when a dollar-offset approach is used to assess effectiveness) and a coefficient of determination (R-squared) of .80 or greater when regression analysis is used.

#### 5.2.4.1 Circumstances in which a qualitative assessment of effectiveness is permissible

As previously mentioned, the effectiveness of a hedging relationship needs to be assessed as of the inception date of the hedge in accordance with the time frames prescribed in Section 5.2. This inception date assessment can be performed qualitatively if one of the exceptions in ASC 815-20-25-3(b)(2)(iv) is met. These exceptions are based on the underlying premise that if the critical terms of the hedging instrument are aligned with the critical terms of the item it is hedging, perfect effectiveness can be assumed. Absent meeting all of the requirements to qualify for one of the exceptions, the initial prospective assessment of effectiveness would need to consist of a quantitative analysis. For those hedging relationships that do qualify for an exception for effectiveness to be assessed qualitatively at inception, the ongoing burden to comply with the requirements of hedge accounting is also generally reduced, as an assertion can be made qualitatively that the hedge remains highly effective if all conditions required to qualify for the initial qualitative assessment of effectiveness continue to exist.

Even in those circumstances where no quantitative assessment of effectiveness is required at hedge inception because the entity elects and qualifies for either the shortcut method or critical terms match, we believe it is prudent to document specifically how the effectiveness of the hedge will be assessed going forward in the event circumstances change such that the requirements to assume perfect effectiveness are no longer met. An example would be to indicate that effectiveness will be assessed using the hypothetical-derivative method, which—while outlined in the context of an interest rate swap in Section "Hypothetical-derivative method"—is commonly applied to other hedges and required in certain circumstances when the critical terms do not match.[19] Refer to the RSM commentary that follows Example 5-1 for additional information.

The circumstances for which no quantitative assessment of effectiveness is required for the initial assessment are summarized in the following table.

[19] ASC 815-30-35-33 requires the use of the hypothetical-derivative method for a cash flow hedge with an option as the hedging instrument when effectiveness is based on the option's terminal value. Additionally, as elaborated on throughout ASC 815-35-35, use of the hypothetical-derivative method is also required for certain hedges of a net investment in a foreign operation.

| Method | What it applies to | Requirements |
|---|---|---|
| Shortcut method | Cash flow or fair value hedge of interest rate risk using interest rate swap | ASC 815-20-25-102 through 25-117 (Section "Shortcut method for interest rate swaps") |
| Critical terms match (hedging instrument is not an option) | Cash flow or fair value hedges (forward and futures contracts) other than interest rate risk using interest rate swaps | ASC 815-20-25-84 through 25-85 (Section "Critical terms match approach") |
| Critical terms match (hedging instrument is an option) | Cash flow hedges where the hedging instrument is an option or combination of options | ASC 815-20-25-126 and ASC 815-20-25-129 through 25-129A (Section "Critical terms match approach for option contracts") |
| Simplified hedge accounting approach | Cash flow hedge of interest rate risk using interest rate swap to hedge variable-rate debt (this approach can only be elected by private companies that are not financial institutions) | ASC 815-20-25-133 through 25-138 (Section "Simplified hedge accounting approach for a cash flow hedge of a variable-rate borrowing with a receive-variable, pay-fixed interest rate swap") |
| Variable cash flows method | Cash flow hedge of interest rate risk using interest rate swap | ASC 815-30-35-22 (Section "Change-in-variable-cash-flows method") |
| Hypothetical-derivative method | The example provided is in the context of a cash flow hedge of interest rate risk using an interest rate swap; however, this method is also commonly applied to other types of cash flow hedges when performing quantitative assessments of effectiveness | ASC 815-30-35-25 and 35-26 (Section "Hypothetical-derivative method") |
| Hedge effectiveness assessed based on changes in spot exchange rates | Net investment hedge | ASC 815-35-35-5 (Section "Assessing effectiveness based on changes in spot exchange rates") for derivative instruments or ASC 815-35-35-12 (Section "Assessing effectiveness when hedging instrument is not a derivative instrument") for nonderivative instruments |
| Hedge effectiveness assessed based on changes in forward exchange rates | Net investment hedge | ASC 815-35-35-17A (Section "Assessing effectiveness based on changes in forward exchange rates") |

## Critical terms match approach

ASC 815-20-25-84 permits an entity to assume a hedge is perfectly effective if the critical terms of the hedging instrument and the item it hedges match. While this approach is permitted for both cash flow and fair value hedges, it is rare in practice that the critical terms match for a fair value hedge. Additionally, this methodology is generally not appropriate when the hedging instrument is an option, given there is separate guidance for options, as discussed in Section "Critical terms match approach for option contracts." The critical terms match approach is also not appropriate for hedges of interest rate risk in which the derivative instrument is an interest rate swap; there is separate guidance discussed in Section 7.2 for those types of hedges.

If the critical terms of the hedging instrument and the hedged item 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. The criteria that must be met to assume perfect effectiveness for a hedge of a forecasted purchase of a commodity with a forward contract are illustrated in ASC 815-20-25-84.

**ASC 815-20-25-84 [Partial Excerpt]**

…For example, an entity may assume that a hedge of a forecasted purchase of a commodity with a forward contract will be perfectly effective if all of the following criteria are met:

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. Location differences do not need to be considered if an entity designates the variability in cash flows attributable to changes in a contractually specified component as the hedged risk and the requirements in paragraphs 815-20-25-22A through 25-22B are met.[20]

b. The fair value of the forward contract at inception is zero.

c. Either of the following criteria is met:

   1. The change in the discount or premium on the forward contract is excluded from the assessment of effectiveness pursuant to paragraphs 815-20-25-81 through 25-83.

   2. The change in expected cash flows on the forecasted transaction is based on the forward price for the commodity.

When hedging a group of forecasted transactions, the timing can be assumed to match if the hedged transactions are expected to occur within the same 31-day period or fiscal month as the maturity date of the hedging instrument. We believe the time period should be specified in the initial documentation elaborated on in Section 5.2.1. For example, assume the forward contract or other hedging instrument matures on the 15th day of the month. Amongst other ways, the forecasted transactions could be defined as those expected to occur within the fiscal month, the 31-day period beginning on the 15th day of the month or the 31-day period ending on the 15th day of the month.

Various examples in ASC 815 further illustrate the concept of critical terms matching, including those ASC 815 examples included in Example 6-5 and Example 6-9.

## Critical terms match approach for option contracts

The requirements that must all be met to assume perfect effectiveness for a cash flow hedge involving an option as the hedging instrument are outlined in ASC 815-20-25-129:

[20] Following the adoption of ASU 2025-09, criterion "a" will be replaced with "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. Location differences do not need to be considered if the forward contract's underlying and the designated hedged risk are the same." Refer to the ASU for effective date and transition requirements.

**ASC 815-20-25-129 [partial excerpt]**

a. The critical terms of the hedging instrument (such as its notional amount, underlying, maturity date, and so forth) completely match the related terms of the hedged forecasted transaction (such as the notional amount, the variable that determines the variability in cash flows, the expected date of the hedged transaction, and so forth).

b. The strike price (or prices) of the hedging option (or combination of options) matches the specified level (or levels) beyond (or within) which the entity's exposure is being hedged.

c. The hedging instrument's inflows (outflows) at its maturity date completely offset the change in the hedged transaction's cash flows for the risk being hedged.

d. The hedging instrument can be exercised only on a single date—its contractual maturity date.

As it relates to criterion (a) and determining if the maturity date of the hedging instrument matches the timing of the hedged transaction, ASC 815-20-25-84A permits an assumption that the timing matches when hedging a group of forecasted transactions if the forecasted transactions are expected to occur within the same 31-day period or fiscal month that the derivative instrument will mature.

This guidance applies to cash flow hedges that meet all of the following requirements outlined in ASC 815-20-25-126:

**ASC 815-20-25-126 [partial excerpt]**

a. The hedging instrument is a purchased option or a combination of only options that comprise either a net purchased option or a zero-cost collar.

b. The exposure being hedged is the variability in expected future cash flows attributed to a particular rate or price beyond (or within) a specified level (or levels).

c. The assessment of effectiveness is documented as being based on total changes in the option's cash flows (that is, the assessment will include the hedging instrument's entire change in fair value, not just changes in intrinsic value).

As noted in ASC 815-20-25-127, it is not appropriate to analogize to this guidance for fair value hedges or cash flow hedges that do not meet all of these conditions.

If these conditions are met, it is appropriate to focus on the hedging instrument's terminal value (i.e., the expected pay-off amount at maturity) when determining whether the hedging relationship is expected to be highly effective. For a hedging instrument like an interest rate cap, which consists of a series of purchased caplets that are each hedging a series of hedged transactions (e.g., monthly or quarterly interest payments), the focus can be on the terminal value of each caplet in determining whether each hedging relationship is expected to be highly effective.

If all of the preceding conditions are not met, ASC 815-30-35-33 provides for hedge effectiveness to be assessed by comparing the change in the fair value of the hedging instrument to the change in the fair value of a perfectly effective hypothetical hedging instrument that does meet all of the preceding conditions.

**Example 5-2: Purchased option used in a cash flow hedge (ASC 815-20-55-208 through 55-211)**

An entity forecasts that 1 year later it will purchase 1,000 ounces of gold at then current market prices for use in its operations. The entity wishes to protect itself against increases in the cost of gold above the current market price of $275 per ounce. The entity purchases a 1-year cash-settled at-the-money gold

option on 1,000 ounces of gold, paying a premium of $10,000. If the price of gold is above $275 at the maturity (settlement) date, the counterparty will pay the entity 1,000 times the difference. If the price of gold is $275 or below at the maturity date, the contract expires worthless. The option cannot be exercised before its contractual maturity date. The entity designates the purchased option contract as a hedge of the variability in the purchase price (cash outflow) of the 1,000 ounces of gold for prices above $275 per ounce.

In assessing the effectiveness of the cash flow hedge, the entity would determine that because the change in the expected future pay-off amount of the purchased option completely offsets the change in the expected future cash flows on the purchase of 1,000 ounces of gold above $275 per ounce, the hedging relationship is expected to be highly effective under paragraph 815-20-25-75(b).

The entity would conclude there is perfect effectiveness because all of the following conditions exist:

a. All the critical terms of the hedging derivative completely match the hedged forecasted transaction.

b. The strike price of the hedging instrument matches the specified level ($275) beyond which the entity's exposure is being hedged.

c. The hedging derivative's inflows at expiration completely offset the hedged transaction's outflows for any increase in the price of gold above $275 per ounce.

d. The hedging option cannot be exercised before its contractual maturity date.

## Simplified hedge accounting approach for a cash flow hedge of a variable-rate borrowing with a receive-variable, pay-fixed interest rate swap

### Overview

The simplified approach is meant to facilitate hedge accounting for private companies (other than financial institutions) that enter into plain-vanilla interest rate swaps to achieve a fixed rate of interest on variable-rate borrowings. Careful consideration should be paid to the definition of a private company and the definition of a PBE (to which it refers) when determining if an entity qualifies for this approach.

The primary benefits of the simplified approach compared to one of the other methods that permit the assumption of perfect effectiveness are:

- The ability to elect to measure the swap at settlement value instead of fair value
- Additional time to put the required documentation in place (see the summary in Section 5.2); namely, the date on which the annual financial statements are available to be issued

It may not be advantageous to elect the simplified approach under certain circumstances, such as:

- The private company may go public or be acquired by a PBE. Hedge accounting under the simplified approach cannot be used in financial statements prepared in accordance with accounting principles applicable to a PBE in a filing with the SEC.
- There is a likelihood that the hedged debt will be modified or prepaid, or another circumstance will occur that would result in the criteria to use the simplified approach no longer being met. (If the criteria are no longer met, the hedge would terminate, and hedge accounting would cease as elaborated on in Section 10.4.) This may be the case, for example, if unscheduled pay downs on the debt are made such that the notional amount of the swap exceeds the amount of qualifying debt outstanding at any given point in time. Another example would be if the entity has the option to choose different variable-rate indices or reset frequencies on the debt and elects an option that no longer matches the variable-rate index or reset dates of the swap.

Assuming all requirements are met, a different method would permit the application of hedge accounting to continue uninterrupted if the private company goes public. Additionally, a different method would permit

the application of hedge accounting to continue uninterrupted if there are changes with the debt, provided the relevant requirements were met at the appropriate time frames, including documenting the quantitative approach that would be used to assess effectiveness and demonstrating that the hedge is highly effective using that approach.

### Criteria to elect the simplified approach

The simplified approach can only be elected when all the following criteria are met, as outlined in ASC 815-20-25-133 through 25-138:

- The variable rate on the swap and the borrowing are both based on the same index and reset period (e.g., both are based on one- or three-month SOFR).
- The terms of the swap are typical (i.e., a plain-vanilla swap), and there is no floor or cap on the variable interest rate of the swap unless the borrowing has a comparable floor or cap.
- The repricing and settlement dates for the swap and the borrowing match or differ by no more than a few days.
- The swap's fair value at inception (i.e., at the time the derivative instrument was executed) is at or near zero.
- The notional amount of the swap matches the principal amount of the borrowing being hedged (i.e., it is not necessary to hedge the entire borrowing).
- The interest payments occurring on the borrowing during the term of the swap (or the effective term of the swap if it is forward starting) are all designated as hedged (either in total or in proportion to the principal amount of the borrowing being hedged).

With regards to interest rate swaps and borrowings that contain caps or floors on the variable rate, the use of the word "comparable" in the second criterion does not necessarily mean equal. For example, if an interest rate swap has a variable rate based on SOFR and the borrowing has a variable rate of SOFR plus 2%, a 10% cap on the swap would be comparable to a 12% cap on the borrowing. Forward-starting swaps can also qualify for the simplified approach if the interest payments designated as the hedged transactions are probable and all other criteria are met. For example, a two-year interest rate swap forward starting in three years could meet the required criteria if executed in the beginning of the first year of a five-year borrowing. In addition, a five-year interest rate swap forward starting in one year could meet the required criteria for a five-year borrowing forecasted to occur in one year.

Borrowings with different options for the variable-rate index are eligible for the simplified approach if the required criteria are met at the inception of the interest rate swap agreement. If the borrower subsequently elects a different rate index or reset period that differs from the swap, the hedge would be disqualified or dedesignated.

It is important to keep in mind that the general requirements in ASC 815 pertaining to cash flow hedge accounting also apply when the simplified approach is elected. This would include, for example, the requirement in ASC 815-20-25-122 to consider the likelihood of the counterparty's compliance with the contractual terms of the swap on an ongoing basis.

### Documentation of election

Under ASC 815-20-25-136, an entity has until the date on which the annual financial statements are available to be issued to complete the required documentation to elect the simplified approach. It is important to note that while the documentation to elect the simplified approach does not need to be contemporaneous, it does need to meet the stringent and detailed requirements of ASC 815-20-25-3 with regards to content. Additionally, while additional time is provided for the election to apply the simplified approach to be made and documentation to be put in place, it would be prudent to not delay this process. In the event the requirements are not met to use the simplified approach, the entity would need to comply with the contemporaneous documentation and other requirements of the general provisions of ASC 815-20 to qualify for hedge accounting.

The following is an example of one approach an entity may use to document its election of the simplified approach. While the documentation does not have to follow this format, it does need to meet the requirements of ASC 815-20-25-3.

**Example 5-3: Sample hedge election documentation**

**Date:** [INSERT DATE][21]

**To:** Accounting File

**From:** Private Company CFO

**RE:** Hedge designation of interest rate swap under the private company simplified hedge accounting approach

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**Hedging relationship, risk management objective and strategy**

Private Company LLC (the Company) entered into a $10.5 million notional amount interest rate swap agreement on September 29, 2019, with XXX Institution. The agreement and hedging relationship were undertaken as a cash flow hedge of interest rate risk, specifically of the risk of changes in cash flows on interest payments associated with a corresponding amount of variable-rate borrowings that are attributable to changes in the contractually specified interest rate.

- *Description of the hedging instrument:* The hedging instrument is a pay-fixed, receive-variable interest rate swap agreement with a beginning notional amount of $10.5 million. The term of the swap agreement begins on October 1, 2019, and expires on September 30, 2024.
- *Description of the hedged transaction:* The hedged transactions are the first previously undesignated interest payments made each quarter on the amount of an outstanding three-month SOFR borrowing equivalent to the then-notional amount of the swap during the term of the swap. (Specifically, this SOFR borrowing is the note currently outstanding with XXX Institution or its replacement with similar qualifying terms.)
- *Nature of the risk being hedged:* There is a risk of variations in interest rate payments due to changes in the contractually specified interest rate outlined in the note agreement (three-month SOFR). The Company's objective is to hedge against these variations by fixing the interest rate on a portion of the principal outstanding.
- *Assessment of the hedging instrument's effectiveness:* Under the simplified hedge accounting approach, the Company can assume perfect effectiveness for qualifying interest rate swaps. Use of the simplified hedge accounting approach is appropriate for certain private companies provided certain conditions are met. The Company considered the following conditions (as provided in ASC 815-20-25-137) when concluding it was appropriate to apply the simplified hedge accounting approach to its cash flow hedge of the variable-rate borrowing:

| Condition | Swap | Borrowing | Condition met |
|---|---|---|---|
| Variable rates are based on same index and reset period | Three-month SOFR | While the borrowing has various interest rate options, three-month SOFR is what the Company selected. | Yes |

[21] When applying the simplified approach, this documentation must be completed by the date on which the first annual financial statements are available to be issued after hedge inception.

| Condition | Swap | Borrowing | Condition met |
|---|---|---|---|
| The terms of the swap are typical[22] | Terms are typical | | Yes |
| Repricing and settlement dates differ by no more than a few days: | | | |
| Repricing dates | First day of the quarter | First day of the quarter | Yes |
| Settlement dates | Last day of the quarter | Last day of the quarter | Yes |
| Fair value of swap is at or near zero at its inception | Swap fair value was zero on September 29, 2019. | | Yes |
| Notional amount of swap matches principal amount of borrowing being hedged (which does not need to be full amount of borrowing) | $10.5 million, amortizing | The total borrowing is $20 million and amortizes in such a manner that at all times the outstanding principal amount of it or its replacement will equal or exceed the notional amount of the swap. The amount of the borrowing that is being hedged equals the notional amount of the swap during the term of the swap. | Yes |
| All interest payments occurring on the borrowing during the term of the swap (or the effective term of the swap underlying the forward starting swap) are designated as hedged whether in total or in proportion to the principal amount of the borrowing being hedged | Term is October 1, 2019 to September 30, 2024. | The hedged item is designated as all interest payments on the amount of outstanding borrowing equivalent to the notional amount of the swap during the term of the swap. | Yes |
| If the swap is forward starting, the occurrence of forecasted interest payments is probable | N/A | N/A | N/A |

[22] ASC 815 does not elaborate on what constitutes typical terms other than to state that such a swap is generally considered *plain-vanilla* and have no floor or cap on its variable interest rate unless the borrowing has a comparable floor or cap.

**Note:** ASC 815 does not elaborate on what constitutes typical terms other than to state that such a swap is generally considered plain-vanilla and have no floor or cap on its variable interest rate unless the borrowing has a comparable floor or cap.

As provided in ASC 815-10-35-1A, the Company has elected to measure the interest rate swap at settlement value rather than fair value. The carrying amount of the swap asset or liability will be adjusted to its current settlement value at each reporting period end through other comprehensive income or loss. Amounts in other comprehensive income or loss will be reclassified into interest expense as interest accrues on the debt to result in an overall fixed rate of interest.

The Company will assess on an ongoing basis whether the preceding conditions for applying the simplified hedge accounting approach continue to be met and will assess the likelihood of the counterparty's compliance with its obligations under the interest rate swap agreement.

If the preceding conditions are no longer met, or the likelihood that the counterparty will not default ceases to be probable as elaborated on beginning in ASC 815-20-35-14, the relationship will no longer qualify for the simplified hedge accounting approach. Upon failing to qualify, the hedge will be dedesignated with the gain or loss on the swap in accumulated other comprehensive income reclassified to earnings in accordance with ASC 815-30-40-1 through 40-6. The swap will be measured at fair value on the date of dedesignation with subsequent changes in fair value reported in earnings.

### Measurement at settlement value

If the simplified approach is elected for any swaps, as illustrated in the example in the preceding section, an election can be made to record those swaps at settlement value rather than fair value. The primary difference between settlement value and fair value is that nonperformance risk (which relates primarily to the creditworthiness of both parties to the swap) is not considered in determining settlement value. Settlement value is typically based on a present value calculation of the swap's remaining estimated cash flows.

## Shortcut method for interest rate swaps

### Overview

There is a shortcut method available for both fair value and cash flow hedges of interest rate risk involving interest rate swaps; if the hedging relationship meets all the relevant requirements and this method is elected, the hedge can be assumed to be perfectly effective. The shortcut method is illustrated in Example 7-5 for a cash flow hedge of variable-rate debt and in Example 7-12 for a fair value hedge of fixed-rate debt.

### Requirements to apply the shortcut method

The requirements that must be met to apply the shortcut method and their applicability are outlined in ASC 815-20-25-104 through 25-106. The term "match" is expected to be strictly applied to mean the relevant terms of the swap and debt instrument are exactly the same.

**ASC 815-20-25-104**

All of the following criteria apply to both fair value hedges and cash flow hedges:

a. The notional amount of the interest rate swap matches the principal amount of the interest-bearing asset or liability being hedged.

b. If the hedging instrument is solely an interest rate swap, the fair value of that interest rate swap at the inception of the hedging relationship must be zero, with one exception. The fair value of the swap may be other than zero at the inception of the hedging relationship only if the swap was entered into at the relationship's inception, the transaction price of the swap was zero in the entity's principal market (or most advantageous market), and the difference between transaction price and fair value is attributable solely to differing prices within the bid-ask spread between the entry transaction and a hypothetical exit transaction. The guidance in the preceding sentence is applicable only to transactions considered at market (that is, transaction price is zero exclusive of commissions and other transaction costs, as discussed in paragraph 820-10-35-9B). If the hedging instrument is solely an interest rate swap that at the inception of the hedging relationship has a positive or negative fair value, but does not meet the one exception specified in this paragraph, the shortcut method shall not be used even if all the other conditions are met.

c. If the hedging instrument is a compound derivative composed of an interest rate swap and mirror-image call or put option as discussed in (e), the premium for the mirror-image call or put option shall be paid or received in the same manner as the premium on the call or put option embedded in the hedged item based on the following:

    1. If the implicit premium for the call or put option embedded in the hedged item is being paid principally over the life of the hedged item (through an adjustment of the interest rate), the fair value of the hedging instrument at the inception of the hedging relationship shall be zero (except as discussed previously in (b) regarding differing prices due to the existence of a bid-ask spread).

    2. If the implicit premium for the call or put option embedded in the hedged item was principally paid at inception-acquisition (through an original issue discount or premium), the fair value of the hedging instrument at the inception of the hedging relationship shall be equal to the fair value of the mirror-image call or put option.

d. The formula for computing net settlements under the interest rate swap is the same for each net settlement. That is, both of the following conditions are met:

    1. The fixed rate is the same throughout the term.

    2. The variable rate is based on the same index and includes the same constant adjustment or no adjustment. The existence of a stub period and stub rate is not a violation of the criterion in (d) that would preclude application of the shortcut method if the stub rate is the variable rate that corresponds to the length of the stub period.

e. The interest-bearing asset or liability is not prepayable, that is, able to be settled by either party before its scheduled maturity or the assumed maturity date if the hedged item is measured in accordance with paragraph 815-25-35-13B, with the following qualifications:

    1. This criterion does not apply to an interest-bearing asset or liability that is prepayable solely due to an embedded call option (put option) if the hedging instrument is a compound derivative composed of an interest rate swap and a mirror-image call option (put option).

2. The call option embedded in the interest rate swap is considered a mirror image of the call option embedded in the hedged item if all of the following conditions are met:
    i. The terms of the two call options match exactly, including all of the following:
        01. Maturities
        02. Strike price (that is, the actual amount for which the debt instrument could be called) and there is no termination payment equal to the deferred debt issuance costs that remain unamortized on the date the debt is called
        03. Related notional amounts
        04. Timing and frequency of payments
        05. Dates on which the instruments may be called.
    ii. The entity is the writer of one call option and the holder (purchaser) of the other call option.
    iii. Subparagraph not used.

f. Subparagraph superseded by Accounting Standards Update No. 2017-12

g. Any other terms in the interest-bearing financial instruments or interest rate swaps meet both of the following conditions:
    1. The terms are typical of those instruments.
    2. The terms do not invalidate the assumption of perfect effectiveness.

**ASC 815-20-25-105**

All of the following incremental conditions apply to fair value hedges only:

a. The expiration date of the interest rate swap matches the maturity date of the interest-bearing asset or liability or the assumed maturity date if the hedged item is measured in accordance with paragraph 815-25-35-13B.

b. There is no floor or cap on the variable interest rate of the interest rate swap.

c. The interval between repricings of the variable interest rate in the interest rate 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).

d. For fair value hedges of a proportion of the principal amount of the interest-bearing asset or liability, the notional amount of the interest rate swap designated as the hedging instrument (see (a) in the preceding paragraph 815-20-25-104) matches the portion of the asset or liability being hedged.

e. For fair value hedges of portfolios (or proportions thereof) of similar interest-bearing assets or liabilities, both of the following criteria are met:
    1. The notional amount of the interest rate swap designated as the hedging instrument matches the aggregate notional amount of the hedged item (whether it is all or a proportion of the total portfolio).
    2. The remaining criteria for the shortcut method are met with respect to the interest rate swap and the individual assets or liabilities in the portfolio.

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

**ASC 815-20-25-106**

All of the following incremental conditions apply to cash flow hedges only:

a. All interest receipts or payments on the variable-rate asset or liability during the term of the interest rate swap are designated as hedged.

b. No interest payments beyond the term of the interest rate swap are designated as hedged.

c. Either of the following conditions is met:

   1. There is no floor or cap on the variable interest rate of the interest rate swap.

   2. The variable-rate asset or liability has a floor or cap and the interest rate swap has 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 purposes of this paragraph, comparable does not necessarily mean equal. For example, if an interest rate swap's variable rate is based on LIBOR and an asset's variable rate is LIBOR plus 2 percent, a 10 percent cap on the interest rate swap would be comparable to a 12 percent cap on the asset.

d. The repricing dates of the variable-rate asset or liability and the hedging instrument must occur on the same dates and be calculated the same way (that is, both shall be either prospective or retrospective). If the repricing dates of the hedged item occur on the same dates as the repricing dates of the hedging instrument but the repricing calculation for the hedged item is prospective whereas the repricing calculation for the hedging instrument is retrospective, those repricing dates do not match.

e. For cash flow hedges of the interest payments on only a portion of the principal amount of the interest-bearing asset or liability, the notional amount of the interest rate swap designated as the hedging instrument (see paragraph 815-20-25-104(a)) matches the principal amount of the portion of the asset or liability on which the hedged interest payments are based.

f. For a cash flow hedge in which the hedged forecasted transaction is a group of individual transactions (as permitted by paragraph 815-20-25-15(a)), if both of the following criteria are met:

   1. The notional amount of the interest rate swap designated as the hedging instrument (see paragraph 815-20-25-104(a)) matches the notional amount of the aggregate group of hedged transactions.

   2. The remaining criteria for the shortcut method are met with respect to the interest rate swap and the individual transactions that make up the group. For example, the interest rate repricing dates for the variable-rate assets or liabilities whose interest payments are included in the group of forecasted transactions shall match (that is, be exactly the same as) the reset dates for the interest rate swap.

g. The index on which the variable leg of the interest rate swap is based matches the contractually specified interest rate designated as the interest rate being hedged for that hedging relationship.

### Other considerations relevant to the shortcut method

As pointed out in ASC 815-20-55-72, the shortcut method cannot be applied in a cash flow hedge of a forecasted transaction (e.g., debt that does not yet exist). Additionally, as ASC 815-20-25-103 points out, an additional implicit requirement is that a basis exists to conclude on an ongoing basis that the hedging relationship is expected to be highly effective. This necessitates ongoing monitoring, including considering the likelihood that the swap counterparty will comply with the contractual payment terms of the swap.

### Additional views on prepayable instruments that do and do not qualify for the shortcut method

It is not uncommon for instruments to fail to qualify for the shortcut method due to the preceding criterion in ASC 815-20-25-104(e), which is applicable to both fair value and cash flow hedges. When determining if a mirror-image call or put option exists, call or put prices on debt are typically based on a percentage of par value. Conversely, options embedded in an interest rate swap are generally based on a rate or current yield. ASC 815-20-55-79 outlines an approach that can be employed to determine if these strike prices are the same. Additionally, the guidance beginning at ASC 815-20-25-112 indicates that an interest-bearing asset or liability should be considered prepayable if one party to the contract has the right to cause the payment of principal before the scheduled payment dates, unless either of the following conditions is met:

- The debtor has the right to cause settlement of the entire contract before its stated maturity at an amount that is always greater than the then-fair value of the contract absent that right.
- The creditor has the right to cause settlement of the entire contract before its stated maturity at an amount that is always less than the then-fair value of the contract absent that right.

Additionally, ASC 815-20-25-113 lists various terms and clauses in a debt instrument that are not considered prepayment provisions.

**ASC 815-20-25-113**

However, none of the following shall be considered a prepayment provision:

a. Any term, clause, or other provision in a debt instrument that gives the debtor or creditor the right to cause prepayment of the debt contingent upon the occurrence of a specific event related to the debtor's credit deterioration or other change in the debtor's credit risk, such as any of the following:
    1. The debtor's failure to make timely payment, thus making it delinquent
    2. The debtor's failure to meet specific covenant ratios
    3. The debtor's disposition of specific significant assets (such as a factory)
    4. A declaration of cross-default
    5. A restructuring by the debtor.

b. Any term, clause, or other provision in a debt instrument that gives the debtor or creditor the right to cause prepayment of the debt contingent upon the occurrence of a specific event that meets all of the following conditions:
    1. It is not probable at the time of debt issuance.
    2. It is unrelated to changes in benchmark interest rates, contractually specified interest rates, or any other market variable.
    3. It is related either to the debtor's or creditor's death or to regulatory actions, legislative actions, or other similar events that are beyond the control of the debtor or creditor.

c. Contingent acceleration clauses that permit the debtor to accelerate the maturity of an outstanding note only upon the occurrence of a specified event that meets all of the following conditions:

   1. It is not probable at the time of debt issuance.
   2. It is unrelated to changes in benchmark interest rates, contractually specified interest rates, or any other market variable.
   3. It is related to regulatory actions, legislative actions, or other similar events that are beyond the control of the debtor or creditor.

Lastly, a right to prepay a debt instrument at its then-fair value would not cause the instrument to be considered prepayable because that right would have a fair value of zero at all times and essentially just provides liquidity to the holder. The application of the prepayment guidance is further illustrated through examples in ASC 815-20-55-75.

### Implications if the shortcut method was not or no longer is appropriate

ASC 815-20-25-117A permits hedge accounting to continue uninterrupted when the determination is made that the use of the shortcut method was not or no longer is appropriate if the entity documented at hedge inception which quantitative method it would use to assess hedge effectiveness in the event the shortcut method was not or no longer is appropriate and can demonstrate the hedging relationship was highly effective on a prospective and retrospective basis using that method for the periods in which the shortcut method criteria were not met. The terms of the hedged item and hedging instrument as they existed on the date that the shortcut criteria ceased to be met would be used in this assessment of effectiveness. If the hypothetical-derivative method is used for a cash flow hedge (as discussed in Section "Hypothetical-derivative method"), the value of the hypothetical derivative instrument should be set to zero as of hedge inception. If the period in which the shortcut criteria ceased to be met is not known, the quantitative effectiveness assessments should be performed for all periods since hedge inception.

## Ongoing qualitative assessments of effectiveness

### Hedges for which no initial quantitative assessment was required

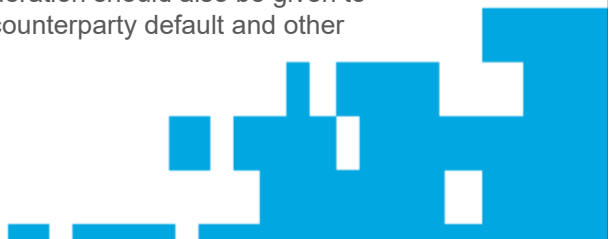
Hedging relationships that meet one of the circumstances in the table in Section 5.2.4.1 such that an initial quantitative assessment of effectiveness is not required can generally be assessed qualitatively on an ongoing basis, which entails giving documented consideration to whether the criteria that permitted the inception-date qualitative assessment of effectiveness continue to be met, as well as considering the ability of the counterparties to the derivative instrument and hedged transaction (if applicable) to perform. As pointed out in ASC 815-20-35-12, if the critical terms of the hedging instrument or the hedged forecasted transaction have changed, or there have been adverse developments with the risk of counterparty default, the quantitative method documented in the initial hedge documentation should be used to determine if the hedge is expected to continue to be highly effective.

### Hedges that were initially assessed quantitatively

Ongoing hedge effectiveness can also be assessed qualitatively for hedges that did not meet one of the circumstances in the table in Section 5.2.4.1 if the quantitative assessment performed as of the inception of the hedge demonstrated that the hedge is highly effective and an expectation of high effectiveness can be reasonably supported on a qualitative basis in subsequent periods. Relevant guidance is contained in ASC 815-20-35-2A through 35-2F.

The qualitative assessment for these hedges should also be performed and documented whenever financial statements or earnings are reported and at least every three months. The assessment entails documenting whether the facts and circumstances related to the hedging relationship have not changed such that the entity can continue to assert qualitatively that the hedging relationship was and continues to be highly effective. This is elaborated on in ASC 815-20-35-2C. Consideration should also be given to whether there have been adverse developments related to the risk of counterparty default and other





relevant factors, such as the probability of hedged forecasted transactions occurring as was initially expected.

If facts and circumstances change such that the entity can no longer assert qualitatively that the hedging relationship was and continues to be highly effective, hedge effectiveness should be assessed on a quantitative basis (using the method that was identified in the initial hedge documentation), beginning as of the period that the facts and circumstances changed (or the current period if there is no identifiable event leading to the change) and for subsequent periods. After performing at least one quantitative assessment, the guidance permits reverting back to qualitative assessments of effectiveness if, with consideration given to the following list of factors from ASC 815-20-55-79G, an expectation of high effectiveness for subsequent periods can be reasonably supported.

**ASC 815-20-55-79G**

An entity should use judgment in determining whether it can reasonably support performing assessments of effectiveness after hedge inception on a qualitative basis. That judgment should include careful consideration of the following factors:

a. Results of the quantitative assessment of effectiveness performed for the hedging relationship.

b. Alignment of the critical terms of the hedging relationship. If one or more of the critical terms of the hedging instrument and the hedged item are not aligned, an entity should consider whether changes in market conditions may cause the changes in fair values or cash flows of the hedging instrument and hedged item or hedged forecasted transaction attributable to the hedged risk to diverge as a result of those differences in terms.

    1. In cases in which the underlyings of the hedged item and hedging instrument are different, an entity should consider the extent and consistency of the correlation exhibited between the changes in the underlyings of the hedged item and hedging instrument.

        i. This may inform the entity about whether expected changes in market conditions could cause the changes in fair values or cash flows of the hedging instrument and the hedged item or hedged forecasted transaction attributable to the hedged risk to diverge. Particularly in the context of reverting to qualitative assessments of hedge effectiveness after being required to perform a quantitative assessment (as discussed in paragraph 815-20-35- 2D), this may inform an entity about whether there is a reasonable expectation that the hedging relationship is expected to remain stable or whether that divergence is expected to continue or recur in the future.

        ii. A specific event or circumstance may cause a temporary disruption to the market that results in an entity concluding that the facts and circumstances of the hedging relationship have changed such that it no longer can assert qualitatively that the hedging relationship was and continues to be highly effective. In those instances, if the results of the quantitative assessment of effectiveness do not significantly diverge from the results of the initial assessment of effectiveness, that market disruption should not prevent the entity from returning to qualitative testing in subsequent periods. If the results of the quantitative assessment of effectiveness do significantly diverge from the results of the initial assessment of effectiveness, the entity should continually monitor whether the temporary market disruption has been resolved when determining whether to return to qualitative testing in subsequent periods.

Examples are included in ASC 815-20-55-79I through 55-79N to illustrate the application of this guidance. It is evident from these examples that the following characteristics are conducive to qualitative effectiveness assessments:

- The initial or most recent quantitative assessment of effectiveness indicates that the relationship is close to achieving perfect offset.
- The underlyings (if different) have been consistently highly correlated such that expected changes in market conditions are not expected to prevent the hedge from being highly effective.

The scenarios from ASC 815-20-55-79P through 55-79V that follow serve to illustrate the thought process when there is a change in facts and circumstances.

**Example 5-4: Change in facts and circumstances in qualitative effectiveness assessments (ASC 815-20-55-79P through 55-79V) – Before the adoption of ASU 2025-09**

**Scenario A**

Entity B expects to purchase 10,000 metric tons of cottonseed meal throughout April 20X3 based on the spot price of the cottonseed meal index on the respective date of each purchase. Entity B wants to hedge the variability in cash flows attributable to changes in the cottonseed meal index on the price that it will pay for the cottonseed meal. It enters into a forward contract on August 24, 20X1, with a notional of 10,000 metric tons, a maturity of April 1, 20X3, and an underlying of the soybean meal index because no market exists for derivatives indexed to the cottonseed meal index. Concurrent with the execution of the forward, Entity B designates the forward as the hedging instrument in a hedging relationship in which the hedged item is documented as the forecasted purchases of the first 10,000 metric tons of cottonseed meal expected to be purchased during April 20X3 and the hedged risk is documented as the variability in cash flows attributable to changes in the contractually specified cottonseed meal index in the not-yet-existing contract. On August 24, 20X1, Entity B determines that all requirements for cash flow hedge accounting are met and that the requirements of paragraph 815-20-25-22A will be met in the contract once executed in accordance with paragraph 815-20-25-22B. Entity B also will assess whether the criteria in 815-20-25-22A are met in the contract when it is executed.

Because the hedged risk and forward contract are based on different indexes, the hedging relationship does not qualify for one of the exemptions in paragraph 815-20-25-3(b)(2)(iv)(01). Entity B performs an initial quantitative hedge effectiveness assessment and determines that the hedging instrument is highly effective at achieving offsetting cash flows associated with the hedged item attributable to the hedged risk. In Entity B's hedge documentation, it elects to perform subsequent assessments of hedge effectiveness on a qualitative basis. It makes this election based on the following factors:

a. The results of the quantitative effectiveness assessment performed at hedge inception indicate that the hedging relationship is close to achieving perfect offset.

b. Changes in the value of the cottonseed meal index have been consistently highly correlated with changes in value of the soybean meal index such that expected changes in market conditions are not anticipated to prevent the hedging relationship from achieving highly effective offset.

c. Although the underlyings of the hedging instrument and hedged item do not match, the notional amount of the derivative and the expected quantity to be purchased do match. Based on the quantitative effectiveness assessment, Entity B also determined that the difference in timing between the maturity date of the derivative and the dates on which the group of forecasted purchases is expected to occur is insignificant.

During the fourth quarter of 20X1, a storm damages the soybean harvest, which leads to a shortage in soybean meal supply and a sharp increase in the price of soybean meal based on the soybean meal index. The cottonseed meal index has not experienced a similar increase because cotton harvests were unaffected by the storm that damaged the soybean harvest. Because the increase in the soybean meal

index is not reflected in the cottonseed meal index, Entity B concludes that a change in facts and circumstance has occurred that prevents a qualitative assertion in subsequent periods that the hedging relationship continues to be highly effective at achieving offsetting cash flows. Thus, on the next subsequent effectiveness assessment date (December 31, 20X1), the company begins performing quantitative assessments of hedge effectiveness based on the method used to perform the initial prospective assessment of effectiveness. In the effectiveness assessment performed on December 31, 20X1, Entity B determines that the hedging relationship remains highly effective but that it is not close to achieving perfect offset.

Entity B returns to assessing effectiveness qualitatively as of June 30, 20X2, because the evaluation of the following criteria leads to the conclusion that high effectiveness can be asserted prospectively on a qualitative basis:

a. Entity B determines that the event that caused the soybean meal index and cottonseed meal index to experience a lack of correlation was temporary, that it was an isolated weather event, and the effect of the weather event has passed.

b. The changes in value of the soybean meal index and cottonseed meal index reverted to levels of correlation that were consistent with those before the storm.

c. The results of the June 30, 20X2 quantitative assessment of effectiveness are in line with the results of the quantitative assessment of effectiveness performed at hedge inception.

d. No further disruptions in supply are expected.

**Scenario B**

On August 17, 20X1, Entity C issues at par a $100 million 5-year fixed-rate noncallable debt instrument with an annual 8 percent interest coupon. On that date, Entity C enters into a 5-year interest rate swap with Financial Institution D and designates it as the hedging instrument in a fair value hedge of the LIBOR interest rate risk of the $100 million liability. Under the terms of the interest rate swap, Entity C will receive fixed interest at 6 percent and pay variable interest at LIBOR based on a notional amount of $100 million. The variable leg of the interest rate swap resets at the end of each quarter for the interest payment that is due at the end of the following quarter.

Entity C performs the initial quantitative and first subsequent hedge effectiveness assessments on September 30 (the entity's first quarterly testing date after hedge inception) and determines that the hedging relationship is highly effective at achieving offsetting changes in fair value attributable to interest rate risk. Entity C also elects at hedge inception to subsequently assess hedge effectiveness on a qualitative basis and documents how it would carry out that qualitative assessment. In its quarterly effectiveness assessment on December 31, the entity asserts that facts and circumstances related to the hedging relationship have not changed and the hedging relationship was and continues to be highly effective.

However, in the first quarter of 20X2, Financial Institution D's risk of default significantly increases, which affects the valuation of the interest rate swap with Entity C. Entity C notes that it no longer can qualitatively assert that the hedging relationship was and continues to be highly effective at achieving offsetting changes in fair value attributable to changes in benchmark interest rates. Thus, on the next subsequent effectiveness assessment date (March 31, 20X2), Entity C begins performing quantitative assessments of effectiveness using the method documented at hedge inception. In subsequent periods, Entity C does not return to qualitative effectiveness assessments because it cannot reasonably support an expectation of high effectiveness on a qualitative basis for the following reasons:

a. The significant risk of default of Financial Institution D has not reversed and is not expected to be temporary.

b. The results of quantitative effectiveness tests performed indicate that the hedging relationship is close to no longer being highly effective.

**Example 5-4A: Change in facts and circumstances in qualitative effectiveness assessments (ASC 815-20-55-79P through 55-79V) – After the adoption of ASU 2025-09**

**Scenario A**

Entity B expects to purchase 10,000 metric tons of cottonseed meal throughout April 20X3 based on the spot price of the cottonseed meal index on the respective date of each purchase. Entity B wants to hedge the variability in cash flows attributable to changes in the cottonseed meal index on the price that it will pay for the cottonseed meal. It enters into a forward contract on August 24, 20X1, with a notional of 10,000 metric tons, a maturity of April 1, 20X3, and an underlying of the soybean meal index because no market exists for derivatives indexed to the cottonseed meal index. Concurrent with the execution of the forward, Entity B designates the forward as the hedging instrument in a hedging relationship in which the hedged item is documented as the forecasted purchases of the first 10,000 metric tons of cottonseed meal expected to be purchased during April 20X3 and the hedged risk is documented as the variability in cash flows attributable to changes in the cottonseed meal index. On August 24, 20X1, Entity B determines that all requirements for cash flow hedge accounting are met, including the relevant conditions in paragraph 815-20-25-22C on designating the variability in cash flows attributable to changes in a component of the forecasted purchase price of a nonfinancial asset as the hedged risk.

Because the hedged risk and forward contract are based on different indexes, the hedging relationship does not qualify for one of the exemptions in paragraph 815-20-25-3(b)(2)(iv)(01). Entity B performs an initial quantitative hedge effectiveness assessment and determines that the hedging instrument is highly effective at achieving offsetting cash flows associated with the hedged item attributable to the hedged risk. In Entity B's hedge documentation, it elects to perform subsequent assessments of hedge effectiveness on a qualitative basis. It makes this election based on the following factors:

a. The results of the quantitative effectiveness assessment performed at hedge inception indicate that the hedging relationship is close to achieving perfect offset.

b. Changes in the value of the cottonseed meal index have been consistently highly correlated with changes in value of the soybean meal index such that expected changes in market conditions are not anticipated to prevent the hedging relationship from achieving highly effective offset.

c. Although the underlyings of the hedging instrument and hedged item do not match, the notional amount of the derivative and the expected quantity to be purchased do match. Based on the quantitative effectiveness assessment, Entity B also determined that the difference in timing between the maturity date of the derivative and the dates on which the group of forecasted purchases is expected to occur is insignificant.

During the fourth quarter of 20X1, a storm damages the soybean harvest, which leads to a shortage in soybean meal supply and a sharp increase in the price of soybean meal based on the soybean meal index. The cottonseed meal index has not experienced a similar increase because cotton harvests were unaffected by the storm that damaged the soybean harvest. Because the increase in the soybean meal index is not reflected in the cottonseed meal index, Entity B concludes that a change in facts and circumstances has occurred that prevents a qualitative assertion in subsequent periods that the hedging relationship continues to be highly effective at achieving offsetting cash flows. Thus, on the next subsequent effectiveness assessment date (December 31, 20X1), the company begins performing quantitative assessments of hedge effectiveness based on the method used to perform the initial prospective assessment of effectiveness. In the effectiveness assessment performed on December 31, 20X1, Entity B determines that the hedging relationship remains highly effective but that it is not close to achieving perfect offset.

Entity B returns to assessing effectiveness qualitatively as of June 30, 20X2, because the evaluation of the following criteria leads to the conclusion that high effectiveness can be asserted prospectively on a qualitative basis:

a. Entity B determines that the event that caused the soybean meal index and cottonseed meal index to experience a lack of correlation was temporary, that it was an isolated weather event, and the effect of the weather event has passed.

b. The changes in value of the soybean meal index and cottonseed meal index reverted to levels of correlation that were consistent with those before the storm.

c. The results of the June 30, 20X2 quantitative assessment of effectiveness are in line with the results of the quantitative assessment of effectiveness performed at hedge inception.

d. No further disruptions in supply are expected.

**Scenario B**

On August 17, 20X1, Entity C issues at par a $100 million 5-year fixed-rate noncallable debt instrument with an annual 8 percent interest coupon. On that date, Entity C enters into a 5-year interest rate swap with Financial Institution D and designates it as the hedging instrument in a fair value hedge of the LIBOR interest rate risk of the $100 million liability. Under the terms of the interest rate swap, Entity C will receive fixed interest at 6 percent and pay variable interest at LIBOR based on a notional amount of $100 million. The variable leg of the interest rate swap resets at the end of each quarter for the interest payment that is due at the end of the following quarter.

Entity C performs the initial quantitative and first subsequent hedge effectiveness assessments on September 30 (the entity's first quarterly testing date after hedge inception) and determines that the hedging relationship is highly effective at achieving offsetting changes in fair value attributable to interest rate risk. Entity C also elects at hedge inception to subsequently assess hedge effectiveness on a qualitative basis and documents how it would carry out that qualitative assessment. In its quarterly effectiveness assessment on December 31, the entity asserts that facts and circumstances related to the hedging relationship have not changed and the hedging relationship was and continues to be highly effective.

However, in the first quarter of 20X2, Financial Institution D's risk of default significantly increases, which affects the valuation of the interest rate swap with Entity C. Entity C notes that it no longer can qualitatively assert that the hedging relationship was and continues to be highly effective at achieving offsetting changes in fair value attributable to changes in benchmark interest rates. Thus, on the next subsequent effectiveness assessment date (March 31, 20X2), Entity C begins performing quantitative assessments of effectiveness using the method documented at hedge inception. In subsequent periods, Entity C does not return to qualitative effectiveness assessments because it cannot reasonably support an expectation of high effectiveness on a qualitative basis for the following reasons:

a. The significant risk of default of Financial Institution D has not reversed and is not expected to be temporary.

b. The results of quantitative effectiveness tests performed indicate that the hedging relationship is close to no longer being highly effective.

### 5.2.4.2 Deciding whether to make the election to assess effectiveness qualitatively

For those hedging relationships that do not meet one of the circumstances in the table in Section 5.2.4.1 such that perfect effectiveness can be assumed, consideration should be given to the costs and benefits of electing to assess effectiveness qualitatively on an ongoing basis. As noted in BC208 of ASU 2017-12, entities that have a significant volume of hedging relationships and existing systems to assess the effectiveness of their hedging relationships quantitatively may find it to be cost effective to continue performing the quantitative assessments rather than separately determining and monitoring which individual hedges qualify for qualitative testing. Conversely, we believe entities that do not have in-house

systems or capabilities to perform the quantitative tests will likely find it advantageous to perform the ongoing assessments qualitatively where warranted by the facts and circumstances.

#### 5.2.4.3 Quantitative methods used to assess hedge effectiveness

The two most common quantitative approaches that are used to assess the effectiveness of a hedging relationship are the dollar-offset approach (see Section "Assessing effectiveness using a dollar-offset approach") and regression analysis (see Section "Use of regression analysis to assess effectiveness"). Of these two approaches, dollar-offset is typically easier to perform and understand; however, relationships may fail due to small dollar differences (refer to Section "Assessing effectiveness using a dollar-offset approach" for an explanation of small dollar differences). As a result, regression analysis is more commonly applied. Hedge effectiveness is required to be assessed both prospectively and retrospectively. In many cases, entities select and use a single method each period to satisfy both requirements.

**Prospective (ASC 815-20-25-79(a))**

As the name implies, a prospective assessment of effectiveness is forward looking and considers whether the hedging relationship can be expected to be highly effective over future periods. This assessment is typically based on regression or dollar-offset analysis of past changes in fair values or cash flows. The quantitative prospective assessment of hedge effectiveness should consider all reasonably possible changes in fair value (if a fair value hedge) or in fair value or cash flows (if a cash flow hedge) of the derivative instrument and the hedged items (i.e., the analysis should not be limited only to the likely or expected changes in fair value or cash flows).

Following the adoption of ASU 2025-09, except as described in ASC 815-20-25-79B, the quantitative prospective assessment of hedge effectiveness should consider all reasonably possible changes in fair value (if a fair value hedge) or in fair value or cash flows (if a cash flow hedge) of the derivative instrument and the hedged items (i.e., the analysis should not be limited only to the likely or expected changes in fair value or cash flows).

**Retrospective (ASC 815-20-25-79(b))**

The retrospective assessment of effectiveness considers how effective the hedge has been through the assessment date. The retrospective assessment is also typically based on regression or dollar-offset analysis of past changes in fair values or cash flows.

Following the adoption of ASU 2025-09, see ASC 815-30-35-37F and 35-37L through 35-37M for guidance on the retrospective effectiveness assessment for a cash flow hedge within the scope of ASC 815-30-35-37B related to choose-your-rate debt.

There may be circumstances in which the most recent retrospective analysis demonstrates that the hedge was not highly effective, yet the prospective analysis demonstrates that the hedging relationship can be expected to be highly effective over future periods. This is more likely to occur when a dollar-offset approach is used to assess the effectiveness of a hedge, given that the retrospective assessment only considers the results since the inception of the hedge, and a hedging relationship is more likely to fail over a short period of time. Hedge accounting should not be applied for the period of time that failed the retrospective assessment; however, it can be continued prospectively as long as the entity can continue to support the expectation of high effectiveness, using the method it originally documented it would use. If at any time the prospective analysis does not demonstrate the hedge is highly effective, hedge accounting cannot be applied and should be discontinued. As noted in Section 9.3 and Section 10.4.1, if all the requirements are met (including the expectation of high effectiveness), it may be possible to designate a new hedging relationship with a different derivative instrument or hedged item.

For the most part, the guidance in ASC 815 does not prescribe a particular method that should be used to assess the effectiveness of a hedge. In certain cases, the guidance specifically indicates that the

hypothetical-derivative method should be used.[23] This method is described in the context of an interest rate swap hedging variable cash flows in Section "Hypothetical-derivative method" and is commonly selected and applied for other types of cash flow hedges. It entails comparing the change in the fair value or cash flows of the actual derivative instrument or other hedging instrument with the change in the fair value or cash flows of a hypothetical hedging instrument that has terms that identically match the hedged item, and it can be applied using either a dollar-offset approach or regression analysis. Regardless of the specific method that is used, there are certain guidelines to follow, including:

- The method used should be consistently performed and consistent with the method selected and documented in the initial hedge documentation.
- Similar methods should be used for similar hedges (including whether a portion of the gain or loss on a derivative instrument is excluded from the assessment of effectiveness), unless a different method is justified.
- The method should be reasonable and appropriate considering the nature of the risk being hedged and the type of hedging instrument used.
- Consideration should generally be given to the time value of money when assessing the effectiveness of cash flow hedges, particularly if the hedging instrument involves periodic cash settlements. (ASC 815-20-25-125 permits using undiscounted amounts for options.)
- Consideration should be given to the possibility of default by the counterparty to the derivative instrument, as elaborated on in ASC 815-20-35-14 through 35-18, and to the probability of hedged forecasted transactions occurring as and when expected, as discussed in Section "Probability of the hedged forecasted transaction."

The sections that follow expand on how effectiveness is assessed both prospectively and retrospectively using a dollar-offset approach and using regression analysis.

## Assessing effectiveness using a dollar-offset approach

As previously noted, a dollar-offset approach is typically easier to perform and understand; however, relationships may fail due to small dollar differences. The computation is performed using either a period-by-period or cumulative approach as decided on and documented in the initial hedge documentation.

| Dollar-offset approaches | |
|---|---|
| **Period-by-period approach** | **Cumulative approach** |
| The changes in the hedging instrument's fair values (or cash flows) that have occurred during the period being assessed (up to three months) are compared to the changes in the hedged item's fair value (or hedged transaction's cash flows) attributable to the risk hedged that have occurred during the same period. | The cumulative changes in the hedging instrument's fair values (or cash flows) from inception of the hedge to the assessment date are compared to the cumulative changes in the hedged item's fair value (or hedged transaction's cash flows) attributable to the risk hedged for the same period. |

The cumulative approach is applied frequently in practice because the previously noted issue related to small dollar changes is more likely to occur in a discrete period than over the life of a hedge. Referring to Example 6-4, the dollar-offset ratio on the first subsequent assessment of effectiveness is 90%, computed by dividing the $45,000 estimated change in cash flows on the actual derivative instrument (forward contract on Colombian coffee) by the $50,000 estimated change in cash flows on the hedged transaction (forecasted purchase of Brazilian coffee). As noted in Section 5.2.4, while highly effective is not specifically defined in ASC 815, it has been interpreted in practice to mean a cumulative dollar-offset ratio

[23] ASC 815-30-35-33 requires the use of the hypothetical-derivative method for a cash flow hedge with an option as the hedging instrument when effectiveness is based on the option's terminal value.

that ranges from 80% to 125%. Therefore, the hedging relationship would be viewed as highly effective on a retrospective basis as of this assessment date. To illustrate the potential issue related to small dollar changes when using the dollar-offset approach, if the estimated change in cash flows on the derivative instrument were $1,000 for the period in comparison to a $2,000 change in estimated cash flows on the hedged transaction, the dollar-offset ratio would be 50% and the relationship would be viewed as not highly effective, despite the insignificance of the difference in changes in cash flows.

While the prospective assessment of effectiveness was not demonstrated through this example, it is noted in ASC 815-30-55-3.

**ASC 815-30-55-3 (partial excerpt) – Before the adoption of ASU 2025-09**

Both at inception and on an ongoing basis, Entity 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 attributable to changes in the contractually specified component[24] 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.)

If this entity had elected to assess the effectiveness prospectively using a dollar-offset method, this could have been accomplished by considering what the ratio would have been using reasonably possible changes in market prices over a period of time comparable to the hedge. The following section includes a discussion of a method that considers the expected future correlation of the prices.

## Use of regression analysis to assess effectiveness

If regression analysis is used to assess the effectiveness of a hedging relationship, generally for a fair value hedge, changes in the fair value of the derivative instrument are regressed against changes in the fair value of the hedged item. For a cash flow hedge, the data regressed may be changes in cash flows rather than fair value. Additionally, as noted in ASC 815-20-25-79, the quantitative assessment can be based on other relevant data, such as changes in commodity prices, foreign exchange rates or interest rates, as appropriate for a particular hedge. To illustrate the use of regression analysis in the context of Example 6-4, in which the statement was made that the effectiveness computation could 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," an acceptable approach that could be used to assess effectiveness both prospectively and retrospectively would be to perform regression analysis to determine how closely correlated changes in Brazilian coffee prices were to changes in Colombian coffee prices over the most recent six-month periods (to correspond with the hedge period). Such an approach could be employed to determine the effectiveness of the hedge both prospectively and retrospectively, in which case, the computation for both purposes would incorporate the same number of data points that are periodically updated in accordance with ASC 815-20-35-3. In other words, at the inception of the hedge, the regression analysis could consider the historical correlation of changes in Brazilian coffee prices to changes in Colombian coffee prices for six-month periods of time ending at the inception of the hedge. At each subsequent effectiveness assessment date, data for the period of time subsequent to the last assessment of effectiveness would be added and the same number of data points removed from the oldest data in the computation to update the analysis while incorporating the same number of data points. The data that is being regressed should typically encompass a time horizon that mirrors or is less than the original time horizon of the hedge (six months in this example). Thirty data points for each variable are typically viewed as the minimum number to result in a statistically valid sample. As previously indicated, regression analysis is more complex than the dollar-offset approach, but is also more likely to result in a conclusion of high effectiveness. Its complexity and the need to have expertise in this area is emphasized

[24] Following the adoption of ASU 2025-09, "contractually specified component" will be replaced with "price index explicitly referenced in the agreement." Refer to the ASU for effective date and transition requirements.

in the following remarks made by the SEC staff at the 2003 Thirty-First AICPA National Conference on Current SEC Developments:

> Specifically, the staff has noted instances where registrants have utilized statistical techniques to assess hedge effectiveness, such as regression analysis, but did not have sufficient experience with or understanding of such techniques to apply them in an appropriate manner. The use of regression analysis is not problematic. What is problematic is when regression analysis is used and the statistical validity of such analysis is not adequately considered. Specifically, the staff is aware of situations where certain registrants have not fully considered the relevant outputs from the regression analysis when assessing whether the hedge is expected to be highly effective. The staff acknowledges that the assessment of whether a hedging relationship is expected to be highly effective will be determined based on the facts and circumstances of that specific relationship. However, the staff believes that, at a minimum, certain regression outputs such as the coefficient of determination (R-squared), the slope coefficient and the t or F-statistic should be considered when using regression analysis to assess whether a hedge is expected to be highly effective. Additionally, depending on the specifics of the hedging strategy, other regression outputs may also need to be considered. The staff expects that if registrants are utilizing statistical techniques to assess hedge effectiveness that they understand how to use and appropriately evaluate such techniques, which may necessitate the use of specialists.

In practice, a coefficient of determination (R-squared) of .80 or greater is viewed as a highly effective hedging relationship; however, as noted in the SEC staff speech, it is not sufficient to solely consider the coefficient of determination. Certain computerized spreadsheet applications can be used to perform regression analysis; however, specialized expertise is often necessary to structure the analysis and evaluate the results.

## Quantitative methods to assess the effectiveness of cash flow hedges involving interest rate swaps

There are three primary methods—the change-in-variable-cash-flows, hypothetical-derivative and change-in-fair-value methods—outlined beginning at ASC 815-30-35-10 that can be used to assess the effectiveness of cash flow hedges involving interest rate swaps. These methods can be used when hedging interest rate risk or overall changes in hedged cash flows associated with variable interest payments on existing variable-rate assets or liabilities, as well as assets that will be acquired and liabilities that will be incurred at a later date. Regardless of the method used, the risk of default by counterparties to the interest rate swap or hedged transaction should be considered, as the likelihood of the obligor not defaulting needs to be assessed as probable for hedge accounting to continue.

### Change-in-variable-cash-flows method

The change-in-variable-cash-flows method can only be used if the fair value of the swap at the inception of the hedge is at or near zero. Application of this method involves comparing the present value of the cumulative changes between the expected future cash flows on the variable leg of the interest rate swap and the present value of the expected future interest cash flows on the variable-rate asset or liability that is being hedged. The discount rates applicable to determining the fair value of the interest rate swap should be used in deriving the present value amount for both the swap and interest cash flows associated with the hedged item.

This method will result in a perfectly effective hedge if all of the following conditions discussed in ASC 815-30-35-22 are met:

a. “The variable-rate leg of the interest rate swap and the hedged variable cash flows of the asset or liability are based on the same interest rate index (for example, three-month London Interbank Offered Rate (LIBOR) swap rate).

b. The interest rate reset dates applicable to the variable-rate leg of the interest rate swap and to the hedged variable cash flows of the asset or liability are the same.

c. The hedging relationship does not contain any other basis differences (for example, if the variable leg of the interest rate swap contains a cap and the variable-rate asset or liability does not).

d. The likelihood of the obligor not defaulting is assessed as being probable."

This method is illustrated through Example 15 beginning at ASC 815-30-55-91.

### Hypothetical-derivative method

The hypothetical-derivative method involves comparing the change in the fair value of the actual interest rate swap designated as the hedging instrument with the change in the fair value of a hypothetical interest rate swap that has terms that identically match the critical terms of the floating-rate asset or liability that is being hedged. Critical terms include:

- Notional amount
- Repricing dates
- Variable-rate index
- Mirror-image caps and floors

Additionally, the hypothetical interest rate swap would be structured to satisfy all of the applicable criteria to qualify for use of the shortcut method, except the criterion in ASC 815-20-25-104(e). For reasons explained in Example 7 beginning at ASC 815-20-55-106, the hypothetical derivative instrument could be the same as the actual derivative instrument when hedging prepayable debt.

When determining the fair value of both the perfect hypothetical interest rate swap and the actual interest rate swap, the discount rates used should be based on the relevant interest rate swap curves.

As mentioned in Section 5.2.4.1, this method of assessing effectiveness is often adapted to various other types of hedging relationships whereby through either a dollar-offset approach or regression analysis, the change in fair value or cash flows associated with the actual derivative instrument is compared to those of a hypothetically perfect derivative instrument that has terms that exactly match the critical terms of the hedged item.

### Change-in-fair-value method

The change-in-fair-value method involves comparing the present value of the cumulative change in expected variable future interest cash flows that are designated as the hedged transactions to the cumulative change in the fair value of the interest rate swap that is designated as the hedging instrument. Discount rates applicable to determining the fair value of the interest rate swap should also be applied to the computation of present values of the cumulative changes in the hedged cash flows.

## Assessing the effectiveness of net investment hedges

### Assessing effectiveness when the hedging instrument is a derivative instrument

ASC 815-35-35 outlines the two different methods that can be used when the hedging instrument in a net investment hedge is a derivative instrument. Namely, effectiveness can be assessed based on changes in spot exchange rates or in forward exchange rates. The selected method should be applied consistently for all net investment hedges in which the hedging instrument is a derivative instrument. Any change to the method would need to be accomplished through a dedesignation of the original hedging relationship and the designation of a new hedging relationship in accordance with ASC 815-20-55-56.

### Assessing effectiveness based on changes in spot exchange rates

When applying this method, the change in the fair value of the derivative instrument attributable to changes in the difference between the forward rate and spot rate is excluded from the assessment of hedge effectiveness and the hedging relationship is considered perfectly effective if all of the following conditions in ASC 815-35-35-5 are met.

**ASC 815-35-35-5 [partial excerpt]**

a. The notional amount of the derivative instrument designated as a hedge of a net investment in a foreign operation matches (that is, equals) the portion of the net investment designated as being hedged.

b. The derivative instrument's underlying exchange rate is the exchange rate between the functional currency of the hedged net investment and the investor's functional currency.

c. When the hedging derivative instrument is a cross-currency interest rate swap, it is eligible for designation in a net investment hedge in accordance with ASC 815-20-25-67.

As indicated at ASC 815-35-35-9, condition "c" is not met if the two legs of a cross-currency interest rate swap are not both based on comparable interest rate curves. If all of these conditions are not met, the effectiveness of the hedge should be assessed by comparing the change in the fair value of a hypothetical derivative instrument with the change in the fair value of the actual derivative instrument. The hypothetical derivative instrument would meet all of these conditions and have the same maturity, repricing and payment frequencies for any interim payments as the actual derivative instrument.

## Assessing effectiveness based on changes in forward exchange rates

When applying this method in assessing effectiveness, all changes in the fair value of a derivative instrument, including the time value component of purchased options and the interest accruals and periodic cash settlement components of qualifying cross-currency interest rate swaps, are reported in the cumulative translation adjustment section of other comprehensive income. Perfect effectiveness can be assumed, and no quantitative assessment of effectiveness is required at hedge inception if the notional amount of the derivative instrument matches the portion of the net investment designated as being hedged and the derivative instrument's underlying relates solely to the foreign exchange rate between the functional currency of the hedged net investment and the investor's functional currency. As indicated in ASC 815-35-35-18, the hedging relationship would not be perfectly effective if the hedging instrument is a cross-currency interest rate swap, and both legs are not based on comparable interest rate curves.

When differences exist such that perfect effectiveness cannot be assumed, effectiveness is assessed, depending on the nature of the differences, as outlined in ASC 815-35-35-19.

**ASC 815-35-35-19**

The assessment of hedge effectiveness due to such differences between the hedging derivative instrument and the hedged net investment considers the following:

a. Different notional amounts. If the notional amount of the derivative instrument designated as a hedge of the net investment does not match the portion of the net investment designated as being hedged, hedge effectiveness shall be assessed by comparing the following two values:

   1. The change in fair value of the actual derivative instrument designated as the hedging instrument

   2. The change in fair value of a hypothetical derivative instrument that has a notional amount that matches the portion of the net investment being hedged and a maturity that matches the maturity of the actual derivative instrument designated as the net investment hedge. See paragraph 815-35-35-26 for situations in which the hedge of a net investment in a foreign operation is hedging foreign currency risk on an after-tax basis, as permitted by paragraph 815-20-25-3(b)(2)(vi).

b. Different currencies. If the derivative instrument designated as the hedging instrument has an underlying foreign exchange rate that is not the exchange rate between the functional currency of the hedged net investment and the investor's functional currency (a tandem currency hedge), hedge effectiveness shall be assessed by comparing the following two values:

   1. The change in fair value of the actual cross-currency hedging instrument
   2. The change in fair value of a hypothetical derivative instrument that has as its underlying the foreign exchange rate between the functional currency of the hedged net investment and the investor's functional currency and a maturity and repricing and payment frequencies for any interim payments that match the maturity and repricing and payment frequencies for any interim payments of the actual derivative instrument designated as the net investment hedge.

c. Multiple underlyings. In accordance with paragraph 815-20-25-67(a), the only derivative instruments with multiple underlyings permitted to be designated as a hedge of a net investment are receive-variable-rate, pay variable-rate cross-currency interest rate swaps that meet certain criteria. Paragraph 815-20-25-67(b) also permits receive-fixed-rate, pay-fixed rate cross-currency interest rate swaps to be designated as a hedge of a net investment.

## Assessing effectiveness when the hedging instrument is a cross-currency interest rate swap

ASC 815-35-35-20 through 35-21 provides guidance for assessing the effectiveness of a net investment hedge when a cross-currency interest rate swap is the designated hedging instrument.

**ASC 815-35-35-20 through 35-21**

If a receive-variable-rate, pay-variable-rate cross-currency interest rate swap is designated as the hedging instrument in a net investment hedge, hedge effectiveness shall be assessed by comparing the following two values:

a. The change in fair value of the actual cross-currency interest rate swap designated as the hedging instrument

b. The change in fair value of a hypothetical receive-variable-rate, pay-variable- rate cross-currency interest rate swap in which the interest rates are based on the same currencies contained in the hypothetical swap and both legs of the hypothetical swap have the same repricing intervals and dates. The hypothetical derivative instrument also shall have a maturity that matches the maturity of the actual cross-currency interest rate swap designated as the net investment hedge.

If a receive-fixed-rate, pay-fixed-rate cross-currency interest rate swap is designated as the hedging instrument in a net investment hedge, hedge effectiveness shall be assessed by comparing the following two values:

a. The change in fair value of the actual cross-currency interest rate swap designated as the hedging instrument

b. The change in fair value of a hypothetical receive-fixed-rate, pay-fixed rate cross-currency interest rate swap in which the interest rates are based on the same currencies contained in the hypothetical swap. The hypothetical derivative instrument shall also have a maturity that matches the maturity of the actual cross-currency interest rate swap designated as the net investment hedge.

### Assessing effectiveness when hedging instrument is not a derivative instrument

Entities sometimes hedge their exposure associated with a net investment in a foreign operation by using a nonderivative instrument, such as debt that is denominated in a foreign currency. ASC 815-35-35-12 indicates that a hedging relationship would be considered perfectly effective, and no prospective quantitative effectiveness assessment required at hedge inception, if both of the following conditions are met:

a. The notional amount of the nonderivative instrument matches the portion of the net investment designated as being hedged.

b. The nonderivative instrument is denominated in the functional currency of the hedged net investment.

If these conditions are not met, effectiveness is assessed in accordance with ASC 815-35-35-14 by comparing:

a. The foreign currency transaction gain or loss based on the spot rate change (after tax effects, if appropriate) of that nonderivative instrument

b. The transaction gain or loss based on the spot rate change (after tax effects, if appropriate) that would result from the appropriate hypothetical nonderivative instrument that does not incorporate those differences. The hypothetical nonderivative instrument shall also have a maturity that matches the maturity of the actual nonderivative instrument designated as the net investment hedge.

### Redesignation considerations when effectiveness is based on the beginning net investment balance

Guidance is provided in ASC 815-35-35-27 to address circumstances whereby the effectiveness of a hedge of the net investment is assessed based on the beginning balance of the net investment and the net investment changes during the year. This necessitates considering the need to redesignate the hedging relationship to indicate:

- What the hedging instrument is
- What numerical portion of the current net investment is the hedged portion

This should be done whenever financial statements or earnings are reported and at least every three months.

**Example 5-5: Frequency of designation of hedged net investment (ASC 815-35-55-1)**

This Example illustrates the application of paragraph 815-35-35-27. Assume that an entity enters into a foreign currency forward contract that has a notional amount equal to the beginning balance of its investment in a foreign operation (for example, 100,000 foreign currency units [FC]). This foreign currency forward contract is immediately designated as a hedge of the entire beginning balance of the net investment at the inception of the hedge. As the net investment changes, the entity would periodically assess the original hedging relationship and decide whether it needs to remove (that is, dedesignate) that original relationship and designate a new hedging relationship for the following assessment period. The following presents one method of such redesignation in those circumstances in which the entity chooses not to obtain a new derivative instrument:

a. If the net investment had increased (for example, to FC 120,000), the entire forward contract would be designated prospectively as hedging only a portion of the beginning balance of the net investment in that foreign operation. The hedged portion would be the ratio of the net investment at the inception of the hedge to the net investment at the beginning of the new assessment period (for example, five-sixths of the FC 120,000).

b. If the net investment had decreased (for example, to FC 90,000), only a proportion of the forward contract would be designated prospectively as hedging the entire beginning balance of the net investment in that foreign operation. The proportion of the forward contract designated prospectively as the hedging instrument would be the ratio of the net investment at the beginning of the new assessment period to the net investment at the inception of the hedge (for example, nine-tenths of the forward contract). The proportion of the forward contract not designated prospectively as the hedging instrument in the net investment hedge could be designated as a hedging instrument in a different hedging relationship or simply reported at fair value with its gain or loss after the dedesignation date recognized currently in earnings pursuant to paragraph 815-20-35-1(a).

**RSM COMMENTARY:** Guidance is provided in ASC 815-35-35-27 to address circumstances in which the effectiveness of a hedge of the net investment is assessed based on the beginning balance of the net investment and the net investment changes during the year. This necessitates considering the need to redesignate the hedging relationship to indicate the hedging instrument and what numerical portion of the current net investment is the hedged portion whenever financial statements or earnings are reported and at least every three months.

### Changing to a different quantitative method for assessing effectiveness

As noted above, the method or methods that are selected to assess the effectiveness of the hedging relationship should be consistently applied. ASC 815-20-35-19 indicates that if an improved method of assessing effectiveness is identified that an entity wants to apply prospectively, this can be accomplished by discontinuing the existing hedging relationship and designating the new relationship using the improved method. (Refer to Section 9.3 for additional information on discontinuing a fair value hedge and Section 10.4 for additional information on discontinuing a cash flow hedge.) The new method should be applied to similar hedges unless the use of a different method for similar hedges is justified. A change in the method of assessing hedge effectiveness is not considered a change in accounting principle.

## 5.2.4.4 Excluding certain components from the assessment of effectiveness

ASC 815-20-25-82 permits entities to exclude all or a part of a hedging instrument's time value from the assessment of hedge effectiveness. Specifically, if the hedging instrument is an option contract, all or certain components of the change in the time value of the option can be excluded from the assessment of effectiveness. If the hedging instrument is a forward or futures contract, such as a swap, the change in the fair value of the contract related to the changes in the difference between the spot price and the forward or futures price can be excluded from the assessment of effectiveness. If the hedging instrument is a currency swap, the portion of its change in fair value attributable to a cross-currency basis spread can be excluded from the assessment of effectiveness.

The decision about whether to exclude time value, or a component thereof, from the assessment of effectiveness should be made consistently for similar hedges and documented as part of the documentation required by ASC 815-20-25-3. No other components of a hedging instrument's gain or loss can be excluded from the assessment of effectiveness. This decision should be carefully evaluated, as it can impact whether the hedge is highly effective and whether the hedge qualifies for the assumption of perfect effectiveness such that a quantitative assessment of effectiveness is not necessary.

As is elaborated on more fully in Chapter 9 (for fair value hedges) and Chapter 10 (for cash flow hedges), the initial value of a component that is excluded from the assessment of effectiveness is recognized in earnings over the life of the hedging instrument using a systematic and rational method unless an election is made to record changes in the fair value of the excluded component in earnings as they occur. Certain examples illustrate the concept of excluding time value from the assessment of effectiveness, including Example 6-3, Example 6-7, Example 6-15, Example 6-16 and Example 7-10.

#### 5.2.4.5 Ramifications of counterparty possibility of default on hedge effectiveness and the valuation of a derivative instrument

Regardless of whether a qualitative or quantitative method is used to assess the effectiveness of a hedging relationship, each time the effectiveness of the relationship is assessed, consideration should be given to the possibility that the counterparty to the hedging derivative instrument will default. The ramifications of potential default on the effectiveness of the hedge differ depending on whether the hedge is a cash flow or fair value hedge and are discussed in the sections that follow. Additionally, ASC 820 requires nonperformance risk (including credit risk of both the reporting entity and the counterparty, as relevant) to be incorporated into the valuation of derivative instruments, to the extent that such nonperformance risk affects the price that would be received to sell the derivative instrument in an asset position or paid to transfer a derivative instrument in a liability position in an orderly transaction with market participants.[25]

##### Ramifications to effectiveness of cash flow hedge

To conclude that a hedging relationship is expected to be highly effective in achieving offsetting changes in cash flows, consideration should be given to whether payments that may be owed under the contractual provisions of the derivative instrument will be collected. This entails assessing and updating the possibility that the counterparty to the derivative instrument will default by failing to make any contractually required payments. In making this assessment, consideration should be given to the counterparty's credit ratings, as well as other relevant factors such as collateral and financial guarantees. If at any time the likelihood that the counterparty will not default is no longer probable, a cash flow hedge would no longer be considered highly effective and hedge accounting should be discontinued. As long as it remains probable that the counterparty will not default, a change in the risk of nonperformance often does not impact the effectiveness assessment of a cash flow hedge. For example, when applying the most common quantitative method of assessing effectiveness (the hypothetical-derivative method discussed in Section "Hypothetical-derivative method"), ASC 815-30-35-29 indicates that the same discount rates (the relevant interest rate swap curves) should be used in determining the fair value of both the perfect hypothetical interest rate swap and the actual interest rate swap.

##### Ramifications to effectiveness of fair value hedge

If there is a change in the creditworthiness of either party to a derivative instrument designated as the hedging instrument in a fair value hedge, this change has an immediate effect on the derivative instrument's fair value, given the need to consider the risk of nonperformance in deriving the fair value. The fair value impact of a change in creditworthiness will immediately affect the effectiveness assessment by creating a difference between the change in the fair value of the hedging instrument and the change in the fair value of the hedged item attributable to the hedged risk, which is recognized in earnings under fair value hedge accounting. The shortcut method, discussed in Section "Shortcut method for interest rate swaps," requires that consideration be given to the likelihood of the counterparty's compliance with the contractual payment terms of the hedging derivative instrument; however, if compliance is probable, perfect effectiveness can be assumed, despite differences in credit risk associated with the hedging instrument and hedged item.

[25] An exception is provided under ASC 815-10-35-1A for private companies that qualify for and elect the simplified approach; as noted in Section "Measurement at settlement value," an election can be made to measure the interest rate swap at settlement value as a practical expedient for fair value.

# 6 Commodities hedging

## 6.1 Overview

Manufacturing entities commonly enter into derivative transactions for protection against fluctuating commodity prices and the impact this fluctuation may have on the value of inventory, cost of raw materials or finished goods sales prices. Other common uses of commodities derivative instruments include hedging utility or fuel costs or sales prices. While beyond the scope of this guide, commodities purchase agreements with vendors, and sales agreements with customers, may meet the definition of a derivative instrument and require derivative accounting, unless the entity qualifies for, and elects, the normal purchases and normal sales scope exception outlined beginning at ASC 815-10-15-22. Refer to Section 3.2.1 for guidance on the definition of a derivative instrument and Section 3.3.2 for the normal purchases and normal sales scope exception. While derivative instruments can be designated as hedging instruments in a fair value or cash flow hedge, including all-in-one hedges as illustrated beginning at ASC 815-20-55-111, they cannot be designated as a hedged item. Thus, when contemplating hedge accounting, consideration should be given to whether a potential hedged item or transaction is required to be accounted for as a derivative instrument.

The level of effort to comply with the requirements of hedge accounting and demonstrate that a hedge is highly effective can vary depending on the way a hedge is structured, as well as how it is defined and documented to meet the hedge accounting requirements. For example, a cash flow hedge of a contractually specified component associated with the forecasted purchase or sale of a commodity is typically easier to implement and has a greater likelihood of being highly effective than a cash flow or fair value hedge of total changes in price. This is illustrated in the table that follows, using specific examples incorporated in Section 6.5.

| Situation | Factors that preclude the hedge from being perfectly effective | Alternate structure that may be more feasible |
|---|---|---|
| Fair value hedge of natural gas inventories in Texas using futures contracts based on delivery at the Henry Hub point in Louisiana (refer to Example 6-15) | Factors associated with the location (e.g., transmission costs, local supply and demand) | Structure as a cash flow hedge of contractually specified component associated with forecasted purchases or sales of natural gas, if a contractually specified component exists or is expected to exist. As noted in ASC 815-20-25-77, location differences would not need to be considered. |
| Fair value hedge of tire inventory using a forward contract to sell rubber (refer to Example 6-16) | Nonrubber components that impact the price of tires, as well as location differences | Structure as a cash flow hedge of forecasted purchases of the rubber to be used in manufacturing the tires. If this can be accomplished, effectiveness would not be impacted by changes in cash flows associated with the nonrubber components of tires. Additionally, if a contractually specified component exists or is expected to exist for the pricing of the forecasted purchases of rubber (e.g., price |

| Situation | Factors that preclude the hedge from being perfectly effective | Alternate structure that may be more feasible |
|---|---|---|
| | | is contractually linked to a rubber index), and is designated as the hedged risk, location differences would not need to be considered. |
| Fair value hedge of growing wheat with futures contracts based on fully grown harvested wheat (refer to Example 6-17) | Futures contracts are based on harvested wheat and the hedged item is unharvested wheat, which would have different values than harvested wheat due to various factors, such as additional production and harvesting costs, as well as physical condition. | Structure as a cash flow hedge of the forecasted sale of the harvested wheat. If this can be accomplished, the state of production would not cause a mismatch between the futures contracts and the wheat it is hedging. Additionally, if a contractually specified component exists for the pricing of the forecasted sales of wheat (e.g., price is contractually linked to a wheat index), location differences would not need to be considered. |

## 6.2 Cash flow hedge of a contractually specified component – Before the adoption of ASU 2025-09

Rather than designate the hedged risk as changes in total cash flows, an entity can designate changes in cash flows attributable to a contractually specified component of commodities and other nonfinancial assets.

**RSM COMMENTARY: What is a contractually specified component?**

A contractually specified component is defined as "an index or price explicitly referenced in an agreement to purchase or sell a nonfinancial asset, other than an index or price calculated or measured solely by reference to an entity's own operations."

ASC 815-20-55-26A elaborates on this by indicating that the definition is considered met if the component is explicitly referenced in agreements that support the price at which a nonfinancial asset will be purchased or sold and provides the following example:

> …an entity intends to purchase a commodity in the commodity's spot market. If as part of the governing agreements of the transaction or commodities exchange it is noted that prices are based on a pre-defined formula that includes a specific index and a basis, those agreements may be utilized to identify a contractually specified component.

In ASU 2025-09, the FASB has issued a change to hedging components for nonfinancial assets. Refer to the following Pending change: ASU 2025-09, *Hedge accounting improvements* box for details.

**Pending change: ASU 2025-09, *Hedge accounting improvements***

On November 25, 2025, the FASB issued ASU 2025-09, *Derivatives and Hedging (Topic 815): Hedge Accounting Improvements* (ASU 2025-09 or the ASU), to align hedge accounting more closely with the economics of an entity's risk management activities.

ASU 2025-09 broadens the applicability of hedge accounting to forecasted purchases and sales of nonfinancial assets. Rather than requiring that a price component be contractually specified, an entity may, when certain conditions are met, designate hedge relationships for eligible components of forecasted spot transactions, forward transactions and subcomponents of explicitly referenced components in a contract's pricing formula. For a forecasted purchase or sale of a nonfinancial asset to qualify for hedge designation, the variable pricing element must be clearly and closely related to the underlying nonfinancial asset being purchased or sold, consistent with the requirements of the existing normal purchases and normal sales scope exception.

For PBEs, ASU 2025-09 is effective for annual reporting periods beginning after December 15, 2026, and interim periods within those annual reporting periods. For entities other than PBEs, the ASU is effective for annual reporting periods beginning after December 15, 2027, and interim periods within those annual reporting periods. Early adoption is permitted on any date on or after its issuance.

Entities should apply the guidance in ASU 2025-09 prospectively for all hedging relationships. An entity may elect to adopt the ASU for hedging relationships that exist as of the date of adoption.

Assuming all relevant criteria are met, an entity can elect to hedge changes in cash flows attributable to a contractually specified component of a forecasted purchase or sale of commodities, rather than all changes in cash flows associated with a forecasted purchase or sale of commodities. It is typically challenging to structure a commodity hedge that is highly effective at hedging all changes in cash flows or fair value, as well as time consuming to monitor the effectiveness of such hedges. This is because commonly available commodity derivative instruments have cash flows that are only impacted by changes in a commodity index. Conversely, the cash flows associated with a forecasted purchase or sale of a commodity, as well as the fair value of a commodity, are likely also impacted by additional factors, such as transportation costs, quality or grade differentials and local supply and demand for the particular commodity. Designating a contractually specified component as the hedged risk in the forecasted purchase or sale of commodities is advantageous because cash flows attributable to these other factors can be ignored when assessing the effectiveness of the hedge. This is evident from Example 6-9, where basis differentials between grades of plastic and location can be ignored when assessing the effectiveness of the hedge because the hedged risk was designated as the variability in cash flows attributable to changes in the contractually specified component.

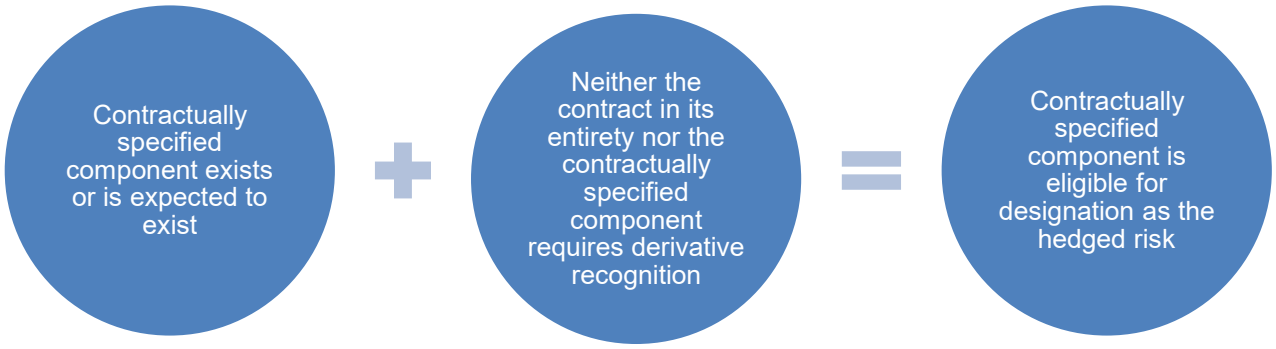
Example 6-2, Example 6-4 and Example 6-8 also illustrate various aspects of hedging a contractually specified component.

### 6.2.1 Criteria for hedging a contractually specified component

ASC 815-20-25-22A and 25-22B outline criteria that should be considered to determine if a contractually specified component can be designated as the hedged risk in a cash flow hedge.[26] Namely, consideration should be given to whether the purchase or sale contract associated with the contractually specified component is a derivative instrument in its entirety or contains an embedded derivative. If the contract is a derivative instrument in its entirety, a contractually specified component can be designated as the hedged risk only if the entity qualifies for, and elects, the normal purchases and normal sales scope exception for that contract as outlined beginning in ASC 815-10-15-22. Similarly, if a contractually specified component

[26] Reference should also be made to Section 5.2 in determining if the general criteria for cash flow hedge accounting are met.

that is embedded in a contract that is not a derivative instrument in its entirety requires bifurcation as a derivative instrument, that embedded component cannot be designated as the hedged risk.




#### 6.2.1.1 Hedging contractually specified component before, after or without a contractual period

When determining whether a contractually specified component exists, it is not necessary to have a contract in place at the inception of the hedge. This is evident from the discussion in BC50 of ASU 2017-12, as well as ASC 815-20-55-26, in which purchases and sales conducted in the spot market are deemed to have a contractually specified component if the governing agreements for the transaction or exchange indicate that the prices are based on a specific index. Additionally, as is evident from Example 6-2, it is permissible to hedge a contractually specified component for a hedge period that extends beyond the contractual term of an existing contract or to hedge a contractually specified component in a contract that does not yet exist as long as the requirements are expected to be met when a replacement contract is executed. The FASB discussed matters such as this at its March 28, 2018, meeting and indicated that upon entering into the contract or other document referencing the contractually specified component, the analysis required by ASC 815-20-25-22A should be performed. In its minutes for this meeting, the FASB also indicated:

> If an entity does not have a contract at hedge inception, it must develop an expectation (for example, through previous experience) that when the transaction is entered into:
>
> - The written agreement for a forecasted purchase or sale will contain an explicitly referenced contractually specified component.
> - The pricing formula that references the explicitly referenced contractually specified component will determine the price of the nonfinancial item.
> - The requirements for cash flow hedge accounting will be met.
> - The agreement will be substantive.

### 6.2.2 Ongoing monitoring associated with hedges of contractually specified components

As is the case with any hedges of forecasted transactions, as part of the ongoing assessments of effectiveness (refer to Section 5.2.4 for additional information), consideration should be given to whether the forecasted transactions are probable of occurring. Any expected differences between the derivative instrument and the transactions it is hedging should be considered in the quantitative assessment of effectiveness. Hedge accounting should be discontinued if the forecasted transactions are no longer probable of occurring, the hedge is no longer highly effective based on the expected terms, or—for hedges associated with contracts that do not yet exist (as discussed in Section 6.2.1.1)—if the contract when executed does not have a contractually specified component.

### 6.2.3 Changes in the designated contractually specified component

Given the ability to hedge a contractually specified component before or after the contract period, circumstances may arise whereby the contractually specified component that was designated as the hedged risk at the inception of the hedge is expected to be replaced with a different contractually specified component. This is illustrated through Example 6-2. The FASB decided to permit the continuation of hedge accounting uninterrupted in this circumstance as long as the hedge remains highly effective, considering the revised hedged risk and the hedged forecasted transactions remain probable. This decision by the FASB constitutes a departure from the general guidance in ASC 815-20-55-56, which indicates that a change to any of the critical terms of a hedging relationship necessitates a dedesignation of that relationship and the designation of a new hedging relationship. As pointed out in BC66 of ASU 2017-12, it is not necessary for the initial hedge documentation or hedge effectiveness assessments to contemplate a possible change to the contractually specified component. The initial hedge documentation should be based on the expected contractually specified component and each assessment of effectiveness should be performed based on the contractually specified component that is expected to occur at the time each effectiveness assessment is performed.

### 6.2.4 Criteria for hedging price component of a nonfinancial asset– After the adoption of ASU 2025-09

ASU 2025-09 broadens the applicability of hedge accounting to forecasted purchases and sales of nonfinancial assets. Rather than requiring that a price component be contractually specified, an entity may, when certain conditions are met, designate hedge relationships for eligible components of forecasted spot transactions, forward transactions and subcomponents of explicitly referenced components in a contract's pricing formula. For a forecasted purchase or sale of a nonfinancial asset to qualify for hedge designation, the variable pricing element must be clearly and closely related to the underlying nonfinancial asset being purchased or sold, consistent with the requirements of the existing normal purchases and normal sales scope exception.

ASU 2025-09 amends ASC 815-20-25-46B, 25-77 and 25-84 as well as ASC 815-20-55-79P to remove the requirement that hedge accounting cannot be allowed for a price component of a nonfinancial item unless the price component is contractually specified. ASU 2025-09 replaced the "contractually specified component" with the conditions in ASC 815-20-25-22C.

**ASC 815-20-25-22C**

An entity may designate the variability in cash flows attributable to changes in a component (or subcomponent) of the forecasted purchase price or sales price of a nonfinancial asset as the hedged risk in a cash flow hedge as follows:

a. If the purchase price or sales price of the nonfinancial asset is not determined in accordance with a pricing formula in an agreement, the hedged variable component is clearly and closely related (as described in paragraph 815-10-15-32(a) through (b)) to the nonfinancial asset being purchased or sold.

b. If the purchase price or sales price of the nonfinancial asset is determined in accordance with a pricing formula in an agreement, the hedged variable component is either of the following:

    1. Explicitly referenced in the agreement's pricing formula and clearly and closely related (as described in paragraph 815-10-15-32(a) through (b)) to the nonfinancial asset being purchased or sold

    2. Clearly and closely related (as described in paragraph 815-10-15-32(a) through (b)) to a variable component that meets the conditions in (b)(1) (that is, a "subcomponent"). (Throughout Subtopic 815-20), reference to a subcomponent refers only to the designation guidance in this subparagraph.)

## 6.3 Cash flow hedge of all changes in cash flows associated with commodities hedge

Our expectation is that most entities will structure cash flow hedges of forecasted commodity transactions as a hedge of a contractually specified component when possible. In those situations when a contractually specified component does not, and is not expected to, exist, ASC 815-20-25-15(i) requires the hedged risk to be designated as the risk of changes in cash flows related to all changes in the purchase or sales price. As demonstrated in the table in Section 6.1, this creates mismatches between the hedging instrument and the forecasted transactions it is hedging that could potentially be avoided through a hedge of a contractually specified component. Following the adoption of ASU 2025-09, a hedged risk component will no longer need to be "contractually specified." Rather, the designation of the risk of changes in the cash flows relating to a component (or subcomponent) of the price of a nonfinancial asset will need to be clearly and closely related to the purchase price or sales price of the nonfinancial asset. Example 6-5 and Example 6-6 illustrate cash flow hedges of total changes in price.

## 6.4 Fair value commodities hedge

For there to be perfect effectiveness in a fair value hedge of a nonfinancial asset, such as inventory, the underlying of the derivative instrument would need to be of the same variety, grade and location as the inventory, which is generally hard to achieve. Because of the difficulties associated with fair value hedges of nonfinancial assets (see the table in Section 6.1), entities commonly structure hedges as cash flow hedges if possible. Example 6-14 to Example 6-18 illustrate fair value hedges of commodities.

## 6.5 Commodity hedge examples

The following select examples related to commodities hedges are from the implementation guidance in ASC 815.

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**Example 6-1: Grouping individual transactions – Before the adoption of ASU 2025-09 (ASC 815-20-55-20 through 55-23)**

It sometimes will be impractical (perhaps impossible) and not cost-effective for an entity to identify each individual transaction that is being hedged. An example is a group of sales or purchases over a period of time to or from one or more parties. This Subtopic permits an entity to aggregate individual forecasted transactions for hedging purposes in some circumstances. As it does for a hedge of a single forecasted transaction, paragraph 815-20-25-3(d)(1)(vi) requires that an entity identify the hedged transactions with sufficient specificity that it is possible to determine which transactions are hedged transactions when they occur.

For example, an entity that expects to sell at least 300,000 units of a particular product in its next fiscal quarter might designate the sales of the first 300,000 units as the hedged transactions. Alternatively, it might designate the first 100,000 sales in each month as the hedged transactions. It could not, however, simply designate any sales of 300,000 units during the quarter as the hedged transaction because it then would be impossible to determine whether the first sales transaction of the quarter was a hedged transaction. Similarly, an entity could not designate the last 300,000 sales of the quarter as the hedged transaction because it would not be possible to determine whether sales early in the quarter were hedged or not.

Under the guidance in this Subtopic, a single derivative instrument of appropriate size could be designated as hedging a given amount of aggregated forecasted transactions, such as any of the following:

a. Forecasted sales of a particular product to numerous customers within a specified time period, such as a month, a quarter, or a year

b. Forecasted purchases of a particular product from the same or different vendors at different dates within a specified time period

c. Forecasted interest payments on several variable-rate debt instruments within a specified time period.

At the time of hedge designation only, the transactions in each group must share the risk exposure for which they are being hedged. For example, the interest payments in the group in (c) in the preceding paragraph shall vary with the same index to qualify for hedging with a single derivative instrument.

**Example 6-1A: Grouping individual transactions – After the adoption of ASU 2025-09 (ASC 815-20-55-20 through 55-23D)**

It sometimes will be impractical (perhaps impossible) and not cost-effective for an entity to identify each individual transaction that is being hedged. An example is a group of sales or purchases over a period of time to or from one or more parties. This Subtopic permits an entity to aggregate individual forecasted transactions for hedging purposes in some circumstances. As it does for a hedge of a single forecasted transaction, paragraph 815-20-25-3(d)(1)(vi) requires that an entity identify the hedged transactions with sufficient specificity that it is possible to determine which transactions are hedged transactions when they occur.

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b. Forecasted purchases of a particular product from the same or different vendors at different dates within a specified time period

c. Forecasted interest payments on several variable-rate debt instruments within a specified time period.

The transactions in each group must have a similar risk exposure for which they are being hedged. To satisfy that requirement, an entity should determine whether the forecasted transactions are expected to have a similar risk exposure prospectively at hedge inception and on an ongoing basis. In addition, an entity should determine whether the forecasted transactions had a similar risk exposure retrospectively on an ongoing basis during the hedge period. An entity should assess similarity each time it assesses hedge effectiveness for a group (for timing of hedge effectiveness assessments, see paragraphs 815-20-25-79 through 25-79A, and for certain private companies and certain not-for-profit entities, see paragraphs 815-20-25-139 through 25-143).

An entity should determine that the risk exposures being hedged in a group of forecasted transactions are similar by applying either of the following methods:

a. The entity determines whether the designated hedging instrument is highly effective in achieving offsetting changes in cash flows attributable to each hedged risk in the group, assessed on an individual basis, by applying the guidance in paragraph 815-20-25-79 and paragraphs 815-30-35-10 through 35-32 for assessing hedge effectiveness.

b. The entity determines whether each hedged risk related to a forecasted transaction hedged in a group is similar to each other hedged risk in the group. In that assessment, an entity should use the same threshold applied to determine whether a relationship is highly effective. When assessing whether hedged risks in a group of forecasted transactions are similar, an entity should consider the guidance in paragraph 815-20-25-79 as well as the guidance in paragraphs 815-30-35-10 through 35-32 for hedges of interest rate risk.

Ordinarily, an entity should apply the selected method consistently to similar hedges. Use of different methods for similar hedges should be justified.

If an entity applies one of the qualitative methods in paragraph 815-20-25-3(b)(2)(iv)(01) for purposes of assessing hedge effectiveness and it applies the similar risk assessment method described in paragraph 815-20-55-23A(a), it also may assume that the hedged risks related to a group of forecasted transactions are similar because the hedging instrument is considered highly effective qualitatively against each hedged risk in the group.

After performing an initial quantitative assessment at hedge inception (if required), an entity may elect on a hedge-by-hedge basis to qualitatively assess whether a group of individual forecasted transactions have a similar risk exposure in subsequent periods, if the entity can reasonably support an expectation of similar risk on a qualitative basis, in a manner similar to the guidance in paragraphs 815-20-35-2A through 35-2F. The qualitative assessment used to reasonably support an expectation of high effectiveness also may be used to support an expectation of similar risk exposure if an entity applies the similar risk assessment method described in paragraph 815-20-55-23A(a).

If an entity determines as part of its ongoing similar risk assessment that one or more hedged risks related to the group of individual forecasted transactions are no longer similar, it should dedesignate the hedging relationship as of the last date when all hedged risks in the group were assessed to have similar risk exposure, unless the entity can determine the specific date that all hedged risks in the group were no longer similar. Amounts previously recognized in accumulated other comprehensive income should remain until the forecasted transactions affect earnings or become probable of not occurring in accordance with paragraphs 815-30-40-4 through 40-6.

**Example 6-2: Contractually specified component in a not-yet-existing contract (ASC 815-20-55-26B through 55-26E) – Before the adoption of ASU 2025-09**

[Following the adoption of ASU 2025-09, this example will be superseded.]

This guidance discusses the implementation of paragraphs 815-20-25-22B and 815-30-35-37A. Entity A's objective is to hedge the variability in cash flows attributable to changes in a contractually specified component in forecasted purchases of a specified quantity of soybeans on various dates during June 20X1. Entity A has executed contracts to purchase soybeans only through the end of March 20X1. Entity A's contracts to purchase soybeans typically are based on the ABC soybean index price plus a variable basis differential representing transportation costs. Entity A expects that the forecasted purchases during June 20X1 will be based on the ABC soybean index price plus a variable basis differential.

On January 1, 20X1, Entity A enters into a forward contract indexed to the ABC soybean index that matures on June 30, 20X1. The forward contract is designated as a hedging instrument in a cash flow hedge in which the hedged item is documented as the forecasted purchases of a specified quantity of soybeans during June 20X1. As of the date of hedge designation, Entity A expects the contractually specified component that will be in the contract once it is executed to be the ABC soybean index.

Therefore, in accordance with paragraph 815-20- 25-3(d)(1), Entity A documents as the hedged risk the variability in cash flows attributable to changes in the contractually specified ABC soybean index in the not-yet-existing contract. On January 1, 20X1, Entity A determines that all requirements for cash flow hedge accounting are met and that the requirements of paragraph 815-20-25-22A will be met in the contract once executed in accordance with paragraph 815-20-25-22B. Entity A also will assess whether the criteria in 815-20-25-22A are met when the contract is executed.

As part of its normal process of assessing whether it remains probable that the hedged forecasted transactions will occur, on March 31, 20X1, Entity A determines that the forecasted purchases of soybeans in June 20X1 will occur but that the price of the soybeans to be purchased will be based on the XYZ soybean index rather than the ABC soybean index. As of March 31, 20X1, Entity A begins assessing the hedge effectiveness of the hedging relationship on the basis of the changes in cash flows associated with the forecasted purchases of soybeans attributable to variability in the XYZ soybean index. Because the hedged forecasted transactions (that is, purchases of soybeans) are still probable of occurring, Entity A may continue to apply hedge accounting if the hedging instrument (indexed to the ABC soybean index) is highly effective at achieving offsetting cash flows attributable to the revised contractually specified component (the XYZ soybean index). On April 30, 20X1, Entity A enters into a contract to purchase soybeans throughout June 20X1 based on the XYZ soybean index price plus a variable basis differential representing transportation costs.

If the hedging instrument is not highly effective at achieving offsetting cash flows attributable to the revised contractually specified component, the hedging relationship must be discontinued. As long as the hedged forecasted transactions (that is, the forecasted purchases of the specified quantity of soybeans) are still probable of occurring, Entity A would reclassify amounts from accumulated other comprehensive income to earnings when the hedged forecasted transaction affects earnings in accordance with paragraphs 815-30-35-38 through 35-41. The reclassified amounts should be presented in the same income statement line item as the earnings effect of the hedged item. Immediate reclassification of amounts from accumulated other comprehensive income to earnings would be required only if it becomes probable that the hedged forecasted transaction (that is, the purchases of the specified quantity of soybeans in June 20X1) will not occur. As discussed in paragraph 815-30-40-5, a pattern of determining that hedged forecasted transactions are probable of not occurring would call into question both an entity's ability to accurately predict forecasted transactions and the propriety of applying cash flow hedge accounting in the future for similar forecasted transactions.

**Example 6-3: Option time value excluded from the assessment of effectiveness in a cash flow hedge and recorded in earnings under an amortization approach (ASC 815-20-55-235 through 55-238)**

This Example illustrates the application of paragraph 815-20-25-83A.

On December 31, 20X0, an entity intends to purchase 1,000 barrels of crude oil in December 20X4. The entity decides to hedge changes in the price of the crude oil by purchasing an at-the-money call option on 1,000 barrels of crude oil. The entity purchases the option on December 31, 20X0, with an initial premium of $9,250, a strike price of $75, and a maturity date of December 31, 20X4. The entity designates the option as the hedging instrument in a cash flow hedge of a forecasted purchase of crude oil.

The entity elects to exclude the time value of the option from the assessment of effectiveness in accordance with paragraph 815-20-25-82 and applies the amortization approach for recognizing excluded components in accordance with paragraph 815-20-25-83A. The entity applies a straight-line amortization method and, based on the initial option premium of $9,250, the entity determines an annual amortization amount of $2,313. The entity records all changes in fair value over the term of the derivative in other comprehensive income and records amortization in earnings each period with an offsetting entry to other comprehensive income. The changes in value of the option over the life of the hedging relationship are as follows.

| | 12/31/20X1 | 12/31/20X2 | 12/31/20X3 | 12/31/20X4 |
|---|---|---|---|---|
| Ending market price of crude oil | $77 | $76 | $74 | $81 |
| Ending fair value of option | | | | |
| Time value | 7,500 | 5,500 | 3,000 | - |
| Intrinsic value | 2,000 | 1,000 | - | 6,000 |
| Total | $9,500 | $6,500 | $3,000 | $6,000 |
| Change in time value | ($1,750) | ($2,000) | ($2,500) | ($3,000) |
| Change in intrinsic value | 2,000 | (1,000) | (1,000) | 6,000 |
| Total current-period gain (loss) on derivative | $250 | ($3,000) | ($3,500) | $3,000 |

On December 31, 20X4, the entity purchases 1,000 barrels of crude oil, and the option expires with an intrinsic value of $6,000. This amount will remain in accumulated other comprehensive income until the commodity is sold in 20X5. The journal entries over the life of the hedging relationship are as follows.

| | | |
|---|---|---|
| **December 31, 20X0** | | |
| Derivative asset | $9,250 | |
| Cash | | $9,250 |
| To record the derivative asset based on the initial premium. | | |
| **December 31, 20X1** | | |
| Derivative asset | $250 | |
| Other comprehensive income | | $250 |
| To record the change in value of the derivative in other comprehensive income. | | |
| Cost of goods sold | $2,313 | |
| Other comprehensive income | | $2,313 |
| To record amortization of the excluded amount. | | |
| **December 31, 20X2** | | |
| Other comprehensive income | $3,000 | |
| Derivative asset | | $3,000 |
| To record the change in value of the derivative in other comprehensive income. | | |
| Cost of goods sold | $2,313 | |
| Other comprehensive income | | $2,313 |
| To record amortization of the excluded amount. | | |
| **December 31, 20X3** | | |
| Other comprehensive income | $3,500 | |
| Derivative asset | | $3,500 |
| To record the change in value of the derivative in other comprehensive income. | | |
| Cost of goods sold | $2,313 | |

| | | |
|---|---|---|
| Other comprehensive income | | $2,313 |
| To record amortization of the excluded amount. | | |
| **December 31, 20X4** | | |
| Derivative asset | $3,000 | |
| Other comprehensive income | | $3,000 |
| To record the change in value of the derivative in other comprehensive income. | | |
| Cost of goods sold | $2,311[(a)] | |
| Other comprehensive income | | $2,311[(a)] |
| To record amortization of the excluded amount. | | |
| **July 1, 20X5** | | |
| Accumulated other comprehensive income | $6,000 | |
| Cost of goods sold | | $6,000 |
| Upon sale of commodity, to record intrinsic value to cost of goods sold. | | |

(a) $2 rounding adjustment

**Example 6-4: Effectiveness of cash flow hedge of a forecasted purchase of inventory with a forward contract (ASC 815-30-55-1A through 55-8) – Before the adoption of ASU 2025-09**

This Example illustrates the application of the guidance in Subtopic 815-20 and this Subtopic to assessing effectiveness for a cash flow hedge of a forecasted purchase of inventory with a forward contract in which the forward contract index differs from the index of the underlying hedged transaction. Assume that the entity elected to perform subsequent quarterly hedge effectiveness assessments on a quantitative basis and that all hedge documentation requirements were satisfied at inception.

Entity G forecasts the purchase of 500,000 pounds of Brazilian coffee for U.S. dollars in 6 months. The agreement outlining purchase terms between Entity G and its supplier contains a contractually specified component referencing a Brazilian coffee index denominated in U.S. dollars. Entity G designates the variability in cash flows related to its forecasted purchase of Brazilian coffee attributable to changes in the contractually specified component (Brazilian coffee index) as the hedged risk. Rather than acquire a derivative instrument based on Brazilian coffee, Entity G enters into a 6-month forward contract to purchase 500,000 pounds of Colombian coffee for U.S. dollars and designates the forward contract as a hedging instrument in a cash flow hedge of the variability in cash flows attributable to changes in the contractually specified Brazilian coffee index component of its forecasted purchase of Brazilian coffee.

Entity G bases its assessment of hedge effectiveness on changes in forward prices, with the resulting gain or loss discounted to reflect the time value of money. Both at inception and on an ongoing basis, Entity 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 attributable to changes in the contractually specified component 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.)

In assessing hedge effectiveness on an ongoing basis, Entity 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 attributable to changes in the contractually specified component. Both changes would be measured on a cumulative basis for actual changes in the forward price of the respective coffees during the hedge period.

See Topic 820 (including paragraph 820-10-55-13) for a discussion of expected cash flows.

Because the only difference between the forward contract and forecasted purchase relates to the type of coffee (Colombian versus Brazilian), Entity 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, Entity 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 | 0.09 | 0.10 |
| × 500,000 pounds of coffee | × 500,000 | × 500,000 |
| Estimate of change in cash flows | $45,000 | $50,000 |

See Topic 820 (including paragraph 820-10-55-13) for a discussion of expected cash flows.

Using the amounts in paragraph 815-30-55-6, Entity G could evaluate effectiveness 3 months into the hedge on its first subsequent quarterly effectiveness assessment testing date 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. Entity G concludes that the hedging relationship would be highly effective, and it would record the $45,000 change in the fair value of the forward contract on Colombian coffee in other comprehensive income.

**Example 6-4A: Effectiveness of cash flow hedge of a forecasted purchase of inventory with a forward contract (ASC 815-30-55-1A through 55-8) – After the adoption of ASU 2025-09**

This Example illustrates the application of the guidance in Subtopic 815-20 and this Subtopic to assessing effectiveness for a cash flow hedge of a forecasted purchase of inventory with a forward contract in which the forward contract index differs from the index of the underlying hedged transaction. Assume that the entity elected to perform subsequent quarterly hedge effectiveness assessments on a quantitative basis and that all hedge documentation requirements were satisfied at inception.

Entity G forecasts the purchase of 500,000 pounds of Brazilian coffee for U.S. dollars in 6 months. The agreement outlining purchase terms between Entity G and its supplier contains a pricing formula that explicitly references the Brazilian coffee index denominated in U.S. dollars. Thus, the purchase price will be based on that coffee index as of the delivery date (that is, in six months). Entity G designates the variability in cash flows related to its forecasted purchase of Brazilian coffee attributable to changes in

the Brazilian coffee index as the hedged risk. Entity G determines that the Brazilian coffee index explicitly referenced in the agreement's pricing formula is clearly and closely related to the forecasted purchase of 500,000 pounds of Brazilian coffee and therefore meets the conditions in paragraph 815-20-25-22C(b)(1). Rather than acquire a derivative instrument based on Brazilian coffee, Entity G enters into a 6-month forward contract to purchase 500,000 pounds of Colombian coffee for U.S. dollars and designates the forward contract as a hedging instrument in a cash flow hedge of the variability in cash flows attributable to changes in the explicitly referenced Brazilian coffee index component of its forecasted purchase of Brazilian coffee.

Entity G bases its assessment of hedge effectiveness on changes in forward prices, with the resulting gain or loss discounted to reflect the time value of money. Both at inception and on an ongoing basis, Entity 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 attributable to changes in the price index explicitly referenced in the agreement 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.)

In assessing hedge effectiveness on an ongoing basis, Entity 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 attributable to changes in the designated price component (Brazilian coffee index). Both changes would be measured on a cumulative basis for actual changes in the forward price of the respective coffees during the hedge period.

See Topic 820 (including paragraph 820-10-55-13) for a discussion of expected cash flows.

Because the only difference between the forward contract and forecasted purchase relates to the type of coffee (Colombian versus Brazilian), Entity 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, Entity 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 | 0.09 | 0.10 |
| × 500,000 pounds of coffee | × 500,000 | × 500,000 |
| Estimate of change in cash flows | $45,000 | $50,000 |

See Topic 820 (including paragraph 820-10-55-13) for a discussion of expected cash flows.

Using the amounts in paragraph 815-30-55-6, Entity G could evaluate effectiveness 3 months into the hedge on its first subsequent quarterly effectiveness assessment testing date 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. Entity G concludes that the hedging relationship would be highly effective, and it would record the $45,000 change in the fair value of the forward contract on Colombian coffee in other comprehensive income.

**Example 6-5: Cash flow hedge of the forecasted sale of a commodity when the critical terms match (ASC 815-30-55-20 through 55-23) – Before the adoption of ASU 2025-09**

This Example illustrates the application of the guidance in paragraphs 815-20-25-84 through 25-85 and this Subtopic to the accounting for a cash flow hedge of a forecasted sale of a commodity. The terms of the hedging derivative have been negotiated to match the terms of the forecasted transaction. Assume that there is no time value in the derivative instrument. Entity ABC has chosen to hedge the variability of the cash flows from the forecasted sale of the commodity instead of the changes in its fair value. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

Because there is no contractually specified component, Entity ABC hedges the risk of changes in its cash flows relating to changes in the sales price of a forecasted sale of 100,000 bushels of Commodity A by entering into a derivative instrument, Derivative Z. Entity ABC expects to sell the 100,000 bushels of Commodity A on the last day of Period 1. On the first day of Period 1, Entity ABC enters into Derivative Z and designates it as a cash flow hedge of the forecasted sale. Entity ABC neither pays nor receives a premium on Derivative Z (that is, its fair value is zero). Entity ABC expects that there will be perfect offset between the hedging instrument and the hedged item because all of the following conditions exist:

a. The notional amount of Derivative Z is 100,000 bushels and the forecasted sale is for 100,000 bushels.

b. The underlying of Derivative Z is the price of the same variety and grade of Commodity A that Entity ABC expects to sell (assuming delivery to Entity ABC's selling point).

c. The settlement date of Derivative Z is the last day of Period 1 and the forecasted sale is expected to occur on the last day of Period 1.

The entity need not perform an initial quantitative assessment of hedge effectiveness in accordance with paragraph 815-20-25-3(b)(2)(iv)(01) because the conditions in paragraphs 815-20-25-84 through 25-85 are met.

At inception of the hedge, the expected sales price of 100,000 bushels of Commodity A is $1,100,000. On the last day of Period 1, the fair value of Derivative Z has increased by $25,000, and the expected sales price of 100,000 bushels of Commodity A has decreased by $25,000. Both the sale of 100,000 bushels of Commodity A and the settlement of Derivative Z occur on the last day of Period 1. The following table illustrates the accounting, including the net effect on earnings and other comprehensive income, for the situation described.

| | Debit (Credit) | | | |
|---|---|---|---|---|
| | **Cash** | **Derivative** | **Other Comprehensive Income** | **Earnings[(a)]** |
| Recognize change in fair value of derivative | | $25,000 | ($25,000) | |
| Recognize revenue from sale | $1,075,000 | | | ($1,075,000) |
| Recognize settlement of derivative | 25,000 | (25,000) | | |

| | Debit (Credit) | | | |
|---|---|---|---|---|
| | Cash | Derivative | Other Comprehensive Income | Earnings[(a)] |
| Reclassify change in fair value of derivative to earnings | | | 25,000 | (25,000) |
| Total | $1,100,000 | $ - | $ - | ($1,100,000) |

(a) The change in fair value of the hedging derivative is presented in the same income statement line item as the earnings effect of the hedged item.

At the inception of the hedge, Entity ABC anticipated that it would receive $1,100,000 from the sale of 100,000 bushels of Commodity A. This Example illustrates that by hedging the risk of changes in its cash flows relating to the forecasted sale of 100,000 bushels of Commodity A, Entity ABC still received a total of $1,100,000 in cash flows even though the sales price of Commodity A declined during the period.

**Example 6-5A: Cash flow hedge of the forecasted sale of a commodity when the critical terms match (ASC 815-30-55-20 through 55-23) – After the adoption of ASU 2025-09**

This Example illustrates the application of the guidance in paragraphs 815-20-25-84 through 25-85 and this Subtopic to the accounting for a cash flow hedge of a forecasted sale of a commodity. The terms of the hedging derivative have been negotiated to match the terms of the designated price component of the forecasted transaction. Entity ABC has chosen to hedge the variability of the cash flows from the forecasted sale of the commodity instead of the changes in its fair value. For simplicity, the time value in the derivative instrument and commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

Entity ABC seeks to hedge the variability of cash flows from the forecasted sale of Commodity A in the spot market at a future date. Accordingly, Entity ABC hedges the risk of changes in its cash flows relating to changes in the sales price of a forecasted sale of 100,000 bushels of Commodity A in the spot market by entering into a derivative instrument, Derivative DEF. Entity ABC expects to sell the 100,000 bushels of Commodity A on the last day of Period 1. On the first day of Period 1, Entity ABC enters into Derivative DEF and designates it as a cash flow hedge of changes in the DEF index component of the forecasted sales price. Entity ABC determines that the DEF index is clearly and closely related (as described in paragraph 815-10-15-32(a) through (b)) to Commodity A in the pertinent spot market and concludes that the conditions in paragraph 815-20-25-22C(a) are met. Entity ABC expects that there will be perfect offset between the hedging instrument and the hedged item because all of the following conditions exist:

a. The notional amount of Derivative DEF is 100,000 bushels and the forecasted sale is for 100,000 bushels.

b. The underlying of Derivative DEF is the same as the designated price component of Commodity A that Entity ABC expects to sell.

c. The settlement date of Derivative DEF is the last day of Period 1 and the forecasted sale is expected to occur on the last day of Period 1.

d. Entity ABC neither pays nor receives a premium on Derivative DEF (that is, its fair value is zero).

The entity need not perform an initial quantitative assessment of hedge effectiveness in accordance with paragraph 815-20-25-3(b)(2)(iv)(01) because the conditions in paragraphs 815-20-25-84 through 25-85 are met.

At inception of the hedge, the expected sales price of 100,000 bushels of Commodity A is $1,100,000. On the last day of Period 1, the fair value of Derivative DEF has increased by $25,000, and the expected sales price of 100,000 bushels of Commodity A has decreased by $25,000 because of changes attributable to the DEF index. Both the sale of 100,000 bushels of Commodity A and the settlement of Derivative DEF occur on the last day of Period 1. The following table illustrates the accounting, including the net effect on earnings and other comprehensive income, for the situation described.

| | Debit (Credit) | | | |
|---|---|---|---|---|
| | Cash | Derivative | Other Comprehensive Income | Earnings[(a)] |
| Recognize change in fair value of derivative | | $25,000 | ($25,000) | |
| Recognize revenue from sale | $1,075,000 | | | ($1,075,000) |
| Recognize settlement of derivative | 25,000 | (25,000) | | |
| Reclassify change in fair value of derivative to earnings | | | 25,000 | (25,000) |
| Total | $1,100,000 | $ - | $ - | ($1,100,000) |

(a) The change in fair value of the hedging derivative is presented in the same income statement line item as the earnings effect of the hedged item.

At inception of the hedge, Entity ABC anticipated that it would receive $1,100,000 from the sale of 100,000 bushels of Commodity A. This Example illustrates that by hedging the risk of cash flow variability attributable to changes in the DEF index component of the forecasted sale of 100,000 bushels of Commodity A, Entity ABC still received a total of $1,100,000 in cash flows even though the sales price of Commodity A declined during the period.

**Example 6-6: Designation and discontinuance of a cash flow hedge of the forecasted purchase of inventory (ASC 815-30-55-40 through 55-51)**

This Example illustrates the effect on earnings and other comprehensive income of discontinuing a cash flow hedge by dedesignating the hedging derivative under paragraph 815-30-40-1(c) before the variability of the cash flows from the hedged forecasted transaction has been eliminated. It also discusses the effect that the location of a physical asset has on the effectiveness of a hedging relationship. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

On February 3, 20X1, Entity JKL forecasts the purchase of 100,000 bushels of corn on May 20, 20X1. The contract does not contain a contractually specified component, and[27] Entity JKL designates changes in cash flows related to the forecasted transaction attributable to all changes in the purchase price as the hedged risk. It expects to sell finished products produced from the corn on May 31, 20X1. On February 3, 20X1, Entity JKL enters into 20 futures contracts, each for the purchase of 5,000 bushels of corn on May 20, 20X1 (100,000 in total), and designates those contracts as a hedging instrument in a cash flow hedge of the forecasted purchase of corn.

[27] Following the adoption of ASU 2025-09, the phrase “The contract does not contain a contractually specified component, and” will be deleted from this paragraph. Refer to the ASU for effective date and transition requirements.

Entity JKL chooses to assess effectiveness by comparing the entire change in fair value of the futures contracts to changes in the expected cash flows on the forecasted transaction. Entity JKL estimates its expected cash flows on the forecasted transaction based on the futures price of corn adjusted for the difference between the cost of corn delivered to Chicago and the cost of corn delivered to Minneapolis. Entity JKL does not choose to use a tailing strategy (as described in paragraph 815-20-25-121). Entity JKL expects changes in fair value of the futures contracts to be highly effective at offsetting changes in the expected cash outflows for the forecasted purchase of corn because both of the following conditions exist:

a. The futures contracts are for the same variety and grade of corn that Entity JKL plans to purchase.

b. On May 20, 20X1, the futures price for delivery on May 20, 20X1 will be equal to the spot price (because futures prices and spot prices converge as the delivery date approaches).

However, the hedge may not achieve perfect offset between the hedged item and hedging instrument because of the difference in the delivery location between the hedging instrument and forecasted transaction.

Entity JKL will purchase corn for delivery to its production facilities in Minneapolis, but the price of the futures contracts is based on delivery of corn to Chicago. Changes in the difference between the price of corn delivered to Chicago and the price of corn delivered to Minneapolis would result in not achieving perfect offset between the hedged item and hedging instrument and, if of significant magnitude, may preclude the hedging relationship from achieving highly effective offset.

On February 3, 20X1, the futures price of corn for delivery to Chicago on May 20, 20X1, is $2.6875 per bushel resulting in a total price of $268,750 for 100,000 bushels.

On May 1, 20X1, Entity JKL dedesignates the related futures contracts and closes them out by entering into offsetting contracts on the same exchange. As of that date, Entity JKL had recognized in accumulated other comprehensive income gains on the futures contracts of $26,250. Entity JKL still plans to purchase 100,000 bushels of corn on May 20, 20X1. Consequently, the gains that occurred before dedesignation will remain in other comprehensive income until the finished product is sold. If Entity JKL had not closed out the futures contracts when it dedesignated them, any further gains or losses would have been recognized in earnings.

On May 20, 20X1, Entity JKL purchases 100,000 bushels of corn, and on May 31, 20X1, Entity JKL sells the finished product.The futures prices of corn that are in effect on key dates are assumed to be as follows.

| Date | Futures Price per Bushel for Delivery to Chicago on May 20, 20X1 | Futures Price Adjusted for Delivery to Minneapolis on May 20, 20X1 |
|---|---|---|
| Inception of hedging relationship—February 3, 20X1 | $2.6875 | $2.7375 |
| End of quarter—March 31, 20X1 | 3.1000 | 3.1500 |
| Discontinue hedge—May 1, 20X1 | 2.9500 | 3.0000 |
| Purchase of corn—May 20, 20X1 | 2.8500 | 2.9000 |

The changes in fair value of the futures contracts between inception (February 3, 20X1) and discontinuation (May 1, 20X1) of the hedge are as follows.

| | February 3–March 31, 20X1 | April 1–May 1, 20X1 |
|---|---|---|
| Futures price at beginning of period | $2.6875 | $3.1000 |
| Futures price at end of period | 3.1000 | 2.9500 |
| Change in price per bushel | 0.4125 | (0.1500) |
| Bushels under contract (20 contracts @ 5,000 bushels each) | × 100,000 | × 100,000 |
| Change in fair value—gain (loss) | $41,250 | ($15,000) |

The following table displays the entries to recognize the effects of all of the following:

a. Entering into futures contracts as a hedge of the forecasted purchase of corn

b. Dedesignating and closing out the futures contracts

c. Completing the forecasted purchase of corn

d. Selling the finished products produced from the corn.

Because the difference in prices between corn delivered to Chicago and corn delivered to Minneapolis ($.05 per bushel, as illustrated in paragraph 815-30-55-47) did not change during the period of the hedge, the hedging relationship achieved perfect offset between the hedged item and the hedging instrument. If that difference had changed, the entire change in fair value of the futures contracts would still have been recorded in accumulated other comprehensive income until the discontinuation date assuming the hedging relationship remained highly effective at offsetting variability in cash flows and the hedged forecasted transaction was still probable of occurring.

| | Debit (Credit) | | | |
|---|---|---|---|---|
| | Cash | Inventory | Other Comprehensive Income | Earnings [(a)] |
| March 31, 20X1 (end of quarter) | | | | |
| Recognize change in fair value of future contracts | $41,250 | | ($41,250) | |
| May 1, 20X1 (discontinue hedge) | | | | |
| Recognize change in fair value of future contracts | (15,000) | | 15,000 | |
| May 20, 20X1 | | | | |
| Recognize purchase of corn | (290,000) | $290,000 | | |
| May 31, 20X1 | | | | |
| Recognize cost of sale of product | | (290,000) | | $290,000 |
| Reclassify changes in fair value of futures contracts to earnings | | | 26,250 | (26,250) |
| Total | ($263,750) | $ - | $ - | $263,750 |

(a) The change in the fair value of the hedging derivative is presented in the same income statement line item as the earnings effect of the hedged item.

To simplify this Example and focus on the effects of the hedging relationship, the margin account with the clearinghouse and certain amounts that would be involved in a sale of Entity JKL's inventory (for example, additional costs of production, selling costs, and sales revenue) have been ignored.

The effect of the hedging strategy is that the cost of the corn recognized in earnings when the finished product was sold was $263,750. If the hedging relationship had not been discontinued early, the cost recognized in earnings would have been $273,750, which was the futures price of the corn, adjusted for delivery to Minneapolis, at the inception of the hedge. Without the strategy, Entity JKL would have recognized $290,000, which was the price of corn delivered to Minneapolis at the time it was purchased.

**RSM COMMENTARY:** In this example, the cash that changes hands with the clearing house through the margin account as the fair value of the futures contract changes is legally characterized as settling the futures contract (rather than collateralizing it), such that each day the futures contract has no or nominal value. As a consequence, the change in the fair value of the derivative instrument is being settled through the exchange of cash payments rather than being reflected as an adjustment to the derivative instrument's carrying amount as was the case in the preceding example, where the derivative is not settled until its maturity. Refer to the January 4, 2017, confirmation letter issued by the International Swaps and Derivatives Association (ISDA) Accounting Policy Committee to the Office of the Chief Accountant of the SEC and the related ISDA whitepaper and follow-up submissions for additional information.

**Example 6-7: Accounting for a derivative instrument's gain or loss in a cash flow hedge—Effectiveness based on changes in intrinsic value (ASC 815-30-55-63 through 55-66)**

This Example illustrates application of the accounting guidance for cash flow hedges described in paragraph 815-30-35-3. At the beginning of Period 1, Entity XYZ purchases for $9.25 an at-the-money call option on 1 unit of Commodity X with a strike price of $125.00 to hedge a forecasted purchase of 1 unit of that commodity projected to occur early in Period 5. Entity XYZ's documented policy is to assess hedge effectiveness by comparing changes in expected cash flows on the hedged transaction (based on changes in the Commodity X spot price) with changes in the option contract's intrinsic value. Because the hedging instrument is a purchased call option, its intrinsic value cannot be less than zero. If the price of the commodity is less than the option's strike price, the option is out-of-the-money. Its intrinsic value cannot decrease further regardless of how far the commodity price falls, and the intrinsic value will not increase until the commodity price increases to exceed the strike price. Thus, changes in cash flows from the option due to changes in its intrinsic value will offset changes in cash flows on the forecasted purchase only when the option is in the money or at the money. That phenomenon is demonstrated in Period 3 in the following table when the commodity price declines by $1.25. Because the commodity price is $.75 below the option's strike price, the option's intrinsic value declines by only $.50 (to zero). The effect reverses in Period 4 when the commodity index price increases by $6.50 and the option's intrinsic value increases by $5.75. [**RSM Commentary:** For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.]

| | Period 1 | Period 2 | Period 3 | Period 4 |
|---|---|---|---|---|
| **Assumptions** | | | | |
| Ending market price of Commodity X | $127.25 | $125.50 | $124.25 | $130.75 |
| Ending fair value of option: | | | | |
| Time value | $7.50 | $5.50 | $3.00 | $ - |
| Intrinsic value | 2.25 | 0.50 | - | 5.75 |
| Total | $9.75 | $6.00 | $3.00 | $5.75 |

| | Period 1 | Period 2 | Period 3 | Period 4 |
|---|---|---|---|---|
| Change in time value | ($1.75) | ($2.00) | ($2.50) | ($3.00) |
| Change in intrinsic value | 2.25 | (1.75) | (0.50) | 5.75 |
| Total current-period gain (loss) on derivative | $0.50 | ($3.75) | ($3.00) | $2.75 |
| Gain (loss) on derivative, adjusted to remove the component excluded from the effectiveness test: | | | | |
| For the current period | $2.25 | ($1.75) | ($0.50) | $5.75 |
| Cumulative | 2.25 | 0.50 | - | 5.75 |
| Change in expected future cash flows on hedged transaction: | | | | |
| For the current period | (2.25) | 1.75 | 1.25 | (6.50) |
| Cumulative | (2.25) | (0.50) | 0.75 | (5.75) |

The following are the entries required to account for the cash flow hedge. Note that consistent with paragraph 815-20-35-1(c), the change in fair value of the hedging instrument that is included in the assessment of hedge effectiveness is recorded in other comprehensive income for qualifying hedging relationships. For this type of hedging relationship, Entity XYZ elects to record changes in the option's time value excluded from the assessment of hedge effectiveness currently in earnings in accordance with paragraph 815-20-25-83B. Amounts recorded in earnings should be presented in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A:

| | | Debit (Credit) | | |
|---|---|---|---|---|
| Period | Description | Derivative | Earnings | Other Comprehensive Income |
| 1 | Adjust derivative to fair value and other comprehensive income by the calculated amount | $0.50 | $1.75 | ($2.25) |
| 2 | Adjust derivative to fair value and other comprehensive income by the calculated amount | (3.75) | 2.00 | 1.75 |
| 3 | Adjust derivative to fair value and other comprehensive income by the calculated amount | (3.00) | 2.50 | 0.50 |
| 4 | Adjust derivative to fair value and other comprehensive income by the calculated amount | 2.75 | 3.00 | (5.75) |

The amount reflected in earnings relates to the component excluded from the effectiveness test, that is, the time value component. The change in cash flows from the hedged transaction was not fully offset in Period 3. However, as described in paragraph 815-20-25-76, a purchased call option is considered effective if it provides one-sided offset.

**Example 6-8: Assessing effectiveness of a cash flow hedge of a forecasted purchase of inventory with a forward contract (contractually specified component) (ASC 815-30-55-134 through 55-141) – Before the adoption of ASU 2025-09**

This Example illustrates the application of the guidance in Subtopic 815-20 and this Subtopic for assessing effectiveness for a cash flow hedge of a forecasted purchase of inventory with a forward contract for which the hedged risk is variability in cash flows attributable to changes in a contractually specified component. Assume the entity elects to perform subsequent assessments of hedge effectiveness on a quantitative basis using a cumulative-dollar-offset approach and all hedge documentation requirements were satisfied at inception.

Entity J manufactures keys for door locks on buildings and cars. The keys are cut from sheets of metal called key plates. Entity J primarily purchases its key plates from Supplier 1 as needed. Supplier 1 and Entity J have an outstanding agreement specifying that the per-unit cost of each key plate will be determined by Supplier 1 on the first business day of each month on the basis of the following pricing formula:

a. Spot price of COMEX Zinc per pound × 0.2 pounds, plus

b. Spot price of COMEX Copper per pound × 0.1 pounds, plus

c. The current cost of refining copper and zinc into key plates, plus

d. The current cost of transporting the key plates to Entity J.

In January 20X1, Entity J expects to purchase 100,000 key plates in July 20X1, which requires 10,000 pounds of copper for the manufacturing process. Entity J decides that it wishes to hedge only the change in value of the price of COMEX Copper used to create the key plates being purchased in July 20X1.

On January 15, 20X1, Entity J enters into a forward contract maturing on July 1, 20X1 (that is, the date on which the price of copper used to manufacture the key plates is fixed) to purchase 10,000 pounds of COMEX Copper at $2.10 per pound. Any settlement amount on the forward contract will be based on the difference between the contract price of $2.10 per pound and the spot price of COMEX Copper on the maturity date (July 1, 20X1), multiplied by the notional amount of 10,000 pounds.

Entity J designates a cash flow hedge in which the hedging instrument is the forward contract, the hedged item is the forecasted purchase of key plates in July 20X1, and the hedged risk is the variability in the purchase price of the key plates attributable to changes in the COMEX Copper price index, which is a contractually specified component within the frame agreement. Entity J documents in its hedge documentation that the requirements to designate variability in cash flows attributable to changes in a contractually specified component as the hedged risk in paragraph 815-20-25-22A are met.

Entity J bases its assessment of hedge effectiveness on cumulative changes in the fair value of the hedging instrument and the hedged item attributable to changes in the hedged risk.

In assessing hedge effectiveness on an ongoing basis, Entity J must consider the extent of offset between the change in expected cash flows on the hedging instrument (the copper forward contract) and the hedged item attributable to changes in the hedged risk (change in expected cash flows associated with forecasted purchases of key plates attributable to changes in the COMEX Copper price index). The table below illustrates the cumulative changes in the hedging instrument and hedged item attributable to changes in the hedged risk as of the first subsequent quarterly effectiveness assessment date.

| | Estimate of Change in Cash Flows | |
|---|---|---|
| | Hedging Instrument | Hedged Item Due to Fluctuation in Hedged Risk |
| Forward price of copper (dollars per pound) | | |
| At hedge inception (Jan 15, 20X1) | $2.10 | $2.10 |
| At first subsequent assessment date (March 31, 20X1) | $2.25 | $2.25 |
| Change in forward price of copper | $0.15 | $0.15 |

| | | |
|---|---|---|
| Cumulative change in copper (per pound) × 10,000 pounds of copper | $1,500.00 | $1,500.00 |

Entity J could assess effectiveness as of March 31, 20X1, by comparing the $1,500 change in the hedging instrument with the $1,500 change in the hedged item attributable to changes in the hedged risk because the hedging instrument's maturity date and the date on which the price of copper will be fixed match (that is, July 1, 20X1).

**Example 6-8A: Assessing effectiveness of a cash flow hedge of a forecasted purchase of inventory with a forward contract (ASC 815-30-55-134 through 55-141) – After the adoption of ASU 2025-09**

This Example illustrates the application of the guidance in Subtopic 815-20 and this Subtopic for assessing effectiveness for a cash flow hedge of a forecasted purchase of inventory with a forward contract for which the hedged risk is variability in cash flows attributable to changes in an explicitly referenced variable component of the purchase price of the inventory. Assume the entity elects to perform subsequent assessments of hedge effectiveness on a quantitative basis using a cumulative-dollar-offset approach and all hedge documentation requirements were satisfied at inception.

Entity J manufactures keys for door locks on buildings and cars. The keys are cut from sheets of metal called key plates. Entity J primarily purchases its key plates from Supplier 1 as needed. Supplier 1 and Entity J have an outstanding agreement specifying that the per-unit cost of each key plate will be determined by Supplier 1 on the first business day of each month on the basis of the following pricing formula:

a. Spot price of COMEX Zinc per pound × 0.2 pounds, plus

b. Spot price of COMEX Copper per pound × 0.1 pounds, plus

c. The current cost of refining copper and zinc into key plates, plus

d. The current cost of transporting the key plates to Entity J.

In January 20X1, Entity J expects to purchase 100,000 key plates in July 20X1, which requires 10,000 pounds of copper for the manufacturing process. Entity J decides that it wishes to hedge only the change in value of the price of COMEX Copper used to create the key plates being purchased in July 20X1.

On January 15, 20X1, Entity J enters into a forward contract maturing on July 1, 20X1 (that is, the date on which the price of copper used to manufacture the key plates is fixed) to purchase 10,000 pounds of COMEX Copper at $2.10 per pound. Any settlement amount on the forward contract will be based on the difference between the contract price of $2.10 per pound and the spot price of COMEX Copper on the maturity date (July 1, 20X1), multiplied by the notional amount of 10,000 pounds.

Entity J designates a cash flow hedge in which the hedging instrument is the forward contract, the hedged item is the forecasted purchase of key plates in July 20X1, and the hedged risk is the variability in the purchase price of the key plates attributable to changes in the COMEX Copper price index. Entity J determines that the COMEX Copper price index explicitly referenced in the agreement's pricing formula is clearly and closely related (as described in paragraph 815-10-15-32(a) through (b)) to key plates and concludes that the conditions in paragraph 815-20-25-22C(b)(1) are met.

Entity J bases its assessment of hedge effectiveness on cumulative changes in the fair value of the hedging instrument and the hedged item attributable to changes in the hedged risk.

In assessing hedge effectiveness on an ongoing basis, Entity J must consider the extent of offset between the change in expected cash flows on the hedging instrument (the copper forward contract) and the hedged item attributable to changes in the hedged risk (change in expected cash flows associated with forecasted purchases of key plates attributable to changes in the COMEX Copper price index). The

table below illustrates the cumulative changes in the hedging instrument and hedged item attributable to changes in the hedged risk as of the first subsequent quarterly effectiveness assessment date.

| | Estimate of Change in Cash Flows | |
|---|---|---|
| | Hedging Instrument | Hedged Item Due to Fluctuation in Hedged Risk |
| Forward price of copper (dollars per pound) | | |
| At hedge inception (Jan 15, 20X1) | $2.10 | $2.10 |
| At first subsequent assessment date (March 31, 20X1) | $2.25 | $2.25 |
| Change in forward price of copper | $0.15 | $0.15 |
| Cumulative change in copper (per pound) × 10,000 pounds of copper | $1,500.00 | $1,500.00 |

Entity J could assess effectiveness as of March 31, 20X1, by comparing the $1,500 change in the hedging instrument with the $1,500 change in the hedged item attributable to changes in the hedged risk because the hedging instrument's maturity date and the date on which the price of copper will be fixed match (that is, July 1, 20X1).

**Example 6-9: Designation of a cash flow hedge of a forecasted purchase of inventory for which commodity exposure is managed centrally (ASC 815-30-55-142 through 55-148) – Before the adoption of ASU 2025-09**

This Example illustrates the application of the guidance in Subtopic 815-20 and this Subtopic to the designation of a cash flow hedge of a forecasted purchase of inventory in which the commodity exposure is managed centrally at the aggregate level. Assume the entity elects to perform subsequent assessments of hedge effectiveness on a qualitative basis and all hedge documentation requirements were satisfied at inception.

Entity Q is seeking to hedge the variability in cash flows associated with commodity price risk of its monthly plastic purchases for the next 12 months. It has two different manufacturing plant locations (Plant A and Plant B) that are purchasing five different grades of plastic from Supplier A. The plastic purchase price for each month is based on the month-end Joint Plastic (JP) index and a fixed basis differential component. The fixed basis differential offered by the supplier is determined by:

a. The grade of the plastic purchased

b. The distance between the plant location and supplier location.

At January 1, 20X1, Entity Q enters into a supply agreement with Supplier A to purchase plastic over the next 12 months. The respective agreements allow Entity Q to purchase the various grades of plastic at both of its plant locations as the need arises over the following year. The following table summarizes the pricing provisions contained in the supply agreement for each grade of plastic.

| | Grade 1 | Grade 2 | Grade 3 | Grade 4 | Grade 5 |
|---|---|---|---|---|---|
| Plant A | JP + $0.14 | JP + $0.11 | JP + $0.09 | JP + $0.05 | JP – $0.02 |
| Plant B | JP + $0.16 | JP + $0.12 | JP + $0.07 | JP + $0.06 | JP – $0.03 |

Entity Q's risk management objective is to hedge the variability in the purchase price of plastic attributable to changes in the JP index of the first 80,000 pounds of plastic purchased in each month regardless of grade or plant location delivered to. To accomplish this objective, Entity Q executes 12 separate forward contracts at January 1, 20X1, to purchase plastic as follows.

| | Settlement Date | Notional Amount | Underlying Index |
|---|---|---|---|
| Jan forward | January 30, 20X1 | 80,000 (lbs) | JP |
| Feb forward | February 28, 20X1 | 80,000 (lbs) | JP |
| Mar forward | March 30, 20X1 | 80,000 (lbs) | JP |
| April forward | April 30, 20X1 | 80,000 (lbs) | JP |
| May forward | May 30, 20X1 | 80,000 (lbs) | JP |
| June forward | June 30, 20X1 | 80,000 (lbs) | JP |
| July forward | July 30, 20X1 | 80,000 (lbs) | JP |
| Aug forward | August 30, 20X1 | 80,000 (lbs) | JP |
| Sep forward | September 30, 20X1 | 80,000 (lbs) | JP |
| Oct forward | October 30, 20X1 | 80,000 (lbs) | JP |
| Nov forward | November 30, 20X1 | 80,000 (lbs) | JP |
| Dec forward | December 30, 20X1 | 80,000 (lbs) | JP |

Entity Q determines that the variable JP index referenced in the supply agreement constitutes a contractually specified component and that the requirements to designate variability in the cash flows attributable to changes in a contractually specified component as the hedged risk in paragraph 815-20-25-22A are met.

Because Entity Q determined that it will purchase at least 80,000 pounds of plastic each month in the coming 12 months to fulfill its expected manufacturing requirements, it documents that the hedged item (that is, the forecasted transaction within each month) is probable of occurring. Entity Q designates each forward contract as a cash flow hedge of the variability in cash flows attributable to changes in the contractually specified JP index on the first 80,000 pounds of plastic purchased (regardless of grade or plant location delivered to) for the appropriate month. The individual purchases of differing grades of plastic by Plant A and Plant B during each month share the risk exposure to the variability in the purchase price of the plastic attributable to changes in the contractually specified JP index. Therefore, the individual transactions in the hedged portfolio of plastic purchases for each month share the same risk exposure for which they are designated as being hedged in accordance with paragraph 815-20-25-15(a)(2).

In accordance with paragraph 815-20-25-3(b)(2)(iv)(01)(B), if Entity Q has determined the critical terms of the hedged item and hedging instrument match, it may elect to assess effectiveness qualitatively both at inception of the hedging relationship and on an ongoing basis on the basis of the following factors in accordance with paragraphs 815-20-25-84 through 25-85:

a. The hedging instrument's underlying matches the index upon which plastic purchases will be determined (that is, the JP Index).

b. The notional of the hedging instrument matches the forecasted quantity designated as the hedged item.

c. The date on which the derivatives mature matches the timing in which the forecasted purchases are expected to be made. That is, the quantity of the hedged item, 80,000 pounds, is an aggregate amount expected to be purchased over the course of the respective month (that is, the same 31- day period) in which the derivative matures.

d. Each hedging instrument was traded with at-market terms (that is, it has an initial fair value of zero).

e. Assessment of effectiveness will be performed on the basis of the total change in the fair value of the hedging instrument.

f. Although the amount of plastic being hedged each period is a cumulative amount across multiple grades of plastic, the basis differentials between grades of plastic and location are not required to be included in assessments of effectiveness because Entity Q has designated the variability in cash flows attributable to changes in the JP index (the contractually specified component) as the hedged risk within its purchases of plastics.

**Example 6-9A: Designation of a cash flow hedge of a forecasted purchase of inventory for which commodity exposure is managed centrally (ASC 815-30-55-142 through 55-148) – After the adoption of ASU 2025-09**

This Example illustrates the application of the guidance in Subtopic 815-20 and this Subtopic to the designation of a cash flow hedge of a forecasted purchase of inventory in which the commodity exposure is managed centrally at the aggregate level. Assume the entity elects to perform subsequent assessments of hedge effectiveness on a qualitative basis and all hedge documentation requirements were satisfied at inception.

Entity Q is seeking to hedge the variability in cash flows associated with commodity price risk of its monthly plastic purchases for the next 12 months. It has two different manufacturing plant locations (Plant A and Plant B) that are purchasing five different grades of plastic from Supplier A. The plastic purchase price for each month is based on the month-end Joint Plastic (JP) index and a fixed basis differential component. The fixed basis differential offered by the supplier is determined by:

a. The grade of the plastic purchased

b. The distance between the plant location and supplier location.

At January 1, 20X1, Entity Q enters into a supply agreement with Supplier A to purchase plastic over the next 12 months. The respective agreements allow Entity Q to purchase the various grades of plastic at both of its plant locations as the need arises over the following year. The following table summarizes the pricing provisions contained in the supply agreement for each grade of plastic.

| | Grade 1 | Grade 2 | Grade 3 | Grade 4 | Grade 5 |
|---|---|---|---|---|---|
| Plant A | JP + $0.14 | JP + $0.11 | JP + $0.09 | JP + $0.05 | JP – $0.02 |
| Plant B | JP + $0.16 | JP + $0.12 | JP + $0.07 | JP + $0.06 | JP – $0.03 |

Entity Q's risk management objective is to hedge the variability in the purchase price of plastic attributable to changes in the JP index of the first 80,000 pounds of plastic purchased in each month regardless of grade or plant location delivered to. To accomplish this objective, Entity Q executes 12 separate forward contracts at January 1, 20X1, to purchase plastic as follows.

| | Settlement Date | Notional Amount | Underlying Index |
|---|---|---|---|
| Jan forward | January 30, 20X1 | 80,000 (lbs) | JP |
| Feb forward | February 28, 20X1 | 80,000 (lbs) | JP |
| Mar forward | March 30, 20X1 | 80,000 (lbs) | JP |
| April forward | April 30, 20X1 | 80,000 (lbs) | JP |
| May forward | May 30, 20X1 | 80,000 (lbs) | JP |
| June forward | June 30, 20X1 | 80,000 (lbs) | JP |
| July forward | July 30, 20X1 | 80,000 (lbs) | JP |
| Aug forward | August 30, 20X1 | 80,000 (lbs) | JP |

| | Settlement Date | Notional Amount | Underlying Index |
|---|---|---|---|
| Sep forward | September 30, 20X1 | 80,000 (lbs) | JP |
| Oct forward | October 30, 20X1 | 80,000 (lbs) | JP |
| Nov forward | November 30, 20X1 | 80,000 (lbs) | JP |
| Dec forward | December 30, 20X1 | 80,000 (lbs) | JP |

Entity Q designates the variability in cash flows attributable to changes in the JP index component as the hedged risk. Entity Q determines that the JP index explicitly referenced in the supply agreement is clearly and closely related (as described in paragraph 815-10-15-32(a) through (b)) to plastic and concludes that the conditions in paragraph 815-20-25-22C(b)(1) are met.

Because Entity Q determined that it will purchase at least 80,000 pounds of plastic each month in the coming 12 months to fulfill its expected manufacturing requirements, it documents that the hedged item (that is, the forecasted transaction within each month) is probable of occurring. Entity Q designates each forward contract as a cash flow hedge of the variability in cash flows attributable to changes in the explicitly referenced JP index on the first 80,000 pounds of plastic purchased (regardless of grade or plant location delivered to) for the appropriate month.

In accordance with paragraph 815-20-25-3(b)(2)(iv)(01)(B), if Entity Q has determined that the critical terms of the hedged item and hedging instrument match, it may elect to assess effectiveness qualitatively both at inception of the hedging relationship and on an ongoing basis on the basis of the following factors in accordance with paragraphs 815-20-25-84 through 25-85:

a. The hedging instrument's underlying matches the index upon which plastic purchases will be determined (that is, the JP index).

b. The notional of the hedging instrument matches the forecasted quantity designated as the hedged item.

c. The date on which the derivatives mature matches the timing in which the forecasted purchases are expected to be made. That is, the quantity of the hedged item (80,000 pounds) is an aggregate amount expected to be purchased over the course of the respective month (that is, the same 31-day period) in which the derivative matures.

d. Each hedging instrument was traded with at-market terms (that is, it has an initial fair value of zero).

e. Assessment of effectiveness will be performed on the basis of the total change in the fair value of the hedging instrument.

f. Although the amount of plastic being hedged each period is a cumulative amount across multiple grades of plastic, the basis differentials between grades of plastic and location are not required to be included in assessments of effectiveness because Entity Q has designated the variability in cash flows attributable to changes in the JP index (the explicitly referenced variable component of the forecasted purchase price) as the hedged risk.

In accordance with paragraph 815-20-55-23B, if Entity Q assesses hedge effectiveness in accordance with paragraphs 815-20-25-84 through 25-85 and applies the similar risk assessment method described in paragraph 815-20-55-23A(a), it also may assume that the hedged risks related to the group of forecasted transactions are similar.

**Example 6-10: Designation of a price component as the hedged risk in a forecasted purchase of nonfinancial assets in a cash flow hedge for which any contractual shortfall is expected to be purchased in the spot market (ASC 815-30-55-149 through to 55-151) – After the adoption of ASU 2025-09**

This Example illustrates the application of the guidance in paragraphs 815-20-25-15(e) and 815-20-25-22C to determine whether a price component is eligible to be designated as the hedged risk in a forecasted purchase of nonfinancial assets in which the associated forward contracts are accounted for as derivatives because physical settlement is not probable of occurring but it is probable that any shortfall will be purchased in the spot market. On January 1, 20X1, Entity R enters into forward contracts with multiple suppliers to purchase an aggregate 1,000 bushels of soybeans for delivery in June 20X1 to use in its operations. Each contract stipulates that the purchase price per bushel is equal to the ABC soybean index price (June maturity) plus a variable basis differential representing transportation costs. Furthermore, each contract permits net settlement of the contract if the quality of the soybeans delivered does not meet Entity R's specifications. If that happens, Entity R will net settle the affected forward contracts and purchase soybeans of the appropriate specifications in the spot market to make up for any shortfall. Given a history of suppliers not delivering soybeans meeting the required specifications, Entity R cannot assert that any specific forward contract will be physically settled and, therefore, determines that the forward contracts do not qualify for the normal purchases and normal sales scope exception.

On January 1, 20X1, Entity R enters into a futures contract to fix the price of 1,000 bushels of ABC soybeans in accordance with its risk management objective. Entity R designates this futures contract as a hedge of the variability in cash flows attributable to changes in the ABC soybean index (a component of the price of soybeans) related to the first 1,000 bushels of soybeans forecasted to be purchased in June 20X1. The forecasted purchases include ABC soybeans purchased from suppliers in accordance with forward contracts and ABC soybeans purchased in the spot market.

Entity R determines that the ABC soybean index is an eligible hedged risk for the forecasted purchase of 1,000 bushels of ABC soybeans for delivery in June 20X1 either in the spot market or in accordance with the supplier contracts. To reach that conclusion, Entity R performs two distinct assessments. In accordance with paragraph 815-20-25-22C(a), Entity R determines that the ABC soybean index (that is, the hedged variable component) is clearly and closely related to the nonfinancial asset being purchased (that is, ABC soybeans in the pertinent spot market). In accordance with paragraph 815-20-25-22C(b)(1), Entity R determines that the ABC soybean index (that is, the hedged variable component) is explicitly referenced in the pricing formula of the supplier contracts and that the ABC soybean index is clearly and closely related to ABC soybeans purchased in accordance with the supplier contracts. Although Entity R is unable to assert that forward contracts with suppliers are probable of physical settlement, Entity R can assert that the forecasted transactions are probable of occurring through a combination of physically settled forward contracts and spot market transactions.

**Example 6-11: Designation of a price subcomponent of an explicitly referenced component in an agreement as the hedged risk in a cash flow hedge of a forecasted purchase of nonfinancial assets (ASC 815-30-55-152 through 55-155) – After the adoption of ASU 2025-09**

This Example illustrates the application of the guidance in paragraph 815-20-25-22C to determine whether a subcomponent of a component that is explicitly referenced in an agreement can be designated as the hedged risk in a cash flow hedge of a forecasted purchase of a nonfinancial asset.

Entity X is a manufacturing company that uses copper wire (that is, copper that has been drawn down to size and processed for manufacturing purposes) in the normal course of business. On January 1, 20X1, Entity X enters into a supply agreement to purchase 1,000 pounds of copper wire for its manufacturing

operations in each of the next 12 months. The supply agreement stipulates that the monthly purchase price per pound is equal to the ABC Copper Wire index price (maturing in month of delivery), plus other basis differentials. Entity X determines that the supply agreement meets the definition of a derivative in Topic 815.

Entity X is seeking to reduce its commodity price exposure to the forecasted purchase of 1,000 pounds of copper wire in each of the next 12 months. Derivatives referencing the ABC Copper Wire index are less liquid than derivatives referencing the core underlying ingredient in copper wire, which is raw copper. Entity X determines that the market for the ABC Copper Wire index is based on the price of raw copper plus processing costs, that it takes one pound of raw copper to produce one pound of copper wire, and that raw copper prices are based on COMEX Copper futures. Therefore, on January 1, 20X1, Entity X executes 12 futures contracts, each having a 1,000-pound notional amount tied to the COMEX Copper index futures price (maturing in successive months). Those derivatives are designated as hedging the risk of cash flow variability attributable to the COMEX Copper index (a subcomponent of the explicitly referenced ABC Copper Wire index) related to its forecasted purchase of the first 1,000 pounds of copper wire per month.

Entity X applies the normal purchases and normal sales scope exception in accordance with Subtopic 815-10 to the contract to purchase copper wire. Therefore, Entity X determines that the condition in paragraph 815-20-25-22C(b)(1) is met and the ABC Copper Wire index (the explicitly referenced component in the forward contract) is clearly and closely related (as described in paragraph 815-10-15-32(a) through (b)) to the forecasted transaction in accordance with paragraph 815-20-55-18D. In addition, Entity X determines that the COMEX Copper index is clearly and closely related (as described in paragraph 815-10-15-32(a) through (b)) to the explicitly referenced ABC Copper Wire index. Thus, Entity X determines that the COMEX Copper index is an eligible risk subcomponent in accordance with paragraph 815-20-25-22C(b)(2).

**Example 6-12: Designation of a price component as the hedged risk in a cash flow hedge of a forecasted purchase of nonfinancial assets in the spot market (ASC 815-30-55-156 through 55-159) – After the adoption of ASU 2025-09**

This Example illustrates the application of the guidance in paragraph 815-20-25-22C to determine whether a price component in a forecasted purchase of a nonfinancial asset in the spot market is eligible to be designated as the hedged risk.

On December 31, 20X0, Entity C forecasts that it will purchase at least 20,000 MMBtus of natural gas in the spot market for production purposes in June 20X1. On January 1, 20X1, Entity C enters into a futures contract to fix the price of 20,000 MMBtus of natural gas that is tied to the XYZ National NatGas index (June 20X1 maturity) in accordance with its risk management objective. Entity C designates the futures contract as the hedging instrument in a cash flow hedge of the variability in cash flows attributable to the XYZ National NatGas index component related to its forecasted purchase of the first 20,000 MMBtus of natural gas in the spot market in June 20X1.

Entity C concludes that agreements to purchase natural gas in this region are frequently priced using one of the following formulas:

a. ABC Regional NatGas index price + Fixed Spread

b. XYZ National NatGas index price + Cost to Transport + Fixed Spread.

Purchases of natural gas in this region are often tied to the ABC Regional NatGas index because it reflects the natural gas prices of the closest geographical proximity to an entity. Additionally, the XYZ National NatGas index is a nationally recognized index that is commonly used by market participants to price contracts throughout the country, adjusted for the cost to transport that natural gas to various hubs

for sale. Entity C reasonably determines that the ABC Regional NatGas index and the XYZ National NatGas index are not extraneous to changes in the fair value of natural gas in the region of the transaction.

Entity C determines that the XYZ National NatGas index component is clearly and closely related (as described in paragraph 815-10-15-32(a) through (b)) to the forecasted purchase of natural gas in the spot market in accordance with paragraph 815-20-25-22C(a). Because the price of natural gas being purchased by Entity C is not set forth in an agreement, the guidance in paragraph 815-20-25-22C(b) would not apply. If Entity C had chosen to designate the ABC Regional NatGas index as the hedged risk and determined that this index was clearly and closely related to the forecasted purchase of natural gas in the spot market, that also would be permissible under paragraph 815-20-25-22C(a).

**Example 6-13: Designation of multiple price components as the hedged risks in a group of forecasted purchases of nonfinancial assets in not-yet-existing contracts (ASC 815-30-55-160 through 55-164) – After the adoption of ASU 2025-09**

This Example illustrates the application of the guidance in paragraph 815-20-25-22C to determine whether multiple price components are eligible to be designated as the hedged risks in a group of forecasted purchases of nonfinancial assets when uncertainty exists about which component or components will be explicitly referenced in the pricing formulas of not-yet-existing contracts.

Entity Y's objective is to hedge the variability in cash flows attributable to changes in the explicitly referenced component or components in not-yet-existing agreements to purchase 1,000 bushels of soybeans. On January 1, 20X1, Entity Y begins negotiations with multiple vendors to purchase 1,000 bushels of soybeans on June 30, 20X2. As of April 1, 20X1, the counterparties have not agreed on whether the pricing formula of the agreements will price the soybeans on the basis of the ABC Soybean index or the DEF Soybean index. Entity Y concludes that it is probable that 1,000 bushels of soybeans will be purchased and that the pricing formula in the agreements will reference any combination of the ABC Soybean index and the DEF Soybean index.

On April 1, 20X1, Entity Y enters into a futures contract for 1,000 bushels of ABC Soybeans maturing on June 30, 20X2. Entity Y designates that futures contract as a hedge of cash flow variability attributable to the designated hedged risk for the forecasted purchase of the first 1,000 bushels of soybeans purchased under agreements with a pricing formula that references any combination of the ABC Soybean index and the DEF Soybean index on June 30, 20X2. Because of the uncertainty of whether the not-yet-existing agreements' pricing formulas will reference the ABC Soybean index or the DEF Soybean index, Entity Y designates both indexes as the hedged risks in the cash flow hedge.

At hedge inception, Entity Y expects that the forecasted transactions will have multiple risks occurring at the same time (that is, the purchase agreements will reference a combination of the ABC Soybean index and the DEF Soybean index), but Entity Y is uncertain what combination of the ABC Soybean index and the DEF Soybean index will be explicitly referenced in the pricing formulas in the agreements. Entity Y determines that both the ABC Soybean index and the DEF Soybean index will be eligible components for designation in accordance with paragraph 815-20-25-22C(b) upon execution of the purchase agreements. Entity Y elects to assess whether the hedged risks in the group of individual forecasted transactions have similar risk exposure by assessing whether the designated hedging instrument is highly effective in achieving offsetting changes in cash flows attributable to each hedged risk in the group, on an individual basis, in accordance with paragraph 815-20-55-23A(a). That is, Entity Y assesses and determines that the hedging instrument is highly effective against both designated risks (ABC and DEF Soybean indexes) in the group. Entity Y uses that assessment as a "dual purpose" test to support that the forecasted transactions in the group are similar and that the hedging instrument is highly effective at achieving offsetting cash flows of the forecasted transactions, regardless of whether the ABC Soybean

index or the DEF Soybean index is ultimately referenced in the not-yet-existing agreements' pricing formulas.

On June 30, 20X1, Entity Y enters into forward contracts with multiple vendors. Each agreement includes a pricing formula referencing either the ABC Soybean index or the DEF Soybean index, with a June 30, 20X2 delivery date. The hedging relationship continues to be eligible for hedge accounting in accordance with paragraph 815-20-25-22C(b). Entity Y determines that the designated hedged risks (ABC and DEF Soybean indexes) in the group are similar because the hedging instrument is highly effective against both risks in the group in accordance with paragraph 815-20-55-23A(a). Therefore, Entity Y concludes that the relationship continues to be eligible for hedge accounting.

**Example 6-14: Firm commitment as hedged item in relation to long-term supply contracts with embedded price caps or floors (ASC 815-20-55-84 through 55-87)**

This Example illustrates the application of paragraph 815-20-25-12 and the definition of firm commitment in relation to long-term supply contracts with embedded price caps or floors.

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

The supply contract in its entirety does not meet the definition of a derivative instrument due to the absence of a net settlement characteristic—that is, the contract does not permit or require net settlement (see guidance beginning in paragraph 815-10-15-100), there is no market mechanism (see guidance beginning in paragraph 815-10-15-110), and it does not require delivery of an asset that is readily convertible to cash (see guidance beginning in paragraph 815-10-15-119). Pursuant to the guidance in paragraph 815-15-25-19, the embedded cap on the selling price is an option that does not warrant separate accounting under Subtopic 815-15 because it is clearly and closely related to the host supply contract. In addition, because the supply contract is not remeasured with changes in fair value reported currently in earnings, it meets the criteria in paragraph 815-20-25-43(c)(3) to qualify as a hedged item in a fair value hedge. Entity A wishes to enter into a transaction to hedge the risk of changes in the fair value of the embedded written price cap in the supply contract. Accordingly, it purchases a cash-settled call option with a strike price of $15 per pound and a notional amount equal to the quantity specified in the supply contract. In accordance with the guidance in paragraph 815-20-25-12, a supply contract for which the contract price is fixed only under certain circumstances (such as when market prices are above an embedded price cap) meets the definition of a firm commitment for purposes of designating the hedged item in a fair value hedge. Therefore, if the selling price in a supply contract is subject to a cap, a floor, or both, either party to the contract is eligible to apply fair value hedge accounting in a hedging relationship to hedge the fair value exposure of the cap or floor. For the range of monthly average list prices above $15 per pound, the contract has a fixed $15 per pound price. Thus, Entity A may designate the written cap embedded in the supply contract as the hedged item in a fair value hedging relationship provided the other criteria for a fair value hedge are met. The embedded written cap in this Example is a specific portion of the contract that is subject to the risk of changes in fair value due to changes in the list price of the underlying materials. Because it is not accounted for separately from the supply contract, the embedded written cap may be designated as the hedged item in a fair value hedge. Paragraph 815-20-25-12 allows a nonbifurcated call option that is embedded in a supply contract to be the hedged item in a fair value hedge regardless of whether that supply contract is a recognized asset or liability or an unrecognized firm commitment.

**Example 6-15: Fair value hedge of natural gas inventory with futures contracts (ASC 815-25-55-1 through 55-7)**

This Example illustrates the guidance in Sections 815-20-25, 815-20-35, and 815-25-35 for how an entity may assess hedge effectiveness in a fair value hedge of natural gas inventory with futures contracts. Assume that the hedge satisfied all of the criteria for hedge accounting at inception.

Entity A has 20,000 million British thermal units of natural gas stored at its location in West Texas. To hedge the fair value exposure of the natural gas, Entity A sells the equivalent of 20,000 million British thermal units of natural gas futures contracts on a national mercantile exchange. The futures contracts prices are based on delivery of natural gas at the Henry Hub gas collection point in Louisiana.

The price of Entity A's natural gas inventory in West Texas and the price of the natural gas that is the underlying for the futures contracts it sold will differ as a result of regional factors (such as location, pipeline transmission costs, and supply and demand). Entity A therefore may not automatically assume that the hedge will be highly effective at achieving offsetting changes in fair value, and it cannot assess effectiveness by looking solely to the change in the price of natural gas delivered to the Henry Hub. The use of a hedging instrument with a different underlying basis than the item or transaction being hedged is generally referred to as a cross-hedge. The principles for cross-hedges illustrated in this Example also apply to hedges involving other risks. For example, the effectiveness of a hedge of interest rate risk in which one interest rate is used as a surrogate for another interest rate would be evaluated in the same way as the natural gas cross-hedge in this Example.

Both at inception of the hedge and on an ongoing basis, Entity A might assess the hedge's expected effectiveness on a quantitative basis based on the extent of correlation in recent years for periods similar to the spot prices term of the futures contracts between the spot prices of natural gas in West Texas and at the Henry Hub. If those prices have been and are expected to continue to be highly correlated, Entity A might reasonably expect the changes in the fair value of the futures contracts attributable to changes in the spot price of natural gas at the Henry Hub to be highly effective in offsetting the changes in the fair value of its natural gas inventory. In assessing effectiveness during the term of the hedge, Entity A must take into account actual changes in spot prices in West Texas and at the Henry Hub. The period of time over which correlation of prices should be assessed would be based on management's judgment in the particular circumstance.

Entity A may not assume that the change in the spot price of natural gas located at Henry Hub, Louisiana, is the same as the change in fair value of its West Texas inventory. The physical hedged item is natural gas in West Texas, not natural gas at the Henry Hub. In identifying the price risk that is being hedged, Entity A also may not assume that its natural gas in West Texas has a Louisiana natural gas component. Use of a price for natural gas located somewhere other than West Texas to assess the effectiveness of a fair value hedge of natural gas in West Texas would be inconsistent with this Subtopic and could result in an assumption that a hedge was highly effective when it was not. If the price of natural gas in West Texas is not readily available, Entity A might use a price for natural gas located elsewhere as a base for estimating the price of natural gas in West Texas. However, that base price must be adjusted to reflect the effects of factors, such as location, transmission costs, and supply and demand, that would cause the price of natural gas in West Texas to differ from the base price.

Consistent with Entity A's method of assessing whether the hedge is expected to be highly effective, the hedge would not be perfectly effective and there would be a net earnings effect to the extent that the actual change in the fair value of the futures contracts attributable to changes in the spot price of natural gas at the Henry Hub did not offset the actual change in the spot price of natural gas in West Texas per million British thermal units multiplied by 20,000.

That method excludes the change in the fair value of the futures contracts attributable to changes in the difference between the spot price and the forward price of natural gas at the Henry Hub in assessing effectiveness. The excluded amount would be recognized in earnings through an amortization approach in accordance with paragraph 815-20-25-83A or a mark-to-market approach in accordance with

paragraph 815-20-25-83B and presented in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20- 45-1A.

**Example 6-16: Fair value hedge of tire inventory with a forward contract (ASC 815-25-55-8 through 55-12)**

This Example illustrates the guidance in Sections 815-20-25, 815-20-35, and 815-25-35 for how an entity may assess hedge effectiveness in a fair value hedge of tire inventory with a forward contract. Assume that the hedge satisfied all of the criteria for hedge accounting at inception.

Entity B manufactures tires. The production of those tires incorporates a variety of physical components, of which rubber and steel are the most significant, as well as labor and overhead. Entity B hedges its exposure to changes in the fair value of its inventory of 8,000 steel-belted radial tires by entering into a forward contract to sell rubber at a fixed price.

Entity B decides to perform subsequent hedge effectiveness assessments on a quantitative basis and bases its assessment on changes in the fair value of the forward contract attributable to changes in the spot price of rubber. To determine whether the forward contract is expected to be highly effective at offsetting the change in fair value of the tire inventory, Entity B could estimate and compare such changes in the fair value of the forward contract and changes in the fair value of the tires (computed as the market price per tire multiplied by 8,000 tires) for different rubber and tire prices. Entity B also should consider the extent to which past changes in the spot prices of rubber and tires have been correlated. Because tires are a nonfinancial asset and rubber is only an ingredient in manufacturing them, Entity B may not assess hedge effectiveness by looking to the change in the fair value of only the rubber component of the steel-belted radial tires (see paragraph 815-20-25-12(e)). Both at inception of the hedge and during its term, Entity B must base its assessment of hedge effectiveness on changes in the market price of steel-belted radial tires and changes in the fair value of the forward contract attributable to changes in the spot price of rubber.

It is unlikely that this transaction would be highly effective in achieving offsetting changes in fair value. However, if Entity B concludes that the hedge will be highly effective and the hedge otherwise qualifies for hedge accounting, the hedge would have a net earnings effect to the extent that the actual changes in the following amounts did not offset:

a. The fair value of the forward contract attributable to the change in the spot price of rubber

b. The market price of steel-belted radials multiplied by the number of tires in inventory.

Because Entity B bases its assessment of effectiveness on changes in spot prices, the change in the fair value of the forward contract attributable to changes in the difference between the spot and forward price of rubber would be excluded from the assessment of effectiveness, recognized in earnings through an amortization approach in accordance with paragraph 815-20-25-83A or a mark-to-market approach in accordance with paragraph 815-20-25-83B, and presented in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A.

**Example 6-17: Fair value hedge of growing wheat with futures contracts (ASC 815-25-55-13 through 55-17)**

This Example illustrates the guidance in Sections 815-20-25, 815-20-35, and 815-25-35 for how an entity may assess hedge effectiveness in a fair value hedge of growing wheat with futures contracts. Assume that the hedge satisfied all of the criteria for hedge accounting at inception.

Entity C has a tract of land on which it is growing wheat. Historically, Entity C has harvested at least 40,000 bushels of wheat from that tract of land. Two months before its expected harvest, Entity C sells 2-

month futures contracts for 40,000 bushels of wheat, which it wants to designate as a fair value hedge of its growing wheat, rather than as a cash flow hedge of the projected sale of the wheat after harvest.

Even though the futures contracts are for the same type of wheat that Entity C expects to harvest in two months, the futures contracts and hedged wheat have different bases because the futures contracts are based on fully grown, harvested wheat, while the hedged item is unharvested wheat with two months left in its growing cycle. Entity C therefore may not automatically assume that the hedge will be highly effective in achieving offsetting changes in fair value.

To determine whether the futures contracts are expected to be highly effective in providing offsetting changes in fair value for the growing wheat, Entity C would need to estimate and compare the fair value of its growing wheat and of the futures contracts for different levels of wheat prices. Entity C may not base its estimate of the value of its growing wheat solely on the current price of wheat because that price is for grown, harvested wheat. Entity C might, however, use the current price of harvested wheat together with other relevant factors, such as additional production and harvesting costs and the physical condition of the growing wheat, to estimate the current fair value of its growing wheat crop.

It is unlikely that wheat futures contracts would be highly effective in offsetting the changes in value of growing wheat.

**Example 6-18: Fair value hedge of a commodity inventory (ASC 815-25-55-30 through 55-39)**

The following Cases illustrate application of the guidance in Sections 815-20-25, 815-20-35, and 815-25-35 to a fair value hedge of a commodity inventory:

a. The terms of the hedging derivative have been negotiated such that the hedging relationship is perfectly effective (Case A).

b. The hedging relationship is not perfectly effective (Case B).

To simplify the illustration and focus on basic concepts, the derivative instrument in Cases A and B is assumed to have no time value. In practice, a derivative instrument used for a fair value hedge of a commodity would have a time value that would change over the term of the hedging relationship. The changes in that time value may be accounted for through an amortization approach in accordance with paragraph 815-20-25-83A or a mark-to-market approach in accordance with paragraph 815-20-25-83B. Under either of those approaches, the portion of excluded components recognized in earnings should be presented in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A.

Other Examples in this Section illustrate accounting for the time value component of a derivative instrument.

For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

Cases A and B share all of the following assumptions:

a. Entity ABC decides to hedge the risk of changes during the period in the overall fair value of its entire inventory of Commodity A by entering into a derivative instrument, Derivative Z.

b. On the first day of Period 1, Entity ABC enters into Derivative Z and neither receives nor pays a premium (that is, the fair value at inception is zero).

c. Entity ABC designates the derivative instrument as a hedge of the changes in fair value of the inventory due to changes in the price of Commodity A during Period 1.

d. The hedging relationship qualifies for fair value hedge accounting. Entity ABC will assess effectiveness on a quantitative basis both initially and subsequently by comparing the entire change in fair value of Derivative Z with the change in the market price of the hedged commodity inventory.

**Case A: Perfect Effectiveness in the Hedging Relationship**

In this Case, Entity ABC expects the hedge to be perfectly effective because both of the following conditions exist:

a. The notional amount of Derivative Z matches the amount of the hedged inventory (that is, Derivative Z is based on the same number of bushels as the number of bushels of the commodity that Entity ABC designated as hedged).

b. The underlying of Derivative Z is the price of the same variety and grade of Commodity A as the inventory at the same location.

At inception of the hedge, Derivative Z has a fair value of zero and the hedged inventory has a carrying amount of $1,000,000 and a fair value of $1,100,000. On the last day of Period 1, the fair value of Derivative Z has increased by $25,000, and the fair value of the inventory has decreased by $25,000. The inventory is sold, and Derivative Z is settled on the last day of Period 1. The following table illustrates the accounting for the situation described in this Case.

| | Debit (Credit) | | | |
|---|---|---|---|---|
| **Period 1** | **Cash** | **Derivative** | **Inventory** | **Earnings [(a)]** |
| Recognize change in fair value of derivative | | $25,000 | | ($25,000) |
| Recognize change in fair value of inventory | | | ($25,000) | 25,000 |
| Recognize revenue from sale | $1,075,000 | | | (1,075,000) |
| Recognize cost of sale of inventory | | | (975,000) | 975,000 |
| Recognize settlement of derivative | 25,000 | (25,000) | | |
| Total | $1,100,000 | $ - | ($1,000,000) | ($100,000) |

(a) For presentation purposes, the change in the fair value of the hedging instrument is in the same income statement line item as the hedged item.

If Entity ABC had sold the hedged inventory at the inception of the hedge, its gross profit on that sale would have been $100,000. This Case illustrates that, by hedging the risk of changes in the overall fair value of its inventory, Entity ABC recognized the same gross profit at the end of the hedge period even though the fair value of its inventory decreased by $25,000.

**Case B: Hedging Relationship Is Not Perfectly Effective**

The hedge in Case A was perfectly effective because the gain on Derivative Z exactly offsets the loss on the inventory. However, in this Case, assume the terms of Derivative Z do not perfectly match the inventory and its fair value has increased by $22,500 as compared with the decline in fair value of the inventory of $25,000. The mismatch of $2,500 has to be recognized in earnings and presented in the same income statement line item as the earnings effect of the hedged item. The following table illustrates the accounting for the situation described in this Case.

| | Debit (Credit) | | | |
|---|---|---|---|---|
| **Period 1** | **Cash** | **Derivative** | **Inventory** | **Earnings [(a)]** |
| Recognize change in fair value of derivative | | $22,500 | | ($22,500) |
| Recognize change in fair value of inventory | | | ($25,000) | 25,000 |
| Recognize revenue from sale | $1,075,000 | | | (1,075,000) |
| Recognize cost of sale of inventory | | | (975,000) | 975,000 |
| Recognize settlement of derivative | 22,500 | (22,500) | | |
| Total | $1,097,500 | $ - | ($1,000,000) | ($97,500) |

(a) For presentation purposes, the change in the fair value of the hedging instrument is in the same income statement line item as the hedged item.

The difference between the effect on earnings in Case B and the effect on earnings in Case A is $2,500.

# 7 Hedges related to interest rate risk

## 7.1 Overview

Hedges of interest rate risk are quite common and typically arise from a desire to convert a variable-rate debt instrument to a fixed rate, or vice versa, using an interest rate swap. Some entities with variable-rate debt instruments choose to limit their exposure to changing interest rates by purchasing an interest rate cap or floor rather than using an interest rate swap to obtain a fixed rate.

The level of effort to comply with the requirements of hedge accounting and demonstrate that a hedge is highly effective can vary depending on the way a hedge is structured, as well as how it is defined and documented to meet the hedge accounting requirements. For example, a cash flow hedge of changes in cash flows attributable to a contractually specified interest rate is commonly employed in practice because it can typically be structured in such a manner that perfect effectiveness can be assumed. This strategy, along with a fair value hedge of changes in fair value attributable to a benchmark interest rate, constitute hedges of interest rate risk. Such a hedge will not be perfectly effective unless it meets the requirements for, and the entity elects, the shortcut method described in Section "Shortcut method for interest rate swaps."

It is also permissible to hedge other components of risk associated with debt instruments, such as credit risk, as well as to hedge all changes in cash flows or fair values; however, hedges that extend beyond interest rate risk can be challenging to implement and are not commonly employed in practice. If, for example, an interest rate swap or cap was used to hedge total cash flows on a variable-rate debt instrument, the hedging relationship may not be highly effective given that other factors, such as a change in the margin paid on the variable-rate index to arrive at the rate of interest on the debt instrument, would cause variability in the cash flows of the debt instrument that would not be mirrored with an interest rate swap or cap. Similarly, when hedging a portfolio of variable-rate assets, changes or differences in the composition of the portfolio, such as the prepayment of old receivables and the origination of new receivables with different credit spreads, could cause the overall hedged portfolio cash flows to change in a manner disproportionate to the change in the cash flows on the derivative instrument.

This chapter focuses on hedges of interest rate risk.

## 7.2 Hedges of interest rate risk

The term "interest rate risk" has different meanings, depending on the context in which it is used.

| Type of hedge | Context | Meaning |
|---|---|---|
| Cash flow | Recognized variable-rate financial instruments and forecasted issuances or purchases of variable-rate financial instruments | The risk of changes in the hedged item's cash flows attributable to changes in the contractually specified interest rate in the agreement |
| Cash flow | Forecasted issuances or purchases of fixed-rate financial instruments | The risk of changes in the hedged item's cash flows attributable to changes in the designated benchmark interest rate |

| Type of hedge | Context | Meaning |
|---|---|---|
| Fair value | Recognized fixed-rate financial instruments | The risk of changes in the hedged item's fair value attributable to changes in the designated benchmark interest rate |

Benchmark interest rates are defined by financial markets and represent the most widely used and quoted rates. The rates designated by the FASB as benchmark rates for the United States are:

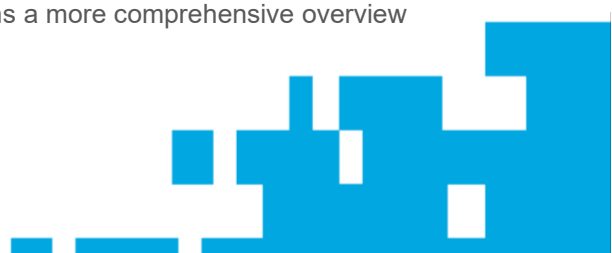
- Interest rates on direct Treasury obligations of the U.S. government
- LIBOR swap rate (eliminated after June 30, 2023)
- Fed Funds Effective Swap Rate (also referred to as the overnight index swap (OIS) Rate)
- Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate
- SOFR OIS Rate

Whereas the designated hedged risk for a fair value hedge must be a benchmark rate, the designated hedged risk for a cash flow hedge can be a contractually specified interest rate. Because of this, it is possible to hedge interest rate risk associated with variable-rate debt regardless of whether the variable rate is a benchmark rate. The main advantage to hedging interest rate risk either through a cash flow hedge of a contractually specified interest rate or a fair value hedge of a benchmark interest rate is that other factors, such as changes in credit risk that can impact the cash flows or fair value associated with the hedged item, can be ignored. If the designated hedged risk in a cash flow hedge is not a contractually specified interest rate, the hedged risk would have to be total cash flows. As a result, the hedging relationship would need to encompass changes in cash flows related to changes in all factors (including credit risk) rather than just changes due to changes in interest rates, which is the only factor most derivative instruments address. This would create significant complexity in hedging portfolios of loans that are not based on the interest rate referenced in the hedging derivative instrument (this would likely be the case hedging a portfolio of prime or SIFMA based loans). Any changes in the composition of the portfolio (e.g., the prepayment of old receivables and the origination of new receivables with different credit spreads) could cause the overall hedged portfolio cash flows to change in a manner disproportionate to the change in the cash flows on the derivative instrument designated as the hedging instrument. This could cause the hedging relationship to not be highly effective. This can be avoided by designating the hedged risk as changes in cash flows attributable to a contractually specified interest rate, which would be beneficial to entities that want to hedge variable interest payments on debt or loans that are indexed to prime or other nonbenchmark rates.

In a hedge of interest rate risk, the benchmark or contractually specified interest rate that is being hedged should be specifically identified. Additionally, the contractually specified interest rate must be the contractual rate for the interest payments that are being hedged and cannot be an implied rate. This is illustrated in ASC 815-20-55-62A, where it is noted that an entity cannot issue variable-rate debt based on its own prime rate and designate the hedged risk as changes in cash flows of the Wall Street Journal prime rate. While the entity could hedge its own prime rate, given it is a contractually specified interest rate, because the cash flows of the derivative instrument are based on a different index, this would impact the effectiveness of the hedge given the basis differences associated with the two different underlying rates.

ASC 815 outlines various methods that can be used to assess the effectiveness of a hedge involving interest rate risk using an interest rate swap as the hedging instrument. Except for the shortcut method, which can be applied to both fair value and cash flow hedges if the relevant criteria are met, these methods apply only to cash flow hedges. Additionally, the use of the simplified hedge accounting approach is restricted to certain types of hedges of certain private companies. A high-level overview of each method follows, along with a reference to the section that contains a more comprehensive overview of the requirements.





- Simplified hedge accounting approach (Section "Simplified hedge accounting approach for a cash flow hedge of a variable-rate borrowing with a receive-variable, pay-fixed interest rate swap"): Private companies (other than financial institutions) who use a plain-vanilla interest rate swap to achieve a fixed rate of interest on a variable-rate borrowing can assume the hedge is perfectly effective and account for the swap at settlement value rather than fair value if all criteria are met. Additionally, this method provides additional time for the relevant documentation to be in place.
- Shortcut method (Section "Shortcut method for interest rate swaps"): Permits the assumption of perfect effectiveness in a cash flow or fair value hedge of interest rate risk involving a recognized interest-bearing asset or liability (as well as certain firm commitments to purchase or issue a recognized asset or liability) and an interest rate swap (including one with a mirror-image call or put option) if all criteria are met.
- Change-in-variable-cash-flows method (Section "Change-in-variable-cash-flows method"): Outlines a quantitative approach that can be used to assess the effectiveness of a cash flow hedge of either interest rate risk or the risk of overall changes in hedged cash flows using an interest rate swap to hedge variable interest payments on existing or future variable-rate assets or liabilities. Permits the assumption of perfect effectiveness if all criteria are met. This method cannot be used if the fair value of the interest rate swap is not somewhat near zero at the inception of the hedge.
- Hypothetical-derivative method (Section "Hypothetical-derivative method"): Outlines a quantitative approach that can be used to assess the effectiveness of a cash flow hedge of either interest rate risk or the risk of overall changes in hedged cash flows using an interest rate swap to hedge variable interest payments on existing or future variable-rate assets or liabilities. Permits the assumption of perfect effectiveness if certain criteria are met.
- Change-in-fair-value method (Section "Change-in-fair-value method"): Outlines a quantitative approach that can be used to assess the effectiveness of a cash flow hedge of either interest rate risk or the risk of overall changes in hedged cash flows using an interest rate swap to hedge variable interest payments on existing or future variable-rate assets or liabilities.

### 7.2.1 Cash flow hedges of interest rate risk (contractually specified interest rate)

Cash flow hedges of interest rate risk commonly take forms such as:

- Use of an interest rate swap to effectively fix the interest rate associated with the forecasted interest payments on an existing variable-rate debt instrument (refer to Example 7-5 for an overview of the accounting)
- Use of an interest rate swap to effectively fix the interest rate on forecasted interest payments associated with a to be issued debt instrument (e.g., if an entity intends to issue variable-rate debt in six months that will have a five-year term, the future interest payments associated with the debt will be subject to variability due to changes in interest rates throughout the five-year term of the debt; conversely, if the entity intends to issue fixed-rate debt in six months, the future interest payments associated with the debt will be subject to variability due to changes in interest rates only until the interest rate is fixed)
- Use of an interest rate cap to effectively ensure that the interest rate on a variable-rate liability does not go above a predefined rate
- Use of an interest rate floor to effectively ensure that the interest rate on a variable-rate asset does not go below a predefined rate
- Use of an interest rate collar, which is a combination of an interest rate cap and an interest rate floor, to effectively ensure that the interest rate on a variable-rate instrument stays within a predefined range (refer to Example 7-4)

When hedging interest payments on variable-rate debt, there is no requirement that the interest payments relate to a specific debt obligation. Given that an entity's sources of debt—and, for lending institutions,

loan portfolios—are often subject to change due to events such as refinancings, pay downs or new borrowings, it is typically beneficial to designate the hedged transactions more generically, as discussed in Section 5.2.1. As noted in ASC 815-20-55-109, it is permissible to replace one source of variable-rate payments with another without terminating the existing hedging relationship, as long as the hedge remains highly effective.

#### 7.2.1.1 Hedging forecasted issuances of debt

As previously mentioned, cash flow hedging strategies can extend to a forecasted issuance of debt. Several of the cash flow hedge examples in Section 7.3 illustrate such hedges. If an entity anticipates issuing or purchasing a fixed-rate debt instrument and wants to hedge only interest rate risk, the hedged risk should be designated as variability in cash flows attributable to changes in the benchmark interest rate. Conversely, if an entity anticipates issuing or purchasing a variable-rate debt instrument and wants to hedge only interest rate risk, the hedged risk would be designated as the variability in cash flows attributable to changes in the anticipated contractually specified interest rate.

ASC 815-20-25-19B addresses what to do if an entity is unsure whether the forecasted debt that will be issued or purchased will have a fixed or variable rate. Namely, the hedged risk should be designated as the variability in cash flows attributable to changes in a stated rate that would qualify both as a benchmark interest rate if the instrument ultimately has a fixed rate and as a contractually specified interest rate if the instrument ultimately has a variable rate.

**Example 7-1: Designating the hedged risk associated with the forecasted issuance of debt**

In June, an entity decides it will enter into a $10 million debt instrument in six months (December) that is expected to have a five-year term. The entity has not yet decided whether it will issue fixed or variable-rate debt, but anticipates that, in the event variable-rate debt is issued, it will be indexed to SOFR. The entity would like to hedge its interest rate risk and therefore enters into a $10 million notional amount, pay fixed, receive SOFR interest rate swap in June with a five-year term that begins in December, to mirror the debt. The entity designates the variability of the SOFR rate as the hedged risk, given that SOFR will qualify as a contractually stated rate if the variable-rate debt is issued as anticipated and will also qualify as a benchmark rate if fixed-rate debt is issued. Assuming that in June and throughout the life of the swap, the entity meets all the requirements to elect and apply hedge accounting, the interest rate swap would be reported on the balance sheet at its fair value, from its June inception date, with changes in fair value reported in other comprehensive income.

**Variable-rate debt scenario:**

In December, the entity enters into a $10 million variable-rate debt instrument indexed to SOFR and effectively recognizes interest expense over the term of the debt and swap at a fixed rate given that amounts in other comprehensive income are reclassified into interest expense in accordance with ASC 815-30-35-38 as illustrated in Example 7-5.

**Fixed-rate debt scenario:**

In December, the entity enters into a $10 million fixed-rate debt instrument. At that point in time, the swap is terminated, given that the entity is no longer exposed to interest rate risk. The carrying amount of the swap is adjusted to its settlement amount through other comprehensive income, with the carrying amount generally extinguished through a cash payment to or from the counterparty. Given that, with the issuance of the debt, the hedged interest payments remain probable, the amounts in other comprehensive income are reclassified into interest expense in accordance with ASC 815-30-35-38.

#### 7.2.1.2 Hedged exposure is limited, but derivative instrument is not

Some debt instruments have an interest rate floor such that the variable rate on the debt cannot go below zero. If the interest rate swap that an entity enters into as a hedge of the interest rate risk associated with the debt does not have a mirror-image floor, the exposure to changes in cash flows is limited on the debt, but not the swap. Similarly, some entities seek to hedge callable debt with a swap that does not have a mirror-image call feature, in which case, the debt's exposure is limited in a way that the swap is not. As the examples that begin at ASC 815-20-55-195 demonstrate, in circumstances such as these, consideration needs to be given to whether the derivative instrument can be expected to be highly effective in light of any option that is embedded in the debt, but not mirrored in the derivative instrument. Perfect effectiveness could not be assumed in these circumstances; however, the hedging relationship could meet the requirements for an expectation of high effectiveness if the option is expected to be out of the money, with consideration given to a probability-weighted analysis of the range of possible changes in interest rates.

#### 7.2.1.3 First-payments-received technique in hedging variable interest payments on a group of loans

When hedging interest-bearing assets, such as loans, it is typically advantageous to hedge the interest payments associated with a similar portfolio of loans rather than the interest payments specific to one or a limited number of loans. For example, ASC 815-20-55-33A outlines a first-payments-received technique whereby the hedged forecasted transactions in a cash flow hedge are identified as the first interest payments based on the contractually specified interest rate received by an entity during each recurring period covered by the hedging instrument. This is further illustrated through Example 7-3.

### 7.2.2 Fair value hedges of interest rate risk

Fair value hedges of interest rate risk are most common in the financial institution industry. Lending customers often desire a fixed-rate loan; however, an institution may be unwilling to lock itself into a fixed rate for a long period of time because loans are often funded with short-term deposits that are variable in nature. Consequently, a financial institution may decide to honor customers' requests for fixed-rate loans and concurrently enter into an interest rate swap to convert the fixed rate to a variable rate. Such a hedging relationship can be structured with a separate swap for each loan the institution desires to hedge or using one interest rate swap to hedge a portfolio of loans. When hedging a portfolio of loans, the individual assets or liabilities within the portfolio need to share the risk exposure for which they are designated as being hedged, as is more fully elaborated on in Section 5.2.2.1.

In the context of a fair value hedge of a fixed-rate debt instrument, the following are eligible to be designated as the risk being hedged:

- Changes in the overall fair value of the entire instrument
- Changes in its fair value attributable to changes in the designated benchmark interest rate (referred to as interest rate risk)
- Changes in its fair value attributable to credit risk
- Both interest rate risk and credit risk

Most commonly, entities elect to hedge solely interest rate risk, as that can be accomplished with a straightforward interest rate swap. Example 7-12 illustrates the accounting for such a fair value hedge.

Certain elections allowed by ASC 815 are meant to help align hedge accounting and common risk management strategies. For example:

- The change in fair value of the hedged item may be measured on the basis of the benchmark rate component rather than on the basis of full contractual coupon cash flows, as illustrated in part through Example 7-14, Example 7-15 and Example 7-16. Limiting the measurement of the change in the fair value of the hedged item to the benchmark rate component should increase the likelihood that the

hedging relationship be deemed highly effective by excluding credit factors that would impact the spread between the benchmark rate and full contractual coupon cash flows.

- The hedged item in a partial-term hedge may be measured for changes in fair value attributable to interest rate risk by assuming it has a term that reflects only the designated cash flows being hedged, as illustrated in part through Example 7-15. Without electing to make this assumption, it could be challenging to establish an effective hedging relationship, given that the principal repayment of the debt would occur subsequent to the maturity date of the hedging instrument. Hence, the FASB decided to permit an assumption that the maturity of the hedged item occurs on the date in which the last hedged cash flow is due and payable. Furthermore, there can be multiple separately designated partial-term fair value hedging relationships of a single financial instrument outstanding at the same time, and the issuance of the hedged item is assumed to occur on the date the first hedged cash flow begins to accrue. An entity is also permitted to measure the change in fair value of the hedged item attributable to interest rate risk with this assumed term when the hedged item is designated in a hedge of both interest rate and foreign exchange risk. However, the change in carrying value of the hedged item attributable to foreign exchange risk should be measured based on changes in the foreign currency spot rate in accordance with ASC 815-25-35-18.
- An entity may consider only how changes in the benchmark interest rate affect a decision to settle a prepayable debt instrument before its scheduled maturity when calculating the change in the fair value of the hedged item (refer to Section 7.2.2.1 for additional information).
- A portfolio layer method designation may be used when hedging a closed portfolio of prepayable or nonprepayable financial assets in which the hedged item can be designated as an amount that is not expected to be affected by prepayments, defaults and other events that could impact cash flows (refer to Section "Portfolio layer method" for additional information).

While these elections can make it easier to establish a highly effective fair value hedge, absent qualifying for the shortcut method discussed in Section "Shortcut method for interest rate swaps," a fair value hedge is unlikely to be perfectly effective for certain reasons—including the fact that the risk of nonperformance (i.e., counterparty creditworthiness) is considered when computing the change in the fair value of the derivative instrument, but not considered when computing the change in fair value of the hedged item in a fair value hedge of interest rate risk.

### 7.2.2.1 Prepayable debt instruments

As it relates to the third bullet point in the preceding section, an entity may elect to consider only how changes in the benchmark interest rate affect the likelihood of settlement before scheduled maturity. As noted in ASC 815-25-35-13A, the factors considered when assessing the effectiveness of a hedge should be consistent with the factors that are incorporated when adjusting the carrying amount of the hedged item. Therefore, if an election is made to consider only how changes in the benchmark interest rate affect the decision to prepay a debt instrument when assessing hedge effectiveness, only that factor should be considered when adjusting the carrying amount of the hedged item.

"Prepayable" is defined in the ASC Master Glossary as "Able to be settled by either party before its scheduled maturity." Based on this, the following types of instruments are considered prepayable. The right hand column provides views for how changes in the fair value of the prepayment option would be measured when the prepayment option is designated as a hedged item.

| Type of instrument | How change in fair value is measured |
|---|---|
| Instruments that have noncontingent features that are currently exercisable and prepayable at any time (e.g., instruments with yield maintenance agreements and make-whole provisions, which are designed to compensate an investor for the loss of interest payments due to prepayment) | When measuring changes in the fair value of the hedged item attributable to interest rate risk, consideration should only be given to how the effect of changes in benchmark interest rates affect the decision to prepay. |

| Type of instrument | How change in fair value is measured |
|---|---|
| | For instruments with make-whole provisions, because the issuer is indifferent to exercising based on interest rates, this type of feature does not affect the assessment of effectiveness or measurement of the change in fair value of the hedged item attributable to benchmark interest rates. |
| Instruments that will become prepayable solely due to the passage of time if they are prepayable at some point during the hedging relationship | When measuring changes in fair value of the hedged item attributable to interest rate risk, consideration should only be given to how the effect of changes in benchmark interest rates affect the decision to prepay. |
| Instruments that will become prepayable upon the occurrence of a specified event that could occur at any time (e.g., change in control, change in tax law, death of the holder); instruments with only contingent acceleration clauses based on credit are specifically excluded from the definition of prepayable | When measuring changes in fair value of the hedged item attributable to interest rate risk, the contingent feature should not be considered in the measurement of the hedged item during the contingent phase, given that changes in benchmark interest rates do not affect the occurrence of these events. After the contingency is resolved, consideration should be given to the effect of the prepayment feature in the measurement of the hedged item based only on how changes in benchmark interest rates affect the decision to prepay. |
| Instruments with interest-rate-related contingencies (i.e., become prepayable upon movement in a specified interest rate) | When measuring changes in fair value of the hedged item attributable to interest rate risk, the hedged item should be measured with consideration given to:<br>• Fluctuations in interest rates that cause the contingent event to occur<br>• The probability of exercise given the interest rate scenario (only considering the effect of the benchmark interest rate)<br>If the contingency is linked to a rate that is not a benchmark rate, consideration does not need to be given to the effects of movements in the actual interest rate linked to the contingency if different from movements in the benchmark rate (for simplicity, it can be assumed that any spread between the benchmark interest rate and the actual interest rate that is linked to the contingency is fixed). |
| Instruments with conversion features, as long as conversion is contractually permitted during the hedge period | When measuring changes in fair value of convertible debt attributable to interest rate risk, consideration should only be given to how changes in benchmark interest rates affect the decision to prepay. In other words, while the decision to |

| Type of instrument | How change in fair value is measured |
|---|---|
| | convert a specific security is typically based on equity prices, equity volatility and dividends, those factors should not be considered because they are not affected by changes in benchmark interest rates. |

## Portfolio layer method

As permitted in ASC 815-20-25-12A, for a closed portfolio of financial assets (or one or more beneficial interests secured by a portfolio of prepayable financial instruments), an entity may designate a hedged layer as the hedged items if the following criteria are met (this is referred to as a "portfolio layer method"):

- As part of the initial hedge documentation, an entity must prepare an analysis to support its expectation that the hedged layer or layers will be outstanding during the designated hedge period. This analysis should incorporate the entity's current expectations of prepayments, defaults and any other factors that may affect the amount and timing of cash flows of the closed portfolio. In addition, as part of this analysis, the entity must assume that as prepayments, defaults and other factors affecting the amount and timing of cash flows occur, they first will be applied to the unhedged portion of the closed portfolio.
- The entity must apply the partial-term hedging guidance in ASC 815-20-25-12(b)(2)(ii) to the assets (or beneficial interest) used as support of its expectation discussed in the preceding bullet. If an asset matures on a hedged layer's assumed maturity date, it meets this requirement.

A hedged layer is defined in the Master Glossary as "the hedged item designated in a portfolio layer method hedging relationship, representing a stated amount or stated amounts of a closed portfolio of financial assets or one or more beneficial interests secured by a portfolio of financial instruments that is not expected to be affected by prepayments, defaults, or other factors affecting the timing and amount of cash flows for the designated hedge period."

As discussed in ASC 815-20-25-12B, after a closed portfolio is established according to the preceding paragraph, an entity may designate new hedging relationships associated with the closed portfolio without dedesignating any existing hedging relationships associated with the closed portfolio if the criteria in the preceding paragraph are met for those newly designated hedging relationships.

Unless a portfolio layer method is elected, fair value hedges of a portfolio are challenging, given that consideration needs to be given to prepayment risk at an individual asset level because of the significant effect it has on the fair value of the assets. If an election is made to use only the benchmark rate component of the contractual coupon cash flows when measuring the change in the fair value of the hedged item, all assets can be assumed to have the same maturity and the same benchmark rate coupon in a hedge of interest rate risk. (Refer to Section 7.2.2 for additional discussion of these elections.) Consequently, the assessment to determine if the individual assets in the portfolio share the same risk exposure, as elaborated on in Section 5.2.2.1, can be performed qualitatively and only at hedge inception. (All assets in the portfolio for hedge accounting purposes are considered nonamortizing and nonprepayable with the same maturity and coupon, and therefore share the same risk exposure.)

In addition to the inception date documentation requirements previously discussed, an entity that designates the hedged item under the portfolio layer method is required to perform and document at inception of the hedge, and at each subsequent effectiveness assessment date, an analysis to support the expectation that the designated hedged layer will be outstanding during the term of the hedge. This analysis should consider expected prepayments, defaults and any other events that would affect the amount and timing of cash flows associated with the overall portfolio or beneficial interest. However, these factors are assumed to impact the undesignated portion of the beneficial interest or closed portfolio first, and ideally leave the designated hedged layer intact.

**Example 7-2: Hedged item in portfolio layer method hedge (ASC 815-20-55-15A through 55-15D)**

This implementation guidance describes the hedged item in a portfolio layer method hedge in several scenarios.

**Scenario A**

[This Example does not address cash flow hedging relationships in which the hedged risk is the risk of overall changes in the hedged cash flows related to an asset or liability, as discussed in paragraph 815-20-25-15(j)(1).]

**[Case A: Designation Based on First Payments Received]**

For a closed portfolio of financial assets of $100 million, Entity A designates a single hedged item of $10 million of the assets that is expected to be outstanding for the hedge period of Years 1–5. Entity A designates as the hedging instrument a spot-starting constant-notional pay-fixed, receive-variable interest rate swap with a notional amount of $10 million and a term of 5 years. In this single-layer hedge, the hedged layer represents $10 million of assets in the closed portfolio that is not expected to be affected by prepayments, defaults, or other factors affecting the timing or amount of cash flows for the hedge period of Years 1–5.

**Scenario B**

For a closed portfolio of financial assets of $100 million, Entity A designates a hedged item of $20 million of assets that is expected to be outstanding for the hedge period of Years 1–3. It also designates a hedged item of $10 million of the assets in the closed portfolio that is expected to be outstanding for the hedge period of Years 1–5. For the $20 million hedged item, Entity A designates as the hedging instrument a spot-starting constant-notional pay-fixed, receive-variable interest rate swap with a notional amount of $20 million and a term of 3 years. For the $10 million hedged item, Entity A designates as the hedging instrument a spot-starting constant-notional pay-fixed, receive-variable interest rate swap with a notional amount of $10 million and a term of 5 years. In this scenario, there are two hedged layers:

a. A hedged layer representing $20 million of assets in the closed portfolio that is not expected to be affected by prepayments, defaults, or other factors affecting the timing or amount of cash flows for the hedge period of Years 1–3

b. A hedged layer representing $10 million of assets in the closed portfolio that is not expected to be affected by prepayments, defaults, or other factors affecting the timing or amount of cash flows for the hedge period of Years 1–5.

Although the $10 million and $20 million hedged layers are separately designated, Entity A should consider the aggregate hedged amount of $30 million in Years 1– 3 when assessing whether the hedged layers are anticipated to be outstanding in accordance with paragraphs 815-20-25-12A(a) and 815-25-35-7A.

**Scenario C**

For a closed portfolio of financial assets of $100 million, Entity A designates a single hedged item of $30 million for Year 1 that decreases to an amount of $20 million for Year 2 and $10 million for Year 3. Entity A designates a single amortizing-notional swap as the hedging instrument. In this single-layer hedge, the hedged layer represents a $30 million stated amount for Year 1, a $20 million stated amount for Year 2, and a $10 million stated amount for Year 3, which reflects the amortizing-notional swap's features.

**RSM COMMENTARY:** The portfolio layer method provides flexibility in terms of structuring the hedges and applying hedge accounting for hedging multiple layers. For example, an entity can hedge three layers of a closed portfolio with three separate interest rate swaps and document three separate hedging relationships. Alternatively, the entity could hedge all three layers with one amortizing interest rate swap in one documented hedging relationship.

### Accounting for gains and losses under the portfolio layer method

As noted in ASC 815-25-35-1, for one or more existing hedged layers designated under the portfolio layer method, the gain or loss on the hedged layer attributable to the hedged risk does not adjust the carrying value of the individual beneficial interest—or individual assets—in or removed from the closed portfolio. Rather, that amount is maintained on a closed portfolio basis and recognized currently in earnings.

As provided for in ASC 815-25-35-6, if the closed portfolio includes only available-for-sale (AFS) debt securities, the entire gain or loss on the hedged layer attributable to the hedged risk should be recognized in earnings rather than in other comprehensive income to offset the gain or loss on the hedging instrument. If the closed portfolio includes AFS debt securities along with other assets, an entity should determine the portion of the change in fair value on the hedged layer attributable to the hedged risk associated with the AFS debt securities using a systematic and rational method. That amount should be reported in earnings rather than in other comprehensive income. However, an entity should not adjust the carrying amount of the individual AFS debt securities included in the closed portfolio, pursuant to ASC 815-25-35-1(c).

## 7.3 Examples of cash flow and fair value hedges related to interest rate risk

The following select examples of cash flow and fair value hedges related to interest rate risk are from the implementation guidance in ASC 815.

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**Example 7-3: Variable interest payments on a group of variable-rate, interest-bearing loans as hedged item (ASC 815-20-55-88 through 55-99) – Before adopting ASU 2025-09**

The following Cases illustrate the implications of two different approaches to designation of variable interest payments on a group of variable-rate, interest-bearing loans:

a. Designation based on first payments received (Case A)

b. Designation based on a specific group of individual loans (Case B).

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

This Example does not address cash flow hedging relationships in which the hedged risk is the risk of overall changes in the hedged cash flows related to an asset or liability, as discussed in paragraph 815-20-25-15(j)(1).

**Case A: Designation Based on First Payments Received**

In this Case, Entity A wishes to hedge its interest rate exposure to changes in the quarterly interest receipts on $100 million principal of those LIBOR-indexed variable-rate loans by entering into a 3-year interest rate swap that provides for quarterly net settlements based on Entity A receiving a fixed interest rate on a $100 million notional amount and paying a variable LIBOR-based rate on a $100 million notional amount.

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

The hedged forecasted transactions for Entity A in this Case are described with sufficient specificity so that when a transaction occurs, it is clear whether that transaction is or is not the hedged transaction.

Because Entity A has designated the hedging relationship as hedging the risk of changes attributable to changes in the LIBOR interest rate in Entity A's first LIBOR-based interest payments received, any prepayment, sale, or credit difficulties related to an individual LIBOR-indexed variable-rate loan would not affect the designated hedging relationship.

Provided Entity A determines it is probable that it will continue to receive interest payments on at least $100 million principal of its then existing LIBOR-indexed variable-rate loans, Entity A can conclude that the hedged forecasted transactions in the documented cash flow hedging relationships are probable of occurring.

An entity may not assume perfect effectiveness in such a hedging relationship as described in paragraph 815-20-25-102 because the hedging relationship does not involve hedging the interest payments related to the same recognized interest-bearing loan throughout the life of the hedging relationship. Consequently, at a minimum, Entity A must consider the timing of the hedged cash flows vis-à-vis the swap's cash flows when assessing effectiveness.

**Case B: Designation Based on a Specific Group of Individual Loans**

In this Case, Entity B wishes to hedge its interest rate exposure to changes in the quarterly interest receipts on $100 million principal of those LIBOR-indexed variable-rate loans by entering into a 3-year interest rate swap that provides for quarterly net settlements based on Entity B receiving a fixed interest rate on a $100 million notional amount and paying a variable LIBOR-based rate on a $100 million notional amount. Entity B initially designates cash flow hedging relationships of interest rate risk and identifies as the related hedged forecasted transactions each of the variable interest receipts on a specified group of individual LIBOR-indexed variable-rate loans aggregating $100 million principal but then some of those loans experience prepayments, are sold, or experience credit difficulties.

This Case addresses whether the original cash flow hedging relationships remain intact if the composition of the group of loans whose interest payments are the hedged forecasted transactions is changed by replacing the principal amount of the specified loans with similar variable-rate interest-bearing loans. Entity B cannot conclude that the original cash flow hedging relationships have remained intact if the composition of the group of loans whose interest payments are the hedged forecasted transactions is changed by replacing the principal amount of the originally specified loans with similar variable-rate interest- bearing loans. Paragraph 815-20-25-15(a) requires that, for a cash flow hedge, the forecasted transaction be specifically identified as a single transaction or group of transactions. At inception, the entity designated cash flow hedging relationships for each of the variable interest receipts on a specified group of variable-rate loans. If a loan within the group experiences a prepayment, has been sold, or experiences an unexpected change in its expected cash flows due to credit difficulties, the remaining hedged interest payments to Entity B specifically related to that loan are now no longer probable of occurring. Pursuant to paragraphs 815-30-40-1 through 40-3, Entity B must discontinue the hedging relationships with respect to the hedged forecasted transactions that are now no longer probable of occurring. However, had the hedged forecasted transactions been designated in a manner similar to that described in Case A, the consequences of a loan's prepayment, a loan sale, or an unexpected change in a loan's expected cash flows due to credit difficulties would not have been the same. How the forecasted transaction in a cash flow hedge is designated can have a significant effect on the application of the Derivatives and Hedging Topic.

Changing the composition of the specified individual loans within the group of variable-rate interest-bearing loans due to prepayment, a loan sale, or an unexpected change in a loan's expected cash flows due to credit difficulties reflects a change in the probability of the identified hedged forecasted transactions for the hedging relationships related to the individual loans removed from the group of variable-rate interest-bearing loans. Consequently, the hedging relationships for future interest payments that are no longer probable of occurring must be terminated. The provisions related to immediately reclassifying a derivative instrument's gain or loss out of accumulated other comprehensive income into earnings are based on the hedged forecasted transaction being probable that it will not occur—not no longer being probable of occurring—and includes consideration of an additional two-month period of time. After the discontinuation of the hedging relationships for interest payments related to the individual loans removed from the group of variable-rate interest-bearing loans and the reclassification into earnings of the net gain or loss in accumulated other comprehensive income related to those hedging relationships, the derivative instrument (or a proportion thereof) specifically related to the hedging relationships that have been terminated is eligible to be redesignated as the hedging instrument in a new cash flow hedging relationship. However, paragraph 815-30-40-5 warns that a pattern of determining that hedged forecasted transactions are probable of not occurring would call into question both the entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions.

**Example 7-3A: Variable interest payments on a group of variable-rate, interest-bearing loans as hedged item (ASC 815-20-55-88 through 55-99E) – After adopting ASU 2025-09**

The following Cases illustrate the implications of two different approaches to designation of variable interest payments on a group of variable-rate, interest-bearing loans:

a. Designation based on a single interest rate index under the first-payments-received technique (Case A)

b. Designation based on a specific group of individual loans (Case B)

c. Designation based on multiple interest rate indexes under the first-payments-received technique (Case C).

For Cases A, B, and C, assume that Entities A, B, and C each make to their respective customers Secured Overnight Financing Rate (SOFR-) indexed variable-rate loans for which monthly interest payments are based on 30-Day Average SOFR (in arrears) (that is, daily compounded average of SOFR during the past 30 days). Entity C also originates SOFR-indexed variable-rate loans for which interest payments are based on both 1-Month Term SOFR (that is, 1-month forward-looking SOFR) and 30-Day Average Effective Federal Funds Rate (in arrears) (that is, daily compounded average Effective Federal Funds Rate during the past 30 days). All loans made by Entities A, B, and C have interest rate floors that range from 0 percent to 0.5 percent and reset and payment dates that occur over the course of a month.

Both Entities A and B determine that they will each always have at least $100 million of 30-Day Average SOFR-indexed (in arrears) variable-rate loans outstanding throughout the next 3 years, even though the composition of those loans will likely change to some degree due to prepayments, loan sales, and potential defaults. Entity C determines that it will always have at least $100 million of variable-rate loans outstanding indexed to any combination of 30-Day Average SOFR (in arrears), 1-Month Term SOFR, and 30-Day Average Effective Federal Funds Rate (in arrears) throughout the next 3 years.

Entities A, B, and C each execute a 3-year, receive-fixed, pay-variable (30-Day Average SOFR [in arrears]) interest rate swap with a $100 million notional amount that settles at the end of each calendar month. Each interest rate swap does not include a floor and has a fair value of $0 at inception.

This Example does not address cash flow hedging relationships in which the hedged risk is the risk of overall changes in the hedged cash flows related to an asset or liability, as discussed in paragraph 815-20-25-15(j)(1).

**Case A: Designation Based on a Single Interest Rate Index under the First-Payments-Received Technique**

In this Case, Entity A designates the 30-Day Average SOFR (in arrears) interest rate swap (described in paragraph 815-20-55-89B) as hedging the cash flow variability attributable to changes in the first interest payments received during each month for the next 3 years on $100 million principal of 30-Day Average SOFR-indexed (in arrears) variable-rate loans.

Any 30-day Average SOFR-indexed (in arrears) interest payments received by Entity A after it has received payments on $100 million aggregate principal would be unhedged interest payments for that period.

The hedged forecasted transactions for Entity A in this Case are described with sufficient specificity so that when a transaction occurs, it is clear whether that transaction is or is not the hedged transaction.

Because Entity A has designated the hedging relationship as hedging the risk of changes in the 30-Day Average SOFR (in arrears) interest rate in Entity A's first 30-Day Average SOFR (in arrears) interest payments received, any prepayment, sale, or credit difficulties related to an individual 30-Day Average SOFR-indexed (in arrears) variable-rate loan would not necessarily affect the designated hedging relationship.

Provided Entity A determines it is probable that it will continue to receive interest payments on at least $100 million principal of its then existing 30-Day Average SOFR-indexed (in arrears) variable-rate loans, Entity A can conclude that the hedged forecasted transactions in the documented cash flow hedging relationships are probable of occurring.

An entity may not assume perfect effectiveness in such a hedging relationship as described in paragraph 815-20-25-102 because the hedging relationship does not involve hedging the interest payments related to the same recognized interest-bearing loan throughout the life of the hedging relationship. Consequently, at a minimum, Entity A must consider the timing of the hedged cash flows vis-à-vis the swap's cash flows when assessing effectiveness.

Entity A elects to assess similar risk exposure for the group of forecasted transactions by determining that the designated hedging instrument is highly effective against each hedged risk in the group in accordance with the method outlined in paragraph 815-20-55-23A(a) and determines that the similar risk exposure requirement is met. Entity A also utilizes that same assessment to satisfy the initial prospective effectiveness assessment. In performing that assessment, Entity A considers the differences between the individual forecasted transactions in the group and the contractual terms of the hedging instrument. Those differences include, for example, payment dates, reset dates, and interest rate floors.

**Case B: Designation Based on a Specific Group of Individual Loans**

In this Case, Entity B designates the 30-Day Average SOFR (in arrears) interest rate swap (described in paragraph 815-20-55-89B) as hedging the cash flow variability attributable to changes in the interest payments received during each month for the next 3 years on a specified group of individual 30-Day Average SOFR-indexed (in arrears) variable-rate loans aggregating $100 million principal. Entity B elects to assess similar risk exposure in accordance with the method outlined in paragraph 815-20-55-23A(a). Consistent with the differences considered by Entity A in paragraph 815-20-55-96A, Entity B should consider differences between the individual forecasted transactions in the group and the contractual terms of the hedging instrument, including, for example, payment dates, reset dates, and interest rate floors.

After designation, some of the specifically identified loans experience prepayments, are sold, or experience credit difficulties. This Case addresses whether the original cash flow hedging relationships remain intact if the composition of the group of loans whose interest payments are the hedged forecasted transactions is changed by replacing the principal amount of the specified loans that experience a prepayment, have been sold, or experience a change in expected cash flows due to credit difficulties with similar variable-rate interest-bearing loans. Entity B cannot conclude that the original cash flow hedging relationships have remained intact if the composition of the group of loans whose interest payments are the hedged forecasted transactions is changed by replacing the principal amount of the originally specified loans with similar variable-rate interest-bearing loans. Paragraph 815-20-25-15(a) requires that, for a cash flow hedge, the forecasted transaction be specifically identified as a single transaction or group of transactions. At inception, the entity designated cash flow hedging relationships for each of the variable interest receipts on a specified group of variable-rate loans. If a loan within the group experiences a prepayment, has been sold, or experiences an unexpected change in its expected cash flows due to credit difficulties, the remaining hedged interest payments to Entity B specifically related to that loan are now no longer probable of occurring. Pursuant to paragraphs 815-30-40-1 through 40-3, Entity B must discontinue the hedging relationships with respect to the hedged forecasted transactions that are now no longer probable of occurring. However, had the hedged forecasted transactions been designated in a manner similar to that described in Case A, the consequences of a loan's prepayment, a loan sale, or an unexpected change in a loan's expected cash flows due to credit difficulties would not have been the same. How the forecasted transaction in a cash flow hedge is designated can have a significant effect on the application of the Derivatives and Hedging Topic.

Changing the composition of the specified individual loans within the group of variable-rate interest-bearing loans due to prepayment, a loan sale, or an unexpected change in a loan's expected cash flows due to credit difficulties reflects a change in the probability of the identified hedged forecasted

transactions for the hedging relationships related to the individual loans removed from the group of variable-rate interest-bearing loans. Consequently, the hedging relationships for future interest payments that are no longer probable of occurring must be terminated. The provisions related to immediately reclassifying a derivative instrument's gain or loss out of accumulated other comprehensive income into earnings are based on the hedged forecasted transaction being probable that it will not occur—not no longer being probable of occurring—and includes consideration of an additional two-month period of time. After the discontinuation of the hedging relationships for interest payments related to the individual loans removed from the group of variable-rate interest-bearing loans and the reclassification into earnings of the net gain or loss in accumulated other comprehensive income related to those hedging relationships, the derivative instrument (or a proportion thereof) specifically related to the hedging relationships that have been terminated is eligible to be redesignated as the hedging instrument in a new cash flow hedging relationship. However, paragraph 815-30-40-5 warns that a pattern of determining that hedged forecasted transactions are probable of not occurring would call into question both the entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions.

**Case C: Designation Based on Multiple Interest Rate Indexes under the First-Payments-Received Technique**

In this Case, Entity C designates the 30-Day Average SOFR (in arrears) interest rate swap (described in paragraph 815-20-55-89B) as hedging cash flow variability in the first interest payments received during each month for the next 3 years attributable to the contractually specified interest rates on $100 million of variable rate loans indexed to any combination of 30-Day Average SOFR (in arrears), 1-Month Term SOFR, and 30-Day Average Effective Federal Funds Rate (in arrears).

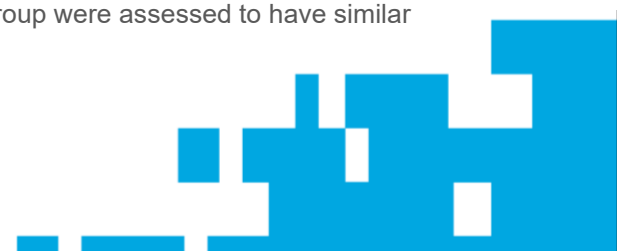
By designating the hedged forecasted transactions as the first interest payments received on 30-Day Average SOFR-indexed (in arrears), 1-Month Term SOFR-indexed, and 30-Day Average Effective Federal Funds Rate-indexed (in arrears) variable-rate loans, Entity C considers the first interest payments on any of those loans as the hedged forecasted transactions when they occur. This method of designation allows Entity C to fulfill its forecasted transactions across a broader population of loans if any variable rate loans experience a prepayment, are sold, or experience a change in its expected cash flows related to credit difficulties.

If Entity C elects to assess similar risk exposure for the group of forecasted transactions using the method outlined in paragraph 815-20-55-23A(a) and determines that the similar risk exposure requirement is met, then Entity C also may reasonably conclude that the hedging relationship is expected to be highly effective at hedge inception if it documents the method described in paragraph 815-20-55-23A(a) as its method for assessing hedge effectiveness. Entity C should consider the differences between the individual forecasted transactions in the group and the contractual terms of the hedging instrument when performing those assessments. Those differences include, for example, interest rates, payment dates, reset dates, and interest rate floors.

Alternatively, if Entity C elects to assess similar risk exposure for the group of forecasted transactions using the method in paragraph 815-20-55-23A(b) and determines that the similar risk exposure requirement is met, then Entity C should perform a separate assessment to conclude that the hedging relationship is expected to be highly effective at hedge inception. Entity C should use the concepts underlying assessments of hedge effectiveness, such as the hypothetical derivative method and regression analysis, when assessing whether each hedged risk is similar to each other risk in the group. Entity C should consider the differences between the respective hedged risks of the individual forecasted transactions in the group when performing the similar risk exposure assessment. Those differences include attributes that affect the hedged indexes, for example, interest rates, reset dates, and interest rate floors.

If Entity C determines as part of its ongoing assessments that one or more hedged risks related to individual forecasted transactions in the group are no longer similar, Entity C should dedesignate the hedging relationship as of the last date when all hedged risks in the group were assessed to have similar





risk exposure, unless Entity C can determine the specific date that all hedged risks in the group were no longer similar. However, the determination that one or more hedged risks in the group are no longer similar does not affect Entity C's probability assessment related to the hedged forecasted transactions performed in accordance with paragraphs 815-30-40-4 through 40-6.

**Example 7-4: Application of the net written option test to collar-based hedging relationships (ASC 815-20-55-230 through 55-234)**

This Example illustrates the application of paragraph 815-20-25-95.

Entity X has LIBOR-indexed floating-rate debt. To hedge its exposure to variability in expected future cash outflows attributable to changes in LIBOR swap rate (the contractually specified interest rate), it enters into an interest rate collar with a bank when the current LIBOR swap rate is 6 percent. The collar also is indexed to LIBOR and consists of a purchased cap with the strike rate equal to 8 percent and a written floor with the strike rate equal to 5 percent. The purchased cap goes into effect when LIBOR increases above 8 percent, and the written floor goes into effect when LIBOR decreases below 5 percent. Thus, the interest collar has the effect of limiting the interest rate of the floating-rate debt to a range between 5 percent and 8 percent. On the basis of market conditions as of the collar transaction date, Entity X received a net premium from the bank.

In accordance with paragraphs 815-20-25-88 through 25-90, the combination of options in the collar in this Example is a net written option from Entity X's perspective. Therefore, the written-option test in paragraphs 815-20-25-94 through 25-95 must be applied to determine whether the hedging relationship between the debt and the collar qualifies for cash flow hedge accounting. That test requires that 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 for all possible percentage changes (from zero percent to 100 percent) in the LIBOR index.

The following table shows the calculation of the favorable cash flows and unfavorable cash flows for LIBOR changes of 50 percent.

| Potential Cash Flows of the Combination of the Hedged Item and the Net Written Option if LIBOR Moves Each Direction by the Same Percentage | | | |
|---|---|---|---|
| | LIBOR at Inception | LIBOR Increase 50% | LIBOR Decrease 50% |
| Cash outflows on LIBOR-indexed debt | 6.00% | 9.00% | 3.00% |
| Cash outflows on written floor | 0.00 | 0.00 | 2.00 |
| Less: Cash inflows on purchased cap | 0.00 | 1.00 | 0.00 |
| Net cash flow (outflows + / inflows -) | 6.00% | 8.00% | 5.00% |

| Potential Cash Flows of the Combination of the Hedged Item and the Net Written Option if LIBOR Moves Each Direction by the Same Percentage | | |
|---|---|---|
| | Unfavorable | Favorable |
| Change in cash flows of combination from inception (in basis points) | 200 | -100 |
| Percentage change in cash flows of combination from inception | 33.33% | -16.67% |

The calculations in the table in paragraph 815-20-55-233 demonstrate that for a 50 percent fluctuation in the LIBOR rate, the collar would fail the written-option test in paragraph 815-20-25-94 because a 50 percent favorable change in LIBOR (that is, a decrease) would not provide at least as much favorable

cash flows as unfavorable cash flows that would result from a 50 percent unfavorable change in LIBOR (that is, an increase). Therefore, the combination of options would not be an eligible hedging instrument.

**RSM COMMENTARY:** The fact pattern warrants the application of the written option test because the combination of options in the collar designated as the hedging instrument in this example is a net written option from Entity X's perspective.

However, as noted in ASC 815-20-25-88, "a derivative instrument that results from combining a written option and any other non-option derivative instrument shall be considered a written option." The combination of a written option and a non-option derivative instrument is referred to as a compound derivative instrument. An example of such a compound derivative instrument is an interest rate swap that has an embedded written floor. That is, the written floor is a written option and the interest rate swap excluding the written floor is a non-option derivative instrument. We see this when an entity uses this type of compound derivative instrument to hedge variable-rate assets that contain an interest rate floor. Because the interest rate swap in this case is considered a combination of a written option and a non-option derivative instrument, it is considered a written option in accordance with ASC 815-20-25-88. As a result, the reporting entity would have to apply the written option test. This could lead to the compound derivative instrument being ineligible for hedge accounting.

Refer to the following Pending change - ASU 2025-09, *Hedge accounting improvements,* for amendments related to the accounting for compound derivative instruments.

**Pending change - ASU 2025-09, *Hedge accounting improvements***

On November 25, 2025, the FASB issued ASU 2025-09, *Derivatives and Hedging (Topic 815): Hedge Accounting Improvements* (ASU 2025-09 or the ASU), to align hedge accounting more closely with the economics of an entity's risk management activities.

ASU 2025-09 revises the hedge accounting requirements applicable to net written options so that the guidance better reflects structural differences that emerged between the loan and swap markets following the discontinuation of LIBOR. In particular, ASU 2025-09 removes the requirement to perform the net written option assessment for a compound derivative consisting of a swap combined with a written option when that compound instrument is designated as the hedging instrument in either a cash flow hedge or a fair value hedge of interest rate risk.

For PBEs, ASU 2025-09 is effective for annual reporting periods beginning after December 15, 2026, and interim periods within those annual reporting periods. For entities other than PBEs, the ASU is effective for annual reporting periods beginning after December 15, 2027, and interim periods within those annual reporting periods. Early adoption is permitted on any date on or after its issuance.

Entities should apply the guidance in ASU 2025-09 prospectively for all hedging relationships. An entity may elect to adopt ASU 2025-09 for hedging relationships that exist as of the date of adoption.

**ASC 815-20-25-88 – Before the adoption of ASU 2025-09**

This guidance addresses how an entity shall determine whether a combination of options is considered a net written option subject to the requirements of paragraph 815-20-25-94. 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. Furthermore, a derivative instrument that results from combining a written option and any other non-option derivative instrument shall be considered a written option. The

determination of whether a combination of options is considered a net written option depends in part on whether strike prices and notional amounts of the options remain constant.

**ASC 815-20-25-88 – After the adoption of ASU 2025-09**

This guidance addresses how an entity shall determine whether a combination of options is considered a net written option subject to the requirements of paragraph 815-20-25-94. 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. The determination of whether a combination of options is considered a net written option depends in part on whether strike prices and notional amounts of the options remain constant. Furthermore, a derivative instrument that results from combining a written option and any other non-option derivative instrument shall be considered a written option unless all of the following criteria are satisfied:

a. The derivative is designated as the hedging instrument in a cash flow hedge or fair value hedge of interest rate risk (including the interest rate risk portion of a hedge of both interest rate risk and foreign exchange risk).
b. The hedging instrument is a combination of a written option and a swap.
c. The notional amount of the written option matches the notional amount of the swap.

For example, an entity designates a receive-fixed, pay-variable interest rate swap with a 1 percent floor and a variable leg that is indexed to Daily SOFR as the hedging instrument in a cash flow hedge of interest rate risk. The notional amounts of the interest rate swap and the interest rate floor match. The forecasted transactions are designated as the interest payments on a portfolio of variable-rate loans that are indexed to 1-Month Term SOFR with a 1 percent floor. The combination of the interest rate swap and the interest rate floor is not considered a net written option. Therefore, the entity would not apply the net written option test to that hedging relationship.

**Example 7-5: Cash flow hedge of variable-rate interest-bearing asset (ASC 815-30-55-24 through 55-33)**

This Example demonstrates the mechanics of accounting for an interest rate swap used as a cash flow hedge of variable interest receipts in accordance with the guidance in Subtopic 815-20 and this Subtopic. It is not intended to demonstrate how to compute the fair value of an interest rate swap. As in Example 8 (see paragraph 815-25-55-40), the zero-coupon method is used to determine the fair values. (Unlike in that Example, the yield curve in this Example is assumed to be upward sloping, that is, interest rates are higher for payments due further into the future.) In this Example, the term, notional amount, and repricing date of the interest rate swap match the term, repricing date, and principal amount of the interest-bearing asset on which the hedged interest receipts are due. The swap terms are at the market (as described in paragraphs 815-20-25-104, 815-20-25-106, and 815-20-25-109), so it has a zero value at inception. Thus, the reporting entity is permitted to assume that the hedging relationship will achieve perfect offset in the variability of cash flows of the hedged item.

As discussed beginning in paragraph 815-20-25-102, a shortcut method can be used to produce the same reporting results as the method illustrated in this Example. This shortcut is appropriate only if the assumption of perfect offset applies for an interest rate swap used as a cash flow hedge of interest receipts on a variable-rate asset (or interest payments on a variable-rate liability). The steps in the shortcut method are as follows:

a. Determine the difference between the variable rate to be paid on the interest rate swap and the variable rate to be received on the bonds.

b. Combine that difference with the fixed rate to be received on the interest rate swap.

c. Compute and recognize interest income using that combined rate and the variable-rate asset's principal amount. (Amortization of any purchase premium or discount on the asset must also be considered, although that complication is not incorporated in this Example.)

d. Determine the fair value of the interest rate swap.

e. Adjust the carrying amount of the interest rate swap to its fair value and adjust other comprehensive income by an offsetting amount.

A slightly different shortcut method for interest rate swaps used as fair value hedges is illustrated in Example 8 (see paragraph 815-25-55-40).

For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

On July 1, 20X1, Entity XYZ invests $10,000,000 in variable-rate corporate bonds that pay interest quarterly at a rate equal to the 3-month USD LIBOR rate plus 2.25 percent. The $10,000,000 principal will be repaid on June 30, 20X3.

Also on July 1, 20X1, Entity XYZ enters into a two-year receive-fixed, pay-variable interest rate swap and designates it as a hedging instrument in a cash flow hedge of the variable-rate interest receipts on the corporate bonds. The risk designated as being hedged is the risk of variability in cash flows received attributable to changes in the contractually specified interest rate. The terms of the interest rate swap and the corporate bonds are shown in the following table.

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

(a) These terms need not match for the assumption of perfect offset to be appropriate. (See paragraphs 815-20-25-102 through 25-110.)

(b) Only the interest rate basis (for example, LIBOR) must match. The spread over LIBOR does not invalidate the assumption of perfect offset.

Because the conditions described in paragraphs 815-20-25-104 and 815-20-25-106 are met, Entity XYZ is permitted to assume that there is perfect offset in the hedging relationship and to recognize in other comprehensive income the entire change in the fair value of the interest rate swap.

The three-month USD LIBOR rates in effect at the inception of the hedging relationship and at each of the quarterly reset dates are assumed to be as follows.

| Reset Date | 3-Month LIBOR |
|---|---|
| 7/1/X1 | 5.56% |
| 9/30/X1 | 5.63% |

| | |
|---|---|
| 12/31/X1 | 5.56% |
| 3/31/X2 | 5.47% |
| 6/30/X2 | 6.75% |
| 9/30/X2 | 6.86% |
| 12/31/X2 | 6.97% |
| 3/31/X3 | 6.57% |

Entity XYZ must reclassify to earnings the amount in accumulated other comprehensive income as each interest receipt affects earnings. In determining the amounts to reclassify each quarter, it is important to recognize that the interest rate swap does not hedge the bonds. Instead, it hedges the eight variable interest payments to be received. That is, each of the eight quarterly settlements on the swap is associated with an interest payment to be received on the bonds. Under the zero-coupon method discussed in paragraph 815-30-55-24, the present value of each quarterly settlement is computed separately. Because each payment occurs at a different point on the yield curve, a different interest rate must be used to determine its present value. As each individual interest receipt on the bonds is recognized in earnings, the fair value of the related quarterly settlement on the swap is reclassified to earnings. The fair values and changes in fair values of the interest rate swap and the effects on earnings and other comprehensive income for each quarter are as follows.

| | Swap Debit (Credit) | Other Comprehensive Income Debit (Credit) | Earnings Debit (Credit) | Cash Debit (Credit) |
|---|---|---|---|---|
| July 1, 20X1 | $ - | | | |
| Interest accrued | - | | | |
| Payment (receipt) | (27,250) | | | $27,250 |
| Effect of change in rates | 52,100 | ($52,100) | | |
| Reclassification to earnings | | 27,250 | ($27,250) | |
| September 30, 20X1 | 24,850 | (24,850) | ($27,250) | $27,250 |
| Interest accrued | 330 | (330) | | |
| Payment (receipt) | (25,500) | | | $25,500 |
| Effect of change in rates | 74,120 | (74,120) | | |
| Reclassification to earnings | | 25,500 | ($25,500) | |
| December 31, 20X1 | 73,800 | (73,800) | ($25,500) | $25,500 |
| Interest accrued | 1,210 | (1,210) | | |
| Payment (receipt) | (27,250) | | | $27,250 |
| Effect of change in rates | 38,150 | (38,150) | | |
| Reclassification to earnings | | 27,250 | ($27,250) | |
| March 31, 20X2 | 85,910 | (85,910) | ($27,250) | $27,250 |
| Interest accrued | 1,380 | (1,380) | | |
| Payment (receipt) | (29,500) | | | $29,500 |
| Effect of change in rates | (100,610) | 100,610 | | |
| Reclassification to earnings | | 29,500 | ($29,500) | |
| June 30, 20X2 | (42,820) | 42,820 | ($29,500) | $29,500 |
| Interest accrued | (870) | 870 | | |
| Payment (receipt) | 2,500 | | | ($2,500) |

| | Swap Debit (Credit) | Other Comprehensive Income Debit (Credit) | Earnings Debit (Credit) | Cash Debit (Credit) |
|---|---|---|---|---|
| Effect of change in rates | 8,030 | (8,030) | | |
| Reclassification to earnings | | (2,500) | $2,500 | |
| September 30, 20X2 | (33,160) | 33,160 | $2,500 | ($2,500) |
| Interest accrued | (670) | 670 | | |
| Payment (receipt) | 5,250 | | | ($5,250) |
| Effect of change in rates | 6,730 | (6,730) | | |
| Reclassification to earnings | | (5,250) | $5,250 | |
| December 31, 20X2 | (21,850) | 21,850 | $5,250 | ($5,250) |
| Interest accrued | (440) | 440 | | |
| Payment (receipt) | 8,000 | | | ($8,000) |
| Effect of change in rates | 16,250 | (16,250) | | |
| Reclassification to earnings | | (8,000) | $8,000 | |
| March 31, 20X3 | 1,960 | (1,960) | $8,000 | ($8,000) |
| Interest accrued | 40 | (40) | | |
| Payment (receipt) | (2,000) | | | $2,000 |
| Reclassification to earnings | | 2,000 | ($2,000) | |
| June 30, 20X3 | $ - | $ - | ($2,000) | $2,000 |

The preceding table shows that, in each quarter, the net cash receipt or payment on the swap equals the income or expense to be recorded. The net effect on earnings of the interest on the bonds and the reclassification of gains or losses on the interest rate swap are presented in the same income statement line item as the earnings effect of the hedged item. The net earnings effect is shown in the following table.

| For the Quarter Ending | Interest on Bonds | Gains (Losses) Reclassified from Other Comprehensive Income | Net Effect |
|---|---|---|---|
| 9/30/X1 | $195,250 | $27,250 | $222,500 |
| 12/31/X1 | 197,000 | 25,500 | 222,500 |
| 3/31/X2 | 195,250 | 27,250 | 222,500 |
| 6/30/X2 | 193,000 | 29,500 | 222,500 |
| 9/30/X2 | 225,000 | (2,500) | 222,500 |
| 12/31/X2 | 227,750 | (5,250) | 222,500 |
| 3/31/X3 | 230,500 | (8,000) | 222,500 |
| 6/30/X3 | 220,500 | 2,000 | 222,500 |
| Totals | $1,684,250 | $95,750 | $1,780,000 |

In this Example, the shortcut method described in paragraph 815-30-55-25 works as follows. The difference between the variable rate on the interest rate swap and the variable rate on the asset is a net receipt of 2.25 percent. That rate combined with the 6.65 percent fixed rate received on the interest rate swap is 8.9 percent. The computed interest income is $890,000 per year or $222,500 per quarter, which is the same as the amount in the table in the preceding paragraph.

**Example 7-6: Changes in a cash flow hedge of forecasted interest payments with an interest rate swap (ASC 815-30-55-52 through 55-61)**

The following Cases describe the effects on earnings and other comprehensive income of certain changes in a cash flow hedging relationship:

a. The variability of the hedged interest payments is eliminated before the hedging derivative expires (Case A).

b. The interest rate index that is the basis for the hedged interest payments is changed to a different index before the hedging derivative expires (Case B).

Cases A and B share the following assumptions. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

Entity MNO enters into an interest rate swap (Swap 1) and designates it as a hedge of the variable quarterly interest payments on Entity MNO's 5-year $5 million borrowing program, initially expected to be accomplished by a series of $5 million notes with 90-day terms. Entity 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 the contractually specified LIBOR rate 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. Entity MNO pays a fixed rate of interest (6.5 percent) and receives interest at LIBOR. Entity MNO neither pays nor receives a premium at the inception of Swap 1. The notional amount of the contract is $5 million, and it expires in 5 years.

Because Swap 1 and the hedged forecasted interest payments are based on the same notional amount, have the same reset dates, and are based on the same contractually specified interest rate (that is, the LIBOR rate) designated under paragraph 815-20-25-15(j)(2), Entity MNO may conclude that the hedging relationship will perfectly offset changes in cash flows of the hedged item attributable to the hedged risk and the hedging instrument (absent a default by the interest rate swap counterparty).

This paragraph explains why the guidance in Example 4, Case B (see paragraph 815-20-55-97) does not conflict with the guidance in this Example. In the cash flow hedge in this Example, had the hedged forecasted transaction been narrowly limited to the interest payments on specific future debt issuances rather than on the five-year borrowing program, the failure to engage in future debt issuances would cause the related derivative instrument net gain or loss in other comprehensive income to be immediately reclassified into earnings pursuant to paragraphs 815-30-40-4 through 40-5 because it would have been probable that the hedged forecasted transactions would not occur. Furthermore, if that failure is part of a pattern of hedged forecasted transactions being probable of not occurring, it would call into question both an entity's ability to accurately predict forecasted transactions and the propriety of using hedge accounting in the future for similar forecasted transactions, pursuant to paragraph 815-30-40-5. In contrast, in Example 4, Case B (see paragraph 815-20-55-97), the hedged quarterly interest payments were directly linked to Entity B's existing LIBOR-indexed floating-rate assets. When those existing assets are later prepaid or sold, the future quarterly interest payments on those specific assets are no longer probable of occurring (that is, no longer probable of being received by Entity B). Consequently, the hedging relationships for those future quarterly interest payments fail to meet the criterion in paragraph 815-20-25-15(b) and must be discontinued under paragraph 815-30-40-1. Because it is probable that the hedged quarterly interest payments that were directly linked to assets that were prepaid or sold will not occur, the related derivative instrument net gain or loss in other comprehensive income must be immediately reclassified into earnings pursuant to paragraphs 815-30-40-4 through 40-5.

**Case A: Variability of Hedged Forecasted Transactions Is Eliminated**

At the end of the second year of the 5-year hedging relationship, Entity MNO discontinues its practice of issuing 90-day notes. Instead, Entity MNO issues a 3-year, $5 million note with a fixed rate of interest (7.25 percent). Because the interest rate on the three-year note is fixed, the variability of the future

interest payments has been eliminated. Thus, Swap 1 no longer qualifies for cash flow hedge accounting. However, the net gain or loss on Swap 1 in accumulated other comprehensive income is not reclassified to earnings immediately. Immediate reclassification is required (and permitted) only if it becomes probable that the hedged transactions (future interest payments) will not occur. The variability of the payments has been eliminated, but it still is probable that they will occur. Thus, those gains or losses will continue to be reclassified from accumulated other comprehensive income to earnings as the interest payments affect earnings (as required by paragraphs 815-30-35-38 through 35-41) and presented in the same income statement line item as the earnings effect of the hedged item. If the term of the fixed rate note had been longer than three years, the amounts in accumulated other comprehensive income still would have been reclassified into earnings over the next three years, which was the term of the designated hedging relationship.

Rather than liquidate the pay-fixed, receive-variable Swap 1, Entity MNO enters into a pay-floating, receive-fixed interest rate swap (Swap 2) with a 3- year term and a notional amount of $5 million. Entity MNO neither pays nor receives a premium. Like Swap 1, Swap 2 requires a settlement every 90 days and reprices immediately following each settlement. The relationship between 90- day interest rates and longer term rates has changed since Entity MNO entered into Swap 1 (that is, the shape of the yield curve is different). As a result, Swap 2 has different terms and its settlements do not exactly offset the settlements on Swap 1. Under the terms of Swap 2, Entity MNO will receive a fixed rate of 7.25 percent and pay interest at LIBOR.

The two swaps are not designated as hedging instruments and are reported at fair value. The changes in fair value are reported immediately in earnings and offset each other to a significant degree.

**Case B: Basis of Hedged Forecasted Transactions Is Changed**

At the end of the second year of the 5-year hedging relationship, Entity MNO discontinues its practice of issuing 90-day notes and issues a 3-year, $5 million note with a different contractually specified interest rate (that is, an interest rate that is not LIBOR) that adjusts every 90 days. As of this date, Entity MNO must begin performing assessments of effectiveness for the hedging relationship by comparing changes in fair value of the hedging instrument (indexed to LIBOR) with changes in the value of the hedged item based on the revised contractually specified interest rate. Because the hedged forecasted transactions (future interest payments) are still probable of occurring, Entity MNO may continue to apply hedge accounting in accordance with paragraph 815-30-35-37A if the hedging instrument (indexed to LIBOR) is highly effective at achieving offsetting cash flows attributable to the revised contractually specified interest rate.

If the revised hedging relationship is not determined to be highly effective, the hedging relationship must be discontinued. However, the net gain or loss on Swap 1 in accumulated other comprehensive income as of the date Entity MNO issues the three-year note is not reclassified into earnings immediately. Immediate reclassification would be required only if, as part of its normal process of assessing whether it remains probable that the hedged forecasted transaction will occur, Entity MNO determines that it is probable that the hedged transactions (future interest payments) will not occur. In this case, the expected amounts of those payments have changed (because they will be based on a revised contractually specified interest rate instead of LIBOR, as originally expected), but it still is probable that the payments will occur. Thus, those gains or losses will continue to be reclassified to earnings as the interest payments affect earnings and presented in the same income statement line item as the earnings effect of the hedged item.

**Example 7-7: Impact on accumulated other comprehensive income of issuing debt with a term that is shorter than originally forecasted (ASC 815-30-55-94 through 55-99)**

This Example illustrates the effect on accumulated other comprehensive income of issuing debt with a term that is shorter than originally forecasted.

Entity A expects to borrow $100 million over a 10-year period beginning in 6 months. Entity A initially plans to issue $100 million of 10-year fixed- rate debt at or near par at the then-current market interest rate; consequently, Entity A will be exposed to variability in cash flows in the future quarterly interest payments on the debt due to changes in credit risk and interest rate risk that occur during this 6-month period before issuance. To hedge the risk of changes in these 40 quarterly interest payments attributable to changes in the benchmark interest rate for the 6-month period, Entity A does all of the following:

a. It enters into a derivative instrument (for example, a forward-starting interest rate swap).

b. It documents that it is hedging the variability in the 40 future quarterly interest payments, attributable to changes in the benchmark interest rate, over the next 10 years related to its 10-year $100 million borrowing program that begins in 6 months.

c. It documents that it will assess the effectiveness of the hedging relationship semimonthly on a quantitative basis.

Six months after inception of the hedging relationship, Entity A issues debt. However, due to market conditions, Entity A decides in the week before issuance that it will issue $100 million of fixed-rate debt with a 5-year maturity and quarterly interest payments.

When Entity A decides that the term of the debt to be issued will differ from the term of the debt originally expected to be issued, Entity A should not immediately reclassify into earnings the entire net gain or loss in accumulated other comprehensive income related to the derivative instrument. Instead, Entity A must first apply the requirements of paragraph 815-30-35-3 using its originally documented hedging strategy and the newly revised best estimate of the cash flows. That is, the assessment of hedge effectiveness should be based on the most recent best estimate of the hedged forecasted transaction as of the date that a cash flow hedge is discontinued prospectively.

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

When Entity A performs its semimonthly assessment of effectiveness for the half-month period immediately preceding the issuance of the debt, it could also possibly conclude that the hedging relationship is no longer considered highly effective under paragraph 815-20-25-75 because the actual variability in the hedged interest payments for Years 1–5 is now based on the 5- year borrowing rate—not on 10-year rates as expected at the inception of the hedge when the entity selected the hedging derivative. In that circumstance, the hedging relationship is terminated. After the hedging relationship is terminated, Entity A must determine whether it is probable that any or all of those specific nonprobable forecasted transactions will not occur by the date (or within the time period) originally specified or within an additional two-month period of time thereafter (see paragraphs 815-30-40-4 through 40-5).

When Entity A originally documented the hedging relationship, it was hedging 40 forecasted transactions (forecasted quarterly interest payments) that would begin in 6 months' time and continue over a 10-year period. In this Example, Entity A terminates the hedging relationship no later than on the date it issues the

5-year debt (because the variability of the first 20 hedged payments ceases on that date) and must determine the amount, if any, to be reclassified into earnings from accumulated other comprehensive income related to the net derivative gain or loss of the terminated cash flow hedge. Because Entity A issued a 5-year debt instrument, Entity A would determine that it is probable that the first 20 forecasted transactions would occur because they are now contractual obligations. Entity A must determine that it is not probable that any of the last 20 forecasted transactions will not occur to continue reporting the net derivative gain or loss related to these forecasted transactions in accumulated other comprehensive income. At issue is whether it is probable that the five-year debt will not be replaced by new borrowings that will involve the quarterly payment of interest. Provided that the entity determines that it is not probable that any of the original 40 forecasted transactions will not occur, Entity A must apply paragraph 815-30-35-3 and continue to report an amount in accumulated other comprehensive income based on the most recent best estimate of the hedged forecasted transactions related to all 40 forecasted transactions and reclassify an appropriate amount into earnings when each hedged forecasted transaction affects earnings and present those amounts in the same income statement line item as the earnings effect of the hedged item. If Entity A determines that it is probable that any of those forecasted transactions will not occur either by the end of the date (or within the time period) originally specified or within an additional two-month period of time thereafter (see paragraphs 815-30- 40-4 through 40-5), Entity A should reclassify into earnings from accumulated other comprehensive income the amount of the net derivative instrument gain or loss related to those specific nonoccuring forecasted transactions. That amount should be equivalent to the portion of the present value of the derivative instrument's cash flows intended to offset the changes in the original forecasted transactions for which Entity A has determined it is probable that they will not occur by the date (or within the time period) originally specified or within an additional two-month period of time thereafter. Thus, the nonoccurrence of one of the hedged forecasted transactions described in this Example could potentially jeopardize Entity A's ability to use cash flow hedge accounting in the future for the situation described.

**Example 7-8: Effect on accumulated other comprehensive income from issuing debt at a date that is not the same as originally forecasted (ASC 815-30-55-128 through 55-133)**

The following Cases illustrate the application of paragraph 815-30-40-5 in determining whether an entity should immediately reclassify into earnings the entire net gain or loss related to the derivative instrument in accumulated other comprehensive income when issuing debt at a date that is not the same as originally forecasted:

a. Amounts are not reclassified immediately into earnings (Case A).

b. Amounts are reclassified immediately into earnings (Case B).

**Case A: Amounts Are Not Reclassified Immediately into Earnings**

This Case has the following assumptions:

a. Entity A expects to borrow $100 million over a 10-year period beginning in 6 months.

b. Entity A initially plans to issue $100 million of 10-year fixed-rate debt at or near par at the then-current market interest rate.

c. Entity A will be exposed to variability in cash flows for the future quarterly interest payments on the debt due to changes in credit risk and interest rate risk that occur during this six-month period before issuance.

d. To hedge the risk of changes in these 40 quarterly interest payments attributable to changes in the benchmark interest rate for the 6-month period, Entity A does both of the following:

    1. Enters into a derivative instrument (for example, a forward-starting interest rate swap)

2. Documents that it is hedging the variability in the 40 future quarterly interest payments, attributable to changes in the benchmark interest rate, over the next 10 years related to its 10-year $100 million borrowing program that begins in 6 months.

e. Entity A documents that it will assess the effectiveness of the hedging relationship semimonthly on a quantitative basis.

f. Six months after inception of the hedging relationship, Entity A decides to delay the issuance of the 10-year debt for 3 months.

When Entity A decides to delay the issuance of the 10-year debt for 3 months, Entity A should not immediately reclassify into earnings the entire net gain or loss in accumulated other comprehensive income related to the derivative instrument. Entity A's strategy is a cash flow hedge of 40 individual probable quarterly interest payments. A cash flow hedge of future interest payments is a hedge of a series of forecasted transactions; consequently, Entity A must first determine the likelihood of whether and when each forecasted transaction in the series will occur. If at any time during the hedging relationship Entity A determines that it is no longer probable that any of the forecasted transactions in the series will occur by the date (or within the time period) originally specified, it must terminate the original hedging relationship for each of those specific nonprobable forecasted transactions—even if the forecasted transaction will occur within an additional two-month period of time after that originally specified date. Entity A need not terminate the original hedging relationship for those specific forecasted transactions that remain probable of occurring by the date or within the time period originally specified. After the hedging relationship is terminated, Entity A must determine whether it is probable that any or all of those specific nonprobable forecasted transactions will not occur either by the date (or within the time period) originally specified or within an additional two-month period of time thereafter (see paragraphs 815-30-40-4 through 40-5). Entity A should reclassify into earnings from accumulated other comprehensive income the amount of the net derivative instrument gain or loss related to those specific nonprobable forecasted transactions for which it is probable they will not occur. That amount should be equivalent to the present value of the derivative instrument's cash flows intended to offset the changes in the original forecasted transactions for which Entity A has determined it is probable that they will not occur by the date (or within the time period) originally specified or within an additional two-month period of time thereafter.

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

**Case B: Amounts Are Reclassified Immediately into Earnings**

This Case has the following assumptions:

a. Entity B expects to issue $100 million of 10-year, 9 percent debt in 6 months.

b. Because the debt will have a fixed interest rate of 9 percent, Entity B will not be exposed to variability in the future quarterly interest payments at 9 percent, but it will be exposed to variability in the cash

flows received as proceeds on the debt due to changes in credit risk and interest rate risk that occur during the 6-month period before issuance.

c. To hedge the risk of changes in the total proceeds attributable to changes in the benchmark interest rate, Entity B does both of the following:

   1. Enters into a derivative instrument (for example, a short position in U.S. Treasury note futures contracts)

   2. Documents that it is hedging the variability in the cash proceeds attributable to changes in the benchmark interest rate to be received from the 9 percent fixed-rate debt it will issue in 6 months and that it will assess effectiveness on a quantitative basis.

d. Because Entity B plans to issue $100 million of 10-year, 9 percent debt regardless of the then-current interest rate environment, the effect of increases or decreases in interest rates will be reflected in issuing the debt at a discount or a premium, respectively.

e. Six months after inception of the hedging relationship, Entity B decides to delay the issuance of the debt for three months.

This strategy is a cash flow hedge of the variability in proceeds attributable to changes in the benchmark interest rate to be received from the issuance of debt in six months. A cash flow hedge of the proceeds attributable to changes in the benchmark interest rate is a hedge of a single forecasted transaction specified to occur in six months; consequently, when the single forecasted transaction is no longer probable of occurring by the date (or within the time period) originally specified, Entity B must terminate the hedging relationship. After the hedging relationship is terminated, Entity B must determine whether it is probable that the specific nonprobable forecasted transaction will not occur by the date (or within the time period) originally specified or within an additional two- month period of time thereafter. Because Entity B decided to delay the issuance of the debt for a three-month period of time, Entity B concludes that it is probable that the forecasted transaction will not occur by the date (or within the time period) originally specified or within an additional two-month period of time thereafter. Consequently, Entity B should immediately reclassify into earnings the entire net gain or loss related to the derivative instrument in accumulated other comprehensive income. Given the guidance in paragraph 815-30-40-5, the nonoccurrence of the hedged forecasted transactions described in this Case could potentially jeopardize Entity B's ability to use cash flow hedge accounting in the future for the situation described.

**Example 7-9: Hedging a portfolio of fixed-rate financial assets (ASC 815-20-55-173 through 55-178)**

This Example illustrates the application of paragraphs 815-20-25-12(b)(1) and 815-20-25-75 to a hedge of a portfolio of fixed-rate financial assets.

Entity A has a portfolio of seasoned, one to four family, fixed-rate mortgages that it wishes to designate as the hedged item in a fair value hedge of the benchmark interest rate (LIBOR). Each loan within the portfolio has similar settlement terms, is collateralized by property in the same geographic region, and has similar scheduled maturities. The loans are all within a specified interest rate band and are prepayable at par; each of the loans contained in the portfolio is expected to react in a generally proportionate manner to changes in the benchmark interest rate based on calculations performed by Entity A.

Entity A enters into a pay-fixed, receive-LIBOR interest rate swap with a fair value of zero at the inception of the hedging relationship. The stated maturity of the interest rate swap is consistent with the stated maturities of the loans. The notional amount of the interest rate swap amortizes based on a schedule that is expected to approximate the principal repayments of the loans (excluding prepayments). There is no optionality included in the interest rate swap. As part of its documented risk management strategy associated with this hedging relationship, on a quarterly basis, Entity A intends to do both of the following:

a. Assess effectiveness of the existing hedging relationship on a quantitative basis for the past three-month period

b. Consider possible changes in value of the hedging derivative and the hedged item over the next three months in deciding whether it has an expectation that the hedging relationship will continue to be highly effective at achieving offsetting changes in fair value

Entity A's portfolio of loans satisfies the requirements of paragraph 815-20-25-12(b)(1) regarding the grouping of similar assets because the portfolio of loans has been defined in a restrictive manner and Entity A determined, by calculation, that each of the loans contained in the portfolio is expected to react in a generally proportionate manner to changes in the benchmark interest rate. Even though certain of the loans may prepay, each loan still may be considered to have the same exposure to prepayment risk because each loan has a similar prepayment option. When aggregating loans in a portfolio, an entity is permitted to consider among other things prepayment history of the loans (if seasoned) and expected prepayment performance in varying interest rate scenarios.

Entity A's documented hedging strategy meets the requirements of paragraph 815-20-25-75 for a prospective assessment of effectiveness provided the entity established that the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated.

Paragraph 815-20-25-79(a) explains that a probable future change in fair value will be more heavily weighted than a reasonably possible future change. For example, Entity A could assign a probability weighting to each possible future change in value of the hedged portfolio. Depending on the level of market interest rates and the expected prepayment rates for the types of loans in the hedged portfolio, Entity A may reach a conclusion that the change in fair value of the swap will be highly effective at offsetting the change in the value of the portfolio of loans, inclusive of the prepayment option. As a result of this analysis, management would conclude that hedge accounting is permitted for the hedging relationship for the next three-month period. Management is required to assess the effectiveness of the existing hedging relationship for the past three-month period. If necessary, the notional amount of the swap in excess of the portfolio balance at the end of each three-month period must be dedesignated to allow high effectiveness to continue in the future.

**RSM COMMENTARY:** When hedging a portfolio of prepayable fixed-rate assets for interest rate risk, it is typically advantageous in comparison to this example to structure the hedged item as a layer as discussed in Section "Portfolio layer method." When a layer designation is made in conjunction with the partial-term hedging election and an election to use only the benchmark rate component of the contractual coupon cash flows when measuring the change in the fair value of the hedged item, all assets can be assumed to have the same maturity and the same benchmark rate coupon. Such a hedge would be expected to be highly effective despite the prepayable nature of the assets as long as the designated layer is expected to remain outstanding during the hedge period and all relevant conditions are met.

**Example 7-10: Fair value hedge of U.S. Treasury bond with put options (ASC 815-25-55-23 through 55-26)**

This Example illustrates the guidance in Sections 815-20-25, 815- 20-35, and 815-25-35 for how an entity may assess hedge effectiveness in a fair value hedge of a U.S. Treasury bond with put options. Assume that the hedge satisfied all of the criteria for hedge accounting at inception.

Entity E owns a U.S. Treasury bond and wants to protect itself against the fair value exposure to declines in the price of the bond. Entity E purchases an at-the-money put option on a U.S. Treasury security with the same terms (remaining maturity, notional amount, and interest rate) as the U.S. Treasury bond held

and designates the option as a hedge of the fair value exposure of the U.S. Treasury bond. Entity E plans to hold the put option until it expires.

Because Entity E plans to hold the put option (a static hedge) rather than manage the position with a delta-neutral strategy, it could assess whether it expects the hedge to be highly effective at achieving offsetting changes in fair value by calculating and comparing the changes in the intrinsic value of the option and changes in the price (fair value) of the U.S. Treasury bond for different possible market prices. In assessing the expectation of effectiveness on an ongoing basis, Entity E also must consider the actual changes in the fair value of the U.S. Treasury bond and in the intrinsic value of the option during the hedge period.

However, because the pertinent critical terms of the option and the bond are the same in this Example, Entity E could expect the changes in value of the bond attributable to changes in interest rates and changes in the intrinsic value of the option to offset completely during the period that the option is in the money. That is, the hedging relationship will be perfectly effective because Entity E has chosen to exclude changes in the option's time value from the assessment of hedge effectiveness. Entity E may elect to account for changes in the time value of the option through an amortization approach in accordance with paragraph 815-20-25-83A or through a mark-to-market approach in accordance with paragraph 815-20-25-83B. Under either of those approaches, it should present the portion of excluded components recognized in earnings in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A.

**Example 7-11: Fair value hedge of an embedded purchased option with a written option (ASC 815-25-55-27 through 55-29)**

This Example illustrates the guidance in Sections 815-20-25, 815-20-35, and 815-25-35 for how an entity may assess hedge effectiveness in a fair value hedge of an embedded purchased option with a written option. Assume that the hedge satisfied all of the criteria for hedge accounting at inception.

Entity F issues five-year, fixed-rate debt with an embedded (purchased) call option and, with a different counterparty, writes a call option to neutralize the call feature in the debt. The embedded call option and the written call option have the same effective notional amount, underlying fixed interest rate, and strike price. (The strike price of the option in the debt usually is referred to as the call price.) The embedded option also can be exercised at the same times as the written option. Entity F designates the written option as a fair value hedge of the embedded prepayment option component of the fixed-rate debt.

To assess whether the hedge is expected to be highly effective in achieving offsetting changes in fair value, Entity F could estimate and compare the changes in fair values of the two options for different market interest rates. Because this Subtopic does not permit derivative instruments, including embedded derivatives whether or not they are required to be accounted for separately, to be separated into components, Entity F can only designate a hedge of the entire change in fair value of the embedded purchased call option. The resulting changes in fair value will be included currently in earnings. Changes in the fair value of the written option also will be included currently in earnings and presented in the same income statement line item as the earnings effect of the hedged item. Any mismatch between the changes in fair values of the hedging instrument and the hedged item attributable to the hedged risk, thus, will be automatically reflected in earnings. (The hedge is likely to have some earnings effect because the premium for the written call option is unlikely to be the same as the premium for the embedded purchased call option.)

**Example 7-12: Fair value hedge of fixed-rate interest-bearing debt (ASC 815-25-55-40 through 55-52)**

This Example demonstrates the guidance in Subtopic 815-20 and this Subtopic as applied to the mechanics of reporting an interest rate swap used as a fair value hedge of an interest-bearing liability. It is not intended to demonstrate how to compute the fair value of an interest rate swap or an interest-bearing liability. This Example has been simplified by assuming that the interest rate applicable to a payment due at any future date is the same as the rate for a payment due at any other date (that is, the yield curve is flat). Although that is an unrealistic assumption, it makes the amounts used easier to understand without detracting from the purpose of the Example. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

The fair values of the interest rate swap in this Example are determined using the zero-coupon method. The zero-coupon method is not the only acceptable method. Explanations of other acceptable methods of determining the fair value of an interest rate swap can be obtained from various published sources. Fair values also may be available from dealers in interest rate swaps and other derivative instruments.

In this Example, the term and notional amount of the interest rate swap match the term and principal amount of the interest-bearing liability being hedged. The fixed and variable interest rates used to determine the net settlements on the interest rate swap match the current yield curve, and the sum of the present values of the expected net settlements is zero at inception. Thus, paragraphs 815-20-25-102 through 25-106 permit the reporting entity to assume perfect effectiveness. Assessment of effectiveness at one of the interest rate swap's repricing dates would confirm the validity of that assumption.

A shortcut method (see paragraphs 815-20-25-102 through 25-106) can be used to produce the same reporting results as the method illustrated in this Example. This shortcut is only appropriate for a fair value hedge of a fixed-rate asset or liability using an interest rate swap and only if the assumption of perfect effectiveness is appropriate. The steps in the shortcut method are as follows:

a. Determine the difference between the fixed rate to be received on the interest rate swap and the fixed rate to be paid on the bonds.

b. Combine that difference with the variable rate to be paid on the interest rate swap.

c. Compute and recognize interest expense using that combined rate and the fixed-rate liability's principal amount. (Amortization of any purchase premium or discount on the liability also must be considered, although that complication is not incorporated in this Example.)

d. Determine the fair value of the interest rate swap.

e. Adjust the carrying amount of the interest rate swap to its fair value and adjust the carrying amount of the liability by an offsetting amount.

Amounts determined using the shortcut method and the facts in this Example will match the amounts in paragraph 815-25-55-48 even though the shortcut does not involve explicitly amortizing the hedge accounting adjustments on the debt. That is, the quarterly adjustments of the debt and explicit amortization of previous adjustments will have the same net effect on earnings as the shortcut method.

A slightly different shortcut method for interest rate swaps used as cash flow hedges is illustrated in Example 6 (see paragraph 815-30-55-24).

On July 1, 20X1, Entity ABC borrows $1,000,000 to be repaid on June 30, 20X3. On that same date, Entity ABC also enters into a two-year receive-fixed, pay-variable interest rate swap. Entity ABC designates the interest rate swap as a hedge of the changes in the fair value of the fixed-rate debt attributable to changes in the designated benchmark interest rate. Entity ABC designates changes in

London Interbank Offered Rate (LIBOR) swap rates as the benchmark interest rate in hedging interest rate risk. The terms of the interest rate swap and the debt are as follows.

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

(a) These terms need not match for the assumption of perfect effectiveness to be appropriate. (See paragraphs 815-20-25-102 through 25-110.)

The USD LIBOR rates that are in effect at inception of the hedging relationship and at each of the quarterly reset dates are assumed to be as follows.

| Reset Date | 3-Month LIBOR |
|---|---|
| 7/1/X1 | 6.41% |
| 9/30/X1 | 6.48% |
| 12/31/X1 | 6.41% |
| 3/31/X2 | 6.32% |
| 6/30/X2 | 7.60% |
| 9/30/X2 | 7.71% |
| 12/31/X2 | 7.82% |
| 3/31/X3 | 7.42% |

The following table summarizes the fair values of the debt and the interest rate swap at each quarter end, the details of the changes in the fair values during each quarter (including accrual and payment of interest, the effect of changes in rates, and level-yield amortization of hedge accounting adjustments), the expense for each quarter, and the net cash payments for each quarter. The calculations of fair value of both the debt and the interest rate swap are made using LIBOR. (A discussion of the appropriate discount rate appears in paragraph 815-20-25-111.)

| | Fixed-Rate Debt | Interest Rate Swap | Expense | Net Payment |
|---|---|---|---|---|
| July 1, 20X1 | ($1,000,000) | $ - | | |
| Interest accrued | (16,025) | - | ($16,025) | |
| Payments (receipts) | 16,025 | - | | $16,025 |
| Effect of change in rates | 1,149 | (1,149) | - | |
| September 30, 20X1 | (998,851) | (1,149) | ($16,025) | $16,025 |
| Interest accrued | (16,025) | (19) | ($16,044) | |
| Payments (receipts) | 16,025 | 175 | | $16,200 |
| Amortization of basis adjustments | (156) | - | (156) | |

| | Fixed-Rate Debt | Interest Rate Swap | Expense | Net Payment |
|---|---|---|---|---|
| Effect of change in rates | (993) | 993 | - | |
| December 31, 20X1 | (1,000,000) | - | ($16,200) | $16,200 |
| Interest accrued | (16,025) | - | ($16,025) | |
| Payments (receipts) | 16,025 | - | | $16,025 |
| Amortization of basis adjustments | - | - | - | |
| Effect of change in rates | (1,074) | 1,074 | - | |
| March 31, 20X2 | (1,001,074) | 1,074 | ($16,025) | $16,025 |
| Interest accrued | (16,025) | 17 | ($16,008) | |
| Payments (receipts) | 16,025 | (225) | | $15,800 |
| Amortization of basis adjustments | 208 | - | 208 | |
| Effect of change in rates | 12,221 | (12,221) | - | |
| June 30, 20X2 | (988,645) | (11,355) | ($15,800) | $15,800 |
| Interest accrued | (16,025) | (216) | ($16,241) | |
| Payments (receipts) | 16,025 | 2,975 | | $19,000 |
| Amortization of basis adjustments | (2,759) | - | (2,759) | |
| Effect of change in rates | 789 | (789) | - | |
| September 30, 20X2 | (990,615) | (9,385) | ($19,000) | $19,000 |
| Interest accrued | (16,025) | (181) | ($16,206) | |
| Payments (receipts) | 16,025 | 3,250 | | $19,275 |
| Amortization of basis adjustments | (3,069) | - | (3,069) | |
| Effect of change in rates | 532 | (532) | - | |
| December 31, 20X2 | (993,152) | (6,848) | ($19,275) | $19,275 |
| Interest accrued | (16,025) | (134) | ($16,159) | |
| Payments (receipts) | 16,025 | 3,525 | | $19,550 |
| Amortization of basis adjustments | (3,391) | - | (3,391) | |
| Effect of change in rates | (978) | 978 | - | |
| March 31, 20X3 | (997,521) | (2,479) | ($19,550) | $19,550 |
| Interest accrued | (16,025) | (46) | ($16,071) | |
| Payments (receipts) | 1,016,025 | 2,525 | | $1,018,550 |
| Amortization of basis adjustments | (2,479) | - | ($2,479) | |
| June 30, 20X3 | $ - | $ - | ($18,550) | $1,018,550 |

The preceding table demonstrates two important points that explain why the shortcut method described in paragraphs 815-25-55-43 through 55-45 produces the same results as the computation in the preceding table if the hedging relationship is perfectly effective:

a. In every quarter, the effect of changes in rates on the interest rate swap completely offsets the effect of changes in rates on the debt. That is as expected because the hedge is perfectly effective.

b. In every quarter except the last when the principal is repaid, the expense equals the cash payment.

The following table illustrates the computation of interest expense using the shortcut method described in paragraphs 815-25-55-43 through 55-45. The results are the same as the results computed in the preceding table.

| Quarter Ended | (a) Difference between Fixed Rates | (b) Variable Rate on Swap | (c) Sum (a) + (b) | (d) Debt's Principal Amount | (e) Interest Expense ([c] × [d]) ÷ 4 |
|---|---|---|---|---|---|
| September 30, 20X1 | 0.00% | 6.41% | 6.41% | $1,000,000 | $16,025 |
| December 31, 20X1 | 0.00% | 6.48% | 6.48% | 1,000,000 | 16,200 |
| March 31, 20X2 | 0.00% | 6.41% | 6.41% | 1,000,000 | 16,025 |
| June 30, 20X2 | 0.00% | 6.32% | 6.32% | 1,000,000 | 15,800 |
| September 30, 20X2 | 0.00% | 7.60% | 7.60% | 1,000,000 | 19,000 |
| December 31, 20X2 | 0.00% | 7.71% | 7.71% | 1,000,000 | 19,275 |
| March 31, 20X3 | 0.00% | 7.82% | 7.82% | 1,000,000 | 19,550 |
| June 30, 20X3 | 0.00% | 7.42% | 7.42% | 1,000,000 | 18,550 |

As stated in the introduction to this Example, a flat yield curve is assumed for simplicity. An upward-sloping yield curve would have made the computations more complex. Paragraph 815-25-55-47 would have shown different interest rates for each quarterly repricing date, and the present value of each future payment would have been computed using a different rate (as described in paragraph 815-25-55-41). However, the basic principles are the same. As long as the hedging relationship meets the criteria for the shortcut method, perfect effectiveness can be assumed.

In this Example of a fair value hedge of fixed-rate interest-bearing debt, it is assumed that Entity ABC elects to immediately begin amortizing the adjustments of the carrying amount of the fixed-rate debt while the hedge is still in place. Because the change in fair value of the interest rate swap attributable to the passage of time is recognized as interest expense by Entity ABC, the amounts recorded as expenses in the table in paragraph 815-25-55-48 would be eligible for capitalization under Subtopic 835-20.

**RSM COMMENTARY:** While in this example Entity ABC elected to immediately amortize fair value hedge accounting adjustments to the carrying amount of the debt it was hedging, this is not required. As an alternative, Entity ABC could have elected to defer amortization of these basis adjustments until the termination of the hedge. Refer to Section 9.2.1 for additional discussion of this matter.

**Example 7-13: Fair value hedge of the LIBOR swap rate in a $100,000 BBB-quality 5-year fixed-rate noncallable note (ASC 815-25-55-53 through 55-61C)**

This Example illustrates one method that could be used pursuant to paragraph 815-20-25-12(f)(2) in determining the hedged item's change in fair value attributable to changes in the benchmark interest rate. Other methods could be used in determining the hedged item's change in fair value attributable to changes in the benchmark interest rate as long as those methods meet the criteria in that paragraph. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

On January 1, 20X0, Entity GHI issues at par a $100,000 BBB- quality 5-year fixed-rate noncallable debt instrument with an annual 10 percent interest coupon. On that date, Entity GHI enters into a 5-year interest rate swap based on the LIBOR swap rate and designates it as the hedging instrument in a fair value hedge of the $100,000 liability. Under the terms of the interest rate swap, Entity GHI will receive fixed interest at 7 percent and pay variable interest at LIBOR. The variable leg of the interest rate swap

resets each year on December 31 for the payments due the following year. This Example has been simplified by assuming that the interest rate applicable to a payment due at any future date is the same as the rate for a payment at any other date (that is, the yield curve is flat). During the hedge period, the gain or loss on the interest rate swap will be recorded in earnings. The Example assumes that immediately before the interest rate on the variable leg resets on December 31, 20X0, the LIBOR swap rate increased by 50 basis points to 7.50 percent, and the change in fair value of the interest rate swap for the period from January 1 to December 31, 20X0, is a loss in value of $1,675.

Under this method, the change in a hedged item's fair value attributable to changes in the benchmark interest rate for a specific period is determined as the difference between two present value calculations that use the remaining cash flows as of the end of the period and reflect in the discount rate the effect of the changes in the benchmark interest rate during the period.

Both present value calculations are computed using the estimated future cash flows for the hedged item, which would be either its remaining contractual coupon cash flows or the LIBOR benchmark rate component of the remaining contractual coupon cash flows determined at hedge inception as illustrated by the following Cases:

a. Using the full contractual coupon cash flows (Case A)

b. Using the LIBOR benchmark rate component of the contractual coupon cash flows (Case B).

This Example illustrates two approaches for computing the change in fair value of the hedged item attributable to changes in the benchmark interest rate. This Subtopic does not specify the discount rate that must be used to calculate the change in fair value of the hedged item.

In Cases A and B in this Example, Entity GHI presents the total change in the fair value of the hedging instrument (that is, the interest accruals and all other changes in fair value) in the same income statement line item (in this case, interest expense) that is used by Entity GHI to present the earnings effect of the hedged item before applying hedge accounting in accordance with paragraph 815-20-45-1A.

**Case A: Using the Full Contractual Coupon Cash Flows**

In this Case, assume Entity GHI elected to calculate the change in the fair value of the hedged item attributable to interest rate risk on the basis of the full contractual coupon cash flows of the hedged item. Accordingly, both present value calculations in accordance with paragraph 815-25-55-55 are computed using the remaining contractual coupon cash flows as of the end of the period and the discount rate that reflects the change in the designated benchmark interest rate during the period. The method chosen by Entity GHI in this Case requires that the discount rate be based on the market interest rate for the hedged item at the inception of the hedging relationship. The discount rates used for those present value calculations would be, respectively:

a. The discount rate equal to the market interest rate for that hedged item at the inception of the hedge adjusted (up or down) for changes in the benchmark rate (designated as the interest rate risk being hedged) from the inception of the hedge to the beginning date of the period for which the change in fair value is being calculated

b. The discount rate equal to the market interest rate for that hedged item at the inception of the hedge adjusted (up or down) for changes in the designated benchmark rate from the inception of the hedge to the ending date of the period for which the change in fair value is being calculated.

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

| *December 31, 20X0* | | |
|---|---|---|
| **Calculate the present value using the beginning-of-period discount rate of 10 percent:** | | |
| $10,000pmt, 10%i, 4n, PV = | $31,699 | (interest payments) |
| $100,000fv, 10%i, 4n, PV = | $68,301 | (principal payment) |
| Total present value | $100,000 | |

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

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

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

When the change in fair value of the hedged item ($1,568 gain) attributable to the risk being hedged is compared with the change in fair value of the hedging instrument ($1,675 loss), a mismatch of $107 results that will be reported in earnings, because both changes in fair value are recorded in earnings. The change in the fair value of the hedging instrument will be presented in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A.

**Case B: Using the LIBOR Benchmark Rate Component of the Contractual Coupon Cash Flows**

In this Case, assume Entity GHI elected to calculate the change in the fair value of the hedged item attributable to interest rate risk on the basis of the benchmark rate component of the contractual coupon cash flows determined at hedge inception. Accordingly, both present value calculations in accordance with paragraph 815-25-55-55 are computed using the remaining benchmark rate component of contractual coupon cash flows as of the end period and the discount rate that reflects the change in the designated benchmark rate during the period. The discount rates used by Entity GHI in this Case would be, respectively:

a. The benchmark rate (designated as the interest rate risk being hedged) as of the beginning date of the period for which the change in fair value is being calculated

b. The designated benchmark rate as of the ending date of the period for which the change in fair value is being calculated.

Entity GHI elected to subsequently assess hedge effectiveness on a quantitative basis. In Entity GHI's quarterly assessments of hedge effectiveness for each of the first three quarters of year 20X0, there was no change in the hedged item's fair value attributable to changes in the benchmark interest rate because there was no change in the LIBOR swap rate. However, in the assessment for the fourth quarter 20X0, the discount rate for the beginning of the period is 7 percent, and the discount rate for the end of the period is 7.50 percent reflecting the change during the period in the LIBOR swap rate. The change in fair value of the hedged item attributable to the change in the benchmark interest risk for the period January 1, 20X0, to December 31, 20X0, is a gain of $1,675, calculated as follows.

| *December 31, 20X0* | | |
|---|---|---|
| **Calculate the present value using the beginning-of-period benchmark interest rate:** | | |
| $7,000pmt, 7%i, 4n, PV = | $23,710 | (benchmark component of coupon payments) |
| $100,000fv, 7%i, 4n, PV = | 76,290 | (principal payment) |
| Total present value | 100,000 | |
| **Calculate the present value using the end-of-period benchmark interest rate:** | | |
| $7,000pmt, 7.50%i, 4n, PV = | 23,445 | (benchmark component of coupon payments) |
| $100,000fv, 7.50%i, 4n, PV = | 74,880 | (principal payment) |
| Total present value | 98,325 | |
| Change in value | $1,675 | |

Because the change in fair value of the hedged item ($1,675 gain) attributable to the risk being hedged is the same as the change in fair value of the hedging instrument ($1,675 loss), there is perfect offset and, therefore, a zero net earnings effect.

**Example 7-14: Interaction with measurement of credit losses (ASC 815-25-55-85 through 55-93)**

This Example illustrates the application of paragraph 815-25-35-11 involving the interaction of hedge accounting and measurement of credit losses in Subtopic 326-20 on financial instruments measured at amortized cost. The following Cases also illustrate the effect of the two approaches to calculate the change in the fair value of the hedged item attributable to interest rate risk discussed in paragraph 815-25-35-13 on that interaction, as follows:

a. Using the full contractual coupon cash flows (Case A)

b. Using the benchmark rate component of the contractual coupon cash flows (Case B).

Entity A formally documents a qualifying fair value hedge (for fair value changes attributable to changes in the designated benchmark interest rate) between a fixed-rate loan receivable from Entity B and an interest rate swap. The 5-year, fixed-rate loan to Entity B has a principal amount of $1,000,000 payable at maturity and interest payable annually at a 10 percent rate. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

One year after inception of the hedging relationship, the following conditions exist:

a. Subparagraph superseded by Accounting Standards Update No 2017-12.

b. There has been an adverse change to Entity B's creditworthiness.

c. The LIBOR swap rate (the designated benchmark interest rate) has decreased from 6 percent to 5.5 percent.

Assume that the repayment of the loan is not dependent on the underlying collateral. In applying the requirements of Subtopic 326-20 to the loan, Entity A evaluates the loan for credit losses on an individual basis because it does not have similar risk characteristics with other loans in the portfolio and uses a discounted cash flow approach. Entity A determines that the present value of expected future cash flows discounted at the loan's effective interest rate at inception of the loan is $930,000. (See row C in the table in paragraph 815-25-55-90, which presents calculations—at the end of the first year of the loan's term—of the net present value of current estimates of expected future cash flows based on the loan's original effective interest rate.)

### Case A: Using the Full Contractual Coupon Cash Flows

In this Case, assume that the entity elected to calculate fair value changes in the hedged item attributable to interest rate risk using the full contractual coupon cash flows of the hedged item. One year after inception of the hedging relationship, the change in the hedged item's fair value attributable to changes in the LIBOR swap rate (the designated benchmark interest rate) is a gain of $16,022. (See row B in the table in paragraph 815-25-55-90, which presents calculations—at the end of the first year of the loan's term—of the net present value of contractual cash flows based on the loan's original effective interest rate adjusted for a 50 basis point decrease in the LIBOR swap rate.)

After adjusting the amortized cost basis of the hedged loan by $16,022 (pursuant to paragraph 815-25-35-1(b)) for the increase in the hedged item's fair value attributable to changes in the benchmark interest rate, Entity A should apply the guidance in Subtopic 326-20 by doing both of the following:

a. Comparing the amortized cost basis of the loan after the effect of the fair value hedge, or $1,016,022, to the $944,901 present value of expected future cash flows discounted using the rate that reflects the rate of return implicit in the loan after adjusting the amortized cost basis of the hedged loan pursuant to paragraph 815-25-35-1(b) (that is, 9.5 percent)

b. Recognizing an allowance for credit losses (with the offsetting entry charged to expense) for the difference of $71,121 ($1,016,022 – $944,901).

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

| | Rate | Net Present Value at End of Year 1 | Assumed Cash Flow in Year | | | |
|---|---|---|---|---|---|---|
| | | | 2 | 3 | 4 | 5 |
| **A.** Original cash flows and original effective rate | 10.0% | $1,000,000 | $100,000 | $100,000 | $100,000 | $1,100,000 |
| **B.** Original cash flows and new implicit rate | 9.5% | $1,016,022 | $100,000 | $100,000 | $100,000 | $1,100,000 |
| **C.** Expected future cash flows and original effective rate | 10.0% | $930,000 | $93,000 | $93,000 | $93,000 | $1,023,000 |
| **D.** Expected future cash flows and new implicit rate | 9.5% | $944,901 | $93,000 | $93,000 | $93,000 | $1,023,000 |

### Case B: Using the Benchmark Rate Component of the Contractual Coupon Cash Flows

In this Case, assume that Entity A elected to calculate fair value changes in the hedged item attributable to interest rate risk using the benchmark rate component of the contractual coupon cash flows of the hedged item determined at hedge inception. One year after inception of the hedging relationship, the change in the hedged item's fair value attributable to changes in the LIBOR swap rate (the designated benchmark interest rate) is a gain of $17,526, which is calculated as follows.

| | |
|---|---|
| ***At the beginning of the loan's term*** | |
| $60,000pmt, 6%i, 5n, 1,000,000fv, PV = | $1,000,000 |
| ***At the end of the first year of the loan's term*** | |
| $60,000pmt, 5.5%i, 4n, 1,000,000fv, PV = | 1,017,526 |
| Change in value | ($17,526) |

After adjusting the amortized cost basis of the hedged loan by $17,526 (in accordance with paragraph 815-25-35-1(b)) for the increase in the hedged item's fair value attributable to changes in the benchmark interest rate, Entity A should apply the guidance in Subtopic 326-20 by doing both of the following:

a. Comparing the amortized cost basis of the loan after the effect of the fair value hedge, or $1,017,526, to the $946,299 present value of expected future cash flows discounted using the rate that reflects the rate of return implicit in the loan after adjusting the amortized cost basis of the hedged loan in accordance with paragraph 815-25-35-1(b) (that is, 9.45 percent that equates the adjusted amortized cost basis of the loan with the present value of the contractual cash flows of the loan)

b. Recognizing an allowance for credit losses (with the offsetting entry charged to expense) for the difference of $71,227 ($1,017,526 – $946,299).

Following are calculations (at the end of the first year of the loan's term) of the net present value of the benchmark rate component of the contractual cash flows and the creditor's best estimate of expected future cash flows based on the loan's original effective interest rate and the new implicit rate. In row B, the net present value at the end of the first year is equal to the net present value of the benchmark rate component of the contractual coupon cash flows discounted at the 5.5 percent benchmark rate.

| | Rate | Net Present Value at End of Year 1 | Assumed Cash Flow in Year | | | |
|---|---|---|---|---|---|---|
| | | | 2 | 3 | 4 | 5 |
| **A.** Original cash flows and original effective rate | 10.00% | $1,000,000 | $100,000 | $100,000 | $100,000 | $1,100,000 |
| **B.** Original cash flows and new implicit rate | 9.45% | $1,017,526 | $100,000 | $100,000 | $100,000 | $1,100,000 |
| **C.** Expected future cash flows and original effective rate | 10.00% | $930,000 | $93,000 | $93,000 | $93,000 | $1,023,000 |
| **D.** Expected future cash flows and new implicit rate | 9.45% | $946,299 | $93,000 | $93,000 | $93,000 | $1,023,000 |

**Example 7-15: Fair value hedge of interest rate risk using the partial-term approach (ASC 815-25-55-94 through 55-99)**

This Example illustrates the application of paragraphs 815-20-25-12(b)(2)(ii) and 815-25-35-13B to the designation and measurement of a hedged item as a portion of the term of a financial instrument in a hedge of interest rate risk. Assume that Entity S elected to calculate fair value changes in the hedged item attributable to interest rate risk on the basis of the benchmark rate component of the contractual coupon cash flows of the hedged item determined at hedge inception.

On January 1, 20X1, Entity S issues a noncallable, 5-year, $100 million debt instrument with a 3 percent semiannual interest coupon. On that date, the issuer also enters into a 2-year interest rate swap with a notional amount of $100 million. Entity S designates the swap as a fair value hedge of the fixed-rate debt attributable to interest rate risk for the first two years of its term in accordance with the guidance in paragraph 815-20-25-12(b)(2)(ii). The swap pays LIBOR and receives a fixed rate of 2 percent, with semiannual payments. The swap has a fair value of zero at inception. The designated benchmark interest rate is the LIBOR swap rate. For ease of calculation, the yield curve is assumed to be flat at the level of the current benchmark interest rate. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

This Example assumes that the LIBOR swap rate increased by 50 basis points to 2.5 percent on June 30, 20X1. The change in fair value of the interest rate swap for the period January 1, 20X1, to June 30, 20X1, is a loss in value of $731,633.

In calculating the change in fair value of the debt attributable to changes in the benchmark interest rate in accordance with paragraph 815-25-35-13B, Entity S determines that the assumed term of the hedged item is two years because it is hedging only the cash flows associated with the first two years of its debt issuance. The change in fair value of the debt attributable to changes in the benchmark interest rate for the period January 1, 20X1, to June 30, 20X1, is a gain of $731,633, calculated as follows.

| | |
|---|---|
| ***January 1, 20X1—beginning balance*** | |
| $1,000,000pmt, 1.00%i, 4n, 100,000,000fv, PV = | $100,000,000 |
| ***June 30, 20X1—ending balance*** | |
| $1,000,000pmt, 1.25%i, 3n, 100,000,000fv, PV = | 99,268,367 |
| Change in value | $731,633 |

As of June 30, 20X1, the change in fair value of the debt attributable to the benchmark interest rate is calculated by discounting the benchmark rate component of the contractual coupon cash flows using the benchmark interest rate at June 30, 20X1 (2.5 percent annual rate and 1.25 percent for each semiannual period). The change in fair value of the debt and the change in fair value of the swap result in perfect offset in current-period earnings. In accordance with paragraph 815-20-45-1A, Entity S presents the total change in the fair value of the hedging instrument (that is, the interest accruals and all other changes in fair value) in the same income statement line item (in this case, interest expense) that is used by Entity S to present the earnings effect of the hedged item before applying hedge accounting.

Although this Example illustrates the hedged item as the first two years of interest payments associated with an existing debt instrument, paragraph 815-20-25-12(b)(2)(ii) permits one interest payment or any consecutive interest payments associated with an existing debt instrument to be designated as the hedged item. An entity also may have one or more separately designated partial-term hedging relationships outstanding at the same time for the same debt instrument. For example, an entity may have 2 outstanding hedging relationships for consecutive interest cash flows in Years 1 and 2 and consecutive interest cash flows in Years 4 and 5 of the 5-year debt instrument.

### Example 7-16: Fair value hedge of the LIBOR swap rate in a $100 million A1-quality 5-year fixed-rate noncallable debt (ASC 815-25-55-100 through 55-108)

The following Cases illustrate application of the guidance in Sections 815-20-25, 815-20-35, and 815-25-35 to a fair value hedge of the LIBOR swap rate in a $100 million A1-quality 5-year fixed-rate noncallable debt:

a. Using the full contractual coupon cash flows (Case A)

b. Using the benchmark rate component of the contractual coupon cash flows (Case B).

On July 2, 20X0, Entity XYZ issues at par a $100 million A1-quality 5-year fixed-rate noncallable debt instrument with an annual 8 percent interest coupon payable semiannually. On that date, Entity XYZ enters into a 5-year interest rate swap based on the LIBOR swap rate and designates it as the hedging instrument in a fair value hedge of interest rate risk of the $100 million liability. Under the terms of the interest rate swap, Entity XYZ will receive a fixed interest rate at 8 percent and pay variable interest at LIBOR plus 200 basis points (current LIBOR 6 percent) on a notional amount of $100 million (semiannual settlement and interest reset dates). For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship. The Example also

assumes that the yield curve is flat and that the LIBOR swap rate increased 100 basis points to 7 percent on December 31, 20X0. The change in fair value of the interest rate swap for the period from July 2, 20X0, to December 31, 20X0, is a loss of $3,803,843.

In both Cases A and B in this Example, Entity XYZ presents the total change in the fair value of the hedging instrument (that is, the interest accruals and all other changes in fair value) in the same income statement line item (in this case, interest expense) that is used by Entity XYZ to present the earnings effect of the hedged item before applying hedge accounting in accordance with paragraph 815-20-45-1A.

**Case A: Using the Full Contractual Coupon Cash Flows**

In this Case, assume that Entity XYZ elected to calculate fair value changes in the hedged item attributable to interest rate risk using the full contractual coupon cash flows of the hedged item. The change in fair value of the debt attributable to changes in the benchmark interest rate for the period July 2, 20X0, to December 31, 20X0, is a gain of $3,634,395, calculated as follows.

| | |
|---|---|
| ***July 2, 20X0—beginning balance*** | |
| $4,000,000pmt, 4.00%i, 10n, 100,000,000fv, PV = | $100,000,000 |
| ***December 31, 20X0—ending balance*** | |
| $4,000,000pmt, 4.5%i, 9n, 100,000,000fv, PV = | 96,365,605 |
| Change in value | $3,634,395 |

As of December 31, 20X0, the fair value of the debt attributable to interest rate risk is calculated by discounting the full contractual coupon cash flows at the debt's original market rate with a 100 basis point adjustment related to the increase in the LIBOR swap rate (50 basis point adjustment on a semiannual basis). The following journal entries illustrate the interest rate swap and debt fair value changes attributable to changes in the LIBOR swap rate.

| | | |
|---|---|---|
| Debt | $3,634,395 | |
| Interest expense | | $3,634,395 |
| Interest expense | 3,803,843 | |
| Swap liability | | 3,803,843 |

The net earnings effect of the hedge is $169,448 due to the mismatch between the changes in fair value of the hedging instrument and the hedged item attributable to the changes in the benchmark interest rate.

**Case B: Using the Benchmark Rate Component of the Contractual Coupon Cash Flows**

In this Case, assume that Entity XYZ elected to calculate fair value changes in the hedged item attributable to interest rate risk using the benchmark rate component of the contractual coupon cash flows of the hedged item determined at hedge inception. The change in fair value of the debt attributable to changes in the benchmark interest rate for the period July 2, 20X0, to December 31, 20X0, is a gain of $3,803,843, calculated as follows.

| | |
|---|---|
| ***July 2, 20X0—beginning balance*** | |
| $3,000,000pmt, 3.0%i, 10n, 100,000,000fv, PV = | $100,000,000 |
| ***December 31, 20X0—ending balance*** | |
| $3,000,000pmt, 3.5%i, 9n, 100,000,000fv, PV = | 96,196,157 |
| Change in value | $3,803,843 |

As of December 31, 20X0, the fair value of the debt attributable to interest rate risk is calculated by discounting the benchmark rate component of the contractual coupon cash flows using the benchmark

interest rate at December 31, 20X0 (7 percent annual rate; 3.5 percent for each semiannual period). The following journal entries illustrate the interest rate swap and debt fair value changes attributable to changes in the LIBOR swap rate.

| | | |
|---|---|---|
| Debt | $3,803,843 | |
| Interest expense | | $3,803,843 |
| Interest expense | 3,803,843 | |
| Swap liability | | 3,803,843 |

The net earnings effect of the hedge is zero due to the perfect offset in fair value changes between the hedging instrument and the hedged item attributable to the changes in the benchmark interest rate.

# 8 Foreign currency hedges

## 8.1 Overview

Entities commonly hedge the foreign currency exposure associated with foreign-currency denominated forecasted purchases or sales and, in doing so, may elect hedge accounting. As indicated in ASC 815-20-25-28 and elaborated on in Section 5.2.2, the following types of hedges of foreign currency exposure are permissible, assuming all relevant requirements are met:

a. A fair value hedge of an unrecognized firm commitment or a recognized asset or liability (including an available-for-sale debt security)

b. A cash flow hedge of any of the following:

   1. A forecasted transaction
   2. An unrecognized firm commitment
   3. The forecasted functional-currency-equivalent cash flows associated with a recognized asset or liability
   4. A forecasted intra-entity transaction.

c. A hedge of a net investment in a foreign operation.

ASC 815-20-25-58 permits both derivative instruments and nonderivative financial instruments that may give rise to a foreign currency transaction gain or loss under ASC 830 to be designated as hedging changes in the fair value of an unrecognized firm commitment (or portion thereof) attributable to foreign currency exchange rates. Additionally, as noted in ASC 815-20-25-60, an intra-entity loan or other payable can be the designated hedging instrument in the consolidated financial statements if the member of the consolidated entity that is the counterparty to the loan enters into a third-party contract that offsets the foreign exchange exposure associated with the receivable. (This is illustrated through Example 8-5.)

## 8.2 Incremental requirements relevant to hedges of foreign currency exposure

In addition to the general requirements within Section 5.2 that need to be met for hedge accounting to be applied, ASC 815-20-25-30 outlines additional conditions that must both be met for foreign currency hedges.

**ASC 815-20-25-30**

Both of the following conditions shall be met for foreign currency cash flow hedges, foreign currency fair value hedges, and hedges of the net investment in a foreign operation:

a. For consolidated financial statements, either of the following conditions is met:

   1. The operating unit that has the foreign currency exposure is a party to the hedging instrument.
   2. Another member of the consolidated group that has the same functional currency as that operating unit is a party to the hedging instrument and there is no intervening subsidiary with a different functional currency. See guidance beginning in paragraph 815-20-25-52 for conditions under which an intra-entity foreign currency derivative can be the hedging instrument in a cash flow hedge of foreign exchange risk.

b. The hedged transaction is denominated in a currency other than the hedging unit's functional currency.

For hedge accounting purposes, foreign currency exposure is assessed at the operating unit level to be consistent with the functional currency concept of ASC 830. ASC 830 requires assets and liabilities that

are denominated in a foreign currency to be remeasured in the operating unit's functional currency, resulting in exchange gains and losses—and therefore foreign currency exposure—for the unit, but not for the parent entity if the parent entity has a different functional currency than the unit.

While (as previously mentioned) the operating unit with the foreign currency exposure is required to be a party to the hedging instrument, it is permissible to use an intra-entity hedging instrument between the subsidiary and the parent entity as the designated hedging instrument in the consolidated financial statements, as long as the parent entity enters into an offsetting contract with an unrelated third party pursuant to ASC 815-20-25-52 to hedge the exposure it acquired from the intra-entity derivative instrument. This is illustrated through Example 8-5.

Additionally, as is more fully elaborated on in ASC 815-20-25-32, a parent or other member of a consolidated group that has the same functional currency as the subsidiary with the foreign currency exposure is permitted, subject to certain restrictions, to enter into a derivative or nonderivative instrument that is designated as the hedging instrument in a hedge of the subsidiary's foreign exchange risk in the consolidated financial statements.

### 8.2.1 Additional requirements for cash flow hedge of foreign exchange risk

#### 8.2.1.1 Hedging a group of forecasted transactions

It is not uncommon to hedge a group of forecasted foreign-currency-denominated transactions, such as a stated amount of sales denominated in a specific currency. As indicated in ASC 815-20-25-39, the group of hedged transactions cannot include both forecasted inflows (e.g., sales) and forecasted outflows (e.g., purchases) of a foreign currency.

#### 8.2.1.2 Hedging all variability in functional-currency-equivalent cash flows

When the hedged item is a recognized foreign-currency-denominated asset or liability, all the variability in the hedged item's functional-currency-equivalent cash flows needs to be eliminated by the hedge. This does not mean that the hedge needs to be perfectly effective, but, rather, be structured to eliminate all risks associated with variability in functional-currency-equivalent cash flows (e.g., changes attributable to both changes in foreign currency rates and interest rates) and be highly effective. This concept is further illustrated through Example 8-2 and Example 8-9.

If this and other relevant requirements are met, ASC 815-20-25-41 indicates that when hedging the variability in the functional-currency-equivalent cash flows associated with a foreign-currency-denominated asset or liability, the hedged item can be designated as all or any fixed portion of principal or interest, or select payments of both principal and interest. Hedging portions of a foreign-currency-denominated asset or liability is illustrated through Example 8-4.

In light of the requirement to hedge all the variability in functional-currency-equivalent cash flows, if a hedged foreign-currency-denominated asset or liability pays interest at a variable rate and the hedged transactions include interest payments, the hedging instrument would need to be a cross-currency interest rate swap to eliminate the variability in functional-currency-equivalent cash flows attributable to both changes in foreign currency rates and interest rates. In other words, a simple foreign currency derivative contract would not suffice, as it would not eliminate the variability in functional-currency-equivalent cash flows associated with changes in interest rates.

#### 8.2.1.3 Hedging foreign exchange risk associated with a firm commitment

As indicated previously, forecasted transactions can be designated as the hedged item in a cash flow hedge of foreign exchange risk. While a forecasted transaction is defined in the ASC Master Glossary as a "transaction that is expected to occur for which there is no firm commitment," a firm commitment that is denominated in a foreign currency presents exposure to variability in functional-currency-equivalent cash flows and is therefore eligible to be designated as the hedged item in a cash flow hedge of foreign exchange risk. This is elaborated on in ASC 815-20-25-42 and illustrated at Example 8-3.

## 8.3 Hedging foreign currency exposure associated with receivables or payables resulting from hedged forecasted sales or purchases

As noted in ASC 815-20-25-28, foreign-currency-denominated receivables and payables—including those that result from a hedged forecasted purchase or sale—are eligible hedged items. ASC 815-20-25-34 outlines two different alternatives to structure a hedge or hedges to address the exposure related to both a forecasted purchase or sale and its associated payable or receivable.

**ASC 815-20-25-34**

The provisions of this Section (including paragraph 815-20-25-28) that permit a recognized foreign-currency-denominated asset or liability to be the hedged item in a fair value or cash flow hedge of foreign currency exposure also pertain to a recognized foreign-currency-denominated receivable or payable that results from a hedged forecasted foreign-currency-denominated sale or purchase on credit. Specifically, an entity may choose to designate either of the following:

a. A single cash flow hedge that encompasses the variability of functional currency cash flows attributable to foreign exchange risk related to the settlement of the foreign-currency-denominated receivable or payable resulting from a forecasted sale or purchase on credit

b. Both of the following separate hedges:

   1. A cash flow hedge of the variability of functional currency cash flows attributable to foreign exchange risk related to a forecasted foreign-currency-denominated sale or purchase on credit

   2. A foreign currency fair value hedge of the resulting recognized foreign-currency-denominated receivable or payable.

If alternative (b) is selected, the cash flow hedge would be dedesignated and terminated when the hedged sale or purchase occurs. The same derivative instrument could potentially be used for both the cash flow and fair value hedge if the criteria for high effectiveness are met.

ASC 815-30-35-9 elaborates on how the preceding guidance is applied in the context of a single cash flow hedge.

**ASC 815-30-35-9**

For a single cash flow hedge that encompasses the variability of functional-currency-equivalent cash flows attributable to foreign exchange risk related to the settlement of a foreign-currency-denominated receivable or payable resulting from a forecasted sale or purchase on credit, the guidance in paragraph 815-30-35-3 is applied as follows:

a. The gain or loss on the derivative instrument that is included in the assessment of hedge effectiveness is reported in other comprehensive income during the period before the forecasted purchase or sale.

b. The functional currency interest rate implicit in the hedging relationship as a result of entering into the forward contract is used to determine the amount of cost or income to be ascribed to each period of the hedging relationship. The cash flow hedging model for recognized foreign-currency-denominated assets and liabilities requires use of the interest method at the inception of the hedging relationship to determine the amount of cost or income to be ascribed to each relevant period of the hedging relationship. However, for simplicity, in hedging relationships in which the hedged item is a short-term non-interest-bearing account receivable or account payable, the amount of cost or income to be ascribed each period can also be determined using a pro rata method based on the number of days or months of the hedging relationship.

In addition, in a short-term single cash flow hedging relationship that encompasses the variability of functional-currency-equivalent cash flows attributable to foreign exchange risk related to the settlement of a foreign-currency-denominated receivable or payable resulting from a forecasted sale or purchase on credit, the amount of cost or income to be ascribed each period can also be determined using a pro rata method or a method that uses two foreign currency forward exchange rates. The first foreign currency forward exchange rate would be based on the maturity date of the forecasted purchase or sale transaction. The second foreign currency forward exchange rate would be based on the settlement date of the resulting account receivable or account payable.

c. For forecasted sales on credit, the amount of cost or income ascribed to each forecasted period is reclassified from other comprehensive income to earnings on the date of the sale. For forecasted purchases on credit, the amount of cost or income ascribed to each forecasted period is reclassified from other comprehensive income to earnings in the same period or periods during which the asset acquired affects earnings. The reclassification from other comprehensive income to earnings of the amount of cost or income ascribed to each forecasted period is based on the guidance in paragraphs 815-30-35-38 through 35-41.

d. The income or cost ascribed to each period encompassed within the periods of the recognized foreign-currency-denominated receivable or payable is reclassified from other comprehensive income to earnings at the end of each reporting period.

This guidance is illustrated through Example 8-11.

## 8.4 Accounting for net investment hedges

Similar to a cash flow hedge, hedge accounting for a net investment hedge minimizes earnings volatility because changes in the fair value of the derivative or other hedging instrument are recognized in other comprehensive income and reclassified into earnings when the hedged transaction impacts earnings.

Specifically, the accounting for a net investment hedge is outlined in ASC 815-35 and summarized as follows:

- All changes in the fair value of a derivative instrument that are included in the assessment of hedge effectiveness are recognized in other comprehensive income as part of the cumulative translation adjustment.
- If an election was made to assess effectiveness on an after-tax basis, the portion of the gain or loss on the hedging instrument in excess of the loss or gain on the hedged item is recognized as an offset to the related tax effects when recognized.
- Any components that are excluded from the assessment of effectiveness are recognized in earnings (in the same income statement line item in which the income statement effects of the hedged item are reported), either through an amortization or mark-to-market approach. When hedge accounting is discontinued, any amounts that have not yet been recognized in earnings should remain in the cumulative translation adjustment section of accumulated other comprehensive income until the hedged net investment is sold or liquidated. Any difference between the change in fair value of the excluded component and amounts recognized in earnings under a systematic and rational method is also reported in the cumulative translation adjustment section of other comprehensive income.
- The gain or loss in other comprehensive income associated with amounts included in the assessment of hedge effectiveness is reclassified into earnings (in the same income statement line item as the effect of the hedged item) in the same period or periods during which the hedged forecasted transaction affects earnings.
- The hedged net investment should be accounted for in accordance with ASC 830.

When a method based on changes in spot rates is used to assess effectiveness, the change in fair value of the derivative instrument attributable to changes in the spot rate is reported in the cumulative translation adjustment section of other comprehensive income on an undiscounted basis. When a method based on changes in forward exchange rates is used, all changes in the fair value of the derivative instrument (including the time value component of purchased options) are reported in the cumulative translation adjustment section of other comprehensive income.

The interest accrual (periodic cash settlement) components of qualifying receive-variable-rate, pay-variable-rate and receive-fixed-rate, pay-fixed-rate cross-currency interest rate swaps are also reported directly in earnings.

When the hedging instrument is not a derivative instrument, the translation gain or loss is determined in accordance with ASC 830-30, with reference to the spot exchange rate between the transaction currency of the debt and the functional currency of the investor (after tax effects, if appropriate) and reported in the cumulative translation adjustment section of other comprehensive income.

Example 8-1 illustrates hedging a net investment with a foreign-currency-denominated debt instrument.

## 8.5 Foreign currency hedge examples

The following select examples related to foreign currency hedges are from the implementation guidance in ASC 815.

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**Example 8-1: Foreign-currency-denominated debt instrument as both hedging instrument and hedged item (ASC 815-20-55-127 through 55-129) – Before the adoption of ASU 2025-09**

This Example illustrates the application of paragraph 815-20-55-38.

A U.S. parent entity (Parent A) with a U.S. dollar (USD) functional currency has a German subsidiary that has the Euro (EUR) as its functional currency. On January 1, 2001, Parent A issues a five-year, fixed-rate EUR-denominated debt instrument and designates that EUR-denominated debt instrument as a hedge of its net investment in the German subsidiary. On the same date, Parent A enters into a five-year EUR-denominated receive-fixed, pay-Euribor-interest rate swap. Parent A designates the interest rate swap as a hedge of the foreign-currency-denominated fair value of the fixed-rate EUR-denominated debt instrument attributable to changes in Euribor interest rates, which is considered the benchmark interest rate for a hedge of the EUR-denominated fair value of that instrument.

As permitted by paragraph 815-20-55-38, Parent A may designate the EUR-denominated debt instrument as a hedge of its net investment in the German subsidiary and also as the hedged item in a fair value hedge of the debt instrument's foreign-currency-denominated fair value attributable to changes in the designated benchmark interest rate. As a result of applying fair value hedge accounting, the debt's carrying amount will be adjusted to reflect changes in its foreign-currency-denominated fair value attributable to interest rate risk. The notional amount of the debt that is designated as the hedging instrument in the net investment hedge will change over time such that it may not match the notional amount of the hedged net investment. The entity then applies the net investment hedge guidance in Subtopic 815-35 and the fair value hedge guidance in Subtopic 815-25. As discussed in paragraphs 815-35-35-13 through 35-14, because the notional amount of the nonderivative instrument designated as a hedge of the net investment does not match the portion of the net investment designated as being hedged, hedge effectiveness is assessed by comparing the following two values:

a. The foreign currency transaction gain or loss based on the spot rate change (after tax effects, if appropriate) of that nonderivative hedging instrument

b. The transaction gain or loss based on the spot rate change (after tax effects, if appropriate) that would result from the appropriate hypothetical nonderivative instrument that has a notional amount that matches the portion of the net investment being hedged. The hypothetical nonderivative instrument also would have a maturity that matches the maturity of the actual nonderivative instrument designated as the net investment hedge.

**Pending change: ASU 2025-09, *Hedge accounting improvements***

On November 25, 2025, the FASB issued ASU 2025-09, *Derivatives and Hedging (Topic 815): Hedge Accounting Improvements* (ASU 2025-09 or the ASU), to align hedge accounting more closely with the economics of an entity's risk management activities.

ASU 2025-09 removes the recognition and presentation mismatch that arises in a dual-hedge structure (i.e., when the same foreign-currency-denominated debt instrument is designated both as the hedging instrument in a net investment hedge and as the hedged item in a fair value hedge of interest rate risk). Under the new guidance, an entity must exclude the fair value hedge basis adjustment associated with that debt instrument from the net investment hedge effectiveness analysis. Consequently, any gains or losses resulting from remeasuring the fair value hedge basis adjustment at the spot exchange rate are recorded immediately in earnings. The ASU also prohibits applying this guidance by analogy to other situations.

For PBEs, ASU 2025-09 is effective for annual reporting periods beginning after December 15, 2026, and interim periods within those annual reporting periods. For entities other than PBEs, the ASU is effective for annual reporting periods beginning after December 15, 2027, and

interim periods within those annual reporting periods. Early adoption is permitted on any date on or after its issuance.

Entities should apply the guidance in ASU 2025-09 prospectively for all hedging relationships. An entity may elect to adopt the ASU for hedging relationships that exist as of the date of adoption.

**Example 8-1A: Foreign-currency-denominated debt instrument as both hedging instrument and hedged item (ASC 815-20-55-127 through 55-129) – After the adoption of ASU 2025-09**

This Example illustrates the application of paragraph 815-20-55-38.

A U.S. parent entity (Parent A) with a U.S. dollar (USD) functional currency has a German subsidiary that has the Euro (EUR) as its functional currency. On January 1, 2001, Parent A issues a five-year, fixed-rate EUR-denominated debt instrument and designates that EUR-denominated debt instrument as a hedge of its net investment in the German subsidiary. On the same date, Parent A enters into a five-year EUR-denominated receive-fixed, pay-Euribor-interest rate swap. Parent A designates the interest rate swap as a hedge of the foreign-currency-denominated fair value of the fixed-rate EUR-denominated debt instrument attributable to changes in Euribor interest rates, which is considered the benchmark interest rate for a hedge of the EUR-denominated fair value of that instrument.

As permitted by paragraph 815-20-55-38, Parent A may designate the EUR-denominated debt instrument as a hedge of its net investment in the German subsidiary and also as the hedged item in a fair value hedge of the debt instrument's foreign-currency-denominated fair value attributable to changes in the designated benchmark interest rate. As a result of applying fair value hedge accounting, the debt's carrying amount will be adjusted to reflect changes in its foreign-currency-denominated fair value attributable to interest rate risk. Parent A should exclude the fair value hedge basis adjustment from the assessment of effectiveness in the designated net investment hedging relationship. Accordingly, the notional amount of the debt that is designated as the hedging instrument in the net investment hedge will not change over time as a result of applying fair value hedge accounting such that it may continue to match the portion of the net investment being hedged. The entity then applies the net investment hedge guidance in Subtopic 815-35 and the fair value hedge guidance in Subtopic 815-25. Because the debt's fair value hedge basis adjustment is not included in the assessment of effectiveness of the net investment hedging relationship, the effect of changes in the spot rate on the fair value hedge basis adjustment is recognized currently in earnings in accordance with Subtopic 830-20.

**Example 8-2: Eliminating all variability in cash flows (ASC 815-20-55-132 through 55-135)**

The following Cases illustrate the application of paragraph 815-20-25-39(d) regarding whether all the variability in a hedged item's functional-currency-equivalent cash flows are eliminated by the effect of the hedge:

a. Difference in optionality (Case A)

b. Difference in reset dates (Case B)

c. Difference in notional amounts (Case C).

**Case A: Difference in Optionality**

An entity has issued a fixed-rate foreign-currency-denominated debt obligation that is callable (that is, by that entity) and desires to hedge its foreign currency exposure related to that obligation with a fixed-to-

fixed cross-currency swap. A fixed-to-fixed currency swap could be used to hedge the fixed-rate foreign-currency-denominated debt instrument that is callable even though the swap does not contain a mirror-image call option as long as the terms of the swap and the debt instrument are such that they would be highly effective at providing offsetting cash flows and as long as it was probable that the debt instrument would not be called and would remain outstanding.

**Case B: Difference in Reset Dates**

An entity has issued a variable-rate foreign-currency-denominated debt obligation and desires to hedge its foreign currency exposure related to that obligation. The entity uses a variable-to-fixed cross-currency interest rate swap in which it receives the same foreign currency based on the variable rate index contained in the debt obligation and pays a fixed amount in its functional currency. If the swap would otherwise meet this Subtopic's definition of providing high effectiveness in hedging the foreign currency exposure of the debt instrument, but there is a one day difference between the reset dates in the debt obligation and the swap (that is, the one day difference in reset dates results in the hedge being highly effective, but not perfectly effective),the variable-to-fixed cross-currency interest rate swap could be used to hedge the variable-rate foreign-currency-denominated debt instrument even though there is a one-day difference between the reset dates or a slight difference in the notional amounts in the debt instrument and the swap. This would be true as long as the difference in reset dates or notional amounts is not significant enough to cause the hedge to fail to be highly effective at providing offsetting cash flows.

**Case C: Difference in Notional Amounts**

This Case involves the same facts as in Case B, except that there is no difference in the reset dates. However, there is a slight difference in the notional amount of the swap and the hedged item. If the swap would otherwise meet this Subtopic's definition of providing high effectiveness in hedging the foreign currency exposure of the debt instrument, paragraph 815-20-25-39(d) does not preclude the swap from qualifying for hedge accounting simply because the notional amounts do not exactly match. The mismatch attributable to the slight difference in the notional amount of the swap and the hedged item could be eliminated by designating only a portion of the contract with the larger notional amount as either the hedging instrument or hedged item, as appropriate.

**Example 8-3: Hedging a firm commitment or fixed-price agreement denominated in a foreign currency (ASC 815-20-55-136 through 55-140)**

The following Cases illustrate hedging foreign exchange risk under the cash flow hedging model as discussed in paragraph 815-20-25-42 and others:

a. Firm commitment (Case A)

b. Fixed-price agreement (Case B)

**Case A: Firm Commitment**

On January 1, an entity enters into an agreement to sell 1,000 tons of a nonfinancial asset to an unrelated party on June 30. The agreement meets the definition of a firm commitment. The firm commitment is denominated in the buyer’s functional currency, which is not the seller’s functional currency. Accordingly, the firm commitment exposes the seller to foreign currency risk. The seller may hedge the foreign currency exposure arising from the firm commitment under the fair value hedging model.

The seller may hedge its exposure to foreign currency risk under the cash flow hedging model even though the agreement meets the definition of a firm commitment. Accordingly, the seller may hedge the foreign currency exposure arising from the firm commitment to sell 1,000 tons of the nonfinancial asset under the cash flow hedging model, even though the seller has previously hedged its foreign currency exposure arising from another similar firm commitment under the fair value hedging model.

**Case B: Fixed-Price Agreement**

On January 1, an entity enters into an agreement to sell 1,000 tons of a nonfinancial asset to an unrelated party on June 30. Although the agreement in this Case does not meet the definition of a firm commitment, the seller's assessment of the observable facts and circumstances is that performance under the agreement is probable. The agreement is denominated in the buyer's functional currency, which is not the seller's functional currency. Accordingly, the foreign-currency-denominated fixed-price agreement exposes the seller to foreign currency risk.

If the agreement does not meet the definition of a firm commitment, but contains a fixed foreign-currency-denominated price, the seller may not hedge the foreign currency risk relating to the agreement to sell the nonfinancial asset under the fair value hedging model because the agreement is not a recognized asset, a recognized liability, or a firm commitment, which are the only items that can be designated as the hedged item in a fair value hedge. However, the seller may hedge the foreign currency risk relating to the agreement under the cash flow hedging model. The agreement is by definition a forecasted transaction because the sale of the nonfinancial assets will occur at the prevailing market price, that is, the fixed foreign-currency-denominated market price converted into the seller's functional currency at the prevailing exchange rate when the transaction occurs. Therefore, because the agreement includes a fixed foreign-currency-denominated price, the agreement exposes the seller to variability in the functional-currency-equivalent cash flows. Accordingly, the seller may not hedge the foreign currency risk relating to the agreement to sell 1,000 tons of the nonfinancial asset under the fair value hedging model but may hedge the foreign currency risk under the cash flow hedging model.

**Example 8-4: Portions of a foreign-currency-denominated financial asset or liability as hedged item (ASC 815-20-55-141 through 55-155)**

The following Cases illustrate the application of paragraph 815-20-25-41 to fixed-rate and variable-rate foreign-currency-denominated debt:

a. Foreign-currency-denominated fixed-rate debt (Case A)

b. Foreign-currency-denominated variable-rate debt (Case B).

Specifically, for each of the eight situations presented collectively in Cases A (see paragraph 815-20-55-143) and B (see paragraph 815-20-55-153), an entity can use cash flow hedge accounting to hedge the variability in the specific principal repayments, interest cash flows, or both by applying the guidance in paragraph 815-30-35-3(d) to the specifically identified hedged cash flows. Only an amount that would offset the transaction gain or loss arising from the remeasurement of a hedged cash flow would be reclassified each period from other comprehensive income to earnings. Also, the change in the fair value of the forward points (time value) attributable to the hedged future cash flows would be reported in other comprehensive income, while the change in the fair value of the forward points (time value) attributable to the unhedged future cash flows would be reported in earnings.

**Case A: Foreign-Currency-Denominated Fixed-Rate Debt**

Entity ABC, a U.S. dollar (USD) functional entity, issues a five-year foreign-currency-denominated fixed-rate debt obligation that requires interest payments and partial principal payments annually in the foreign currency with the remaining principal due at the end of five years (maturity) in the foreign currency. More specifically, Entity ABC issues an FC 45 million debt obligation on December 31, 20X0, with FC 5 million due on December 31 of each of the next 4 years and FC 25 million due on December 31, 20X5. Interest payments at 10 percent are paid annually.

In this Case, Entity ABC can use cash flow hedge accounting to hedge the variability in its functional-currency-equivalent cash flows associated with any of the following:

a. All of the payments of both principal and interest of the debt

b. All of the payments of principal of the debt

c. All or a fixed portion of selected payments of either principal or interest of the debt (such as either principal or interest payments on December 31, 2001, and December 31, 2003)

d. Selected payments of both principal and interest of the debt (such as principal and interest payments on December 31, 2001, and December 31, 2003).

For instance, Entity ABC could use a receive-fixed-rate, pay-fixed-rate cross-currency interest rate swap or a series of forward contracts to eliminate variability attributable to foreign exchange rates.

The following illustrates the second option, hedging the variability in all principal cash flows attributable to foreign exchange risk.

Entity ABC enters into the following five forward contracts to hedge all principal cash flows:

a. Forward contract to purchase FC 5,000 on December 31, 20X1, at a forward rate of 1.05061019

b. Forward contract to purchase FC 5,000 on December 31, 20X2, at a forward rate of 1.06061601

c. Forward contract to purchase FC 5,000 on December 31, 20X3, at a forward rate of 1.07066924

d. Forward contract to purchase FC 5,000 on December 31, 20X4, at a forward rate of 1.08076989

e. Forward contract to purchase FC 25,000 December 31, 20X5, at a forward rate of 1.090871.

Exchange rates are as follows.

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

Entity ABC would make the following journal entries.

| | Debit (Credit) | | | | |
|---|---|---|---|---|---|
| | Cash | Forward Contracts | Note Payable | Income or Expense | Accum. Other Comprehensive Income |
| Inception 12/31/X0 | 46,827 | | (46,827) | | |
| **December 31, 20X1 entries:** | | | | | |
| Repayment of principal | (5,500) | | 5,203 | 297 | |
| Payment of interest | (4,950) | | | 4,950 | |
| Transaction loss on note payable | | | (2,376) | 2,376 | |
| Fair value of forward contract #1 | | 247 | | | (247) |
| Settlement of forward #1 | 247 | (247) | | | |

| | Debit (Credit) | | | | |
|---|---|---|---|---|---|
| | Cash | Forward Contracts | Note Payable | Income or Expense | Accum. Other Comprehensive Income |
| Offset $247 of loss on principal ($50 related to cost of hedge remains in earnings) | | | | (247) | 247 |
| Fair value of forward contracts #2–5 (based on 6% discount rate) | | 2,853 | | | (2,853) |
| Paragraph 815-30-35-3(d) adjustment—offset the transaction loss related to principal | | | | (1,734) | 1,734 |
| Paragraph 815-30-35-3(d) adjustment—effect of hedge | | | | 396 | (396) |
| **December 31, 20X2 entries:** | | | | | |
| Repayment of principal | (5,500) | | 5,203 | 297 | |
| Payment of interest | (4,400) | | | 4,400 | |
| Fair value of forward contract #2 | | (89) | | | 89 |
| Settlement of forward #2 | 197 | (197) | | | |
| Offset $197 of loss on principal ($100 related to cost of hedge remains in earnings) | | | | (197) | 197 |
| Fair value of forward contracts #3–5 (based on 6% discount rate) | | (507) | | | 507 |
| Paragraph 815-30-35-3(d) adjustment—effect of hedge | | | | 299 | (299) |
| Change in time value related to principal goes to other comprehensive income or change in time value related to interest goes to earnings[(a)] | | | 297 | (180) | (117) |
| **December 31, 20X3 entries:** | | | | | |
| Repayment of principal | (5,500) | | 5,203 | 297 | |
| Payment of interest | (3,850) | | | (3,850) | |
| Fair value of forward contract #3 | | (92) | | | 92 |
| Settlement of forward #3 | 147 | (147) | | | |

| | Debit (Credit) | | | | |
|---|---|---|---|---|---|
| | Cash | Forward Contracts | Note Payable | Income or Expense | Accum. Other Comprehensive Income |
| Offset $147 of loss on principal ($150 related to cost of hedge remains in earnings) | | | | (147) | 147 |
| Fair value of forward contracts #4–5 (based on 6% discount rate) | | (477) | | | 477 |
| Paragraph 815-30-35-3(d) adjustment—effect of hedge | | | | 202 | (202) |
| Change in time value related to principal goes to other comprehensive income or change in time value related to interest goes to earnings | | | 297 | (168) | (129) |
| **December 31, 20X4 entries:** | | | | | |
| Repayment of principal | (5,500) | | 5,203 | 297 | |
| Payment of interest | (3,300) | | | 3,300 | |
| Fair value of forward contract #4 | | (95) | | | 95 |
| Settlement of forward #4 | 96 | (96) | | | |
| Offset $96 of loss on principal ($201 related to cost of hedge remains in earnings) | | | | (96) | 96 |
| Fair value of forward contract #5 (based on 6% discount rate) | | (437) | | | 437 |
| Paragraph 815-30-35-3(d) adjustment—effect of hedge | | | | 104 | (104) |
| Change in time value related to principal goes to other comprehensive income or change in time value related to interest goes to earnings | | | 297 | (154) | (143) |
| **December 31, 20X5 entries:** | | | | | |
| Repayment of principal | (27,500) | | 26,015 | 1,485 | |
| Payment of interest | (2,750) | | | 2,750 | |
| Fair value of forward contract #5 | | (488) | | | 488 |
| Settlement of forward #5 | 228 | (228) | | | |
| Offset $228 of loss on principal | | | | (228) | 228 |

| | Debit (Credit) | | | | |
|---|---|---|---|---|---|
| | Cash | Forward Contracts | Note Payable | Income or Expense | Accum. Other Comprehensive Income |
| Paragraph 815-30-35-3(d) adjustment—effect of hedge | | | 1,485 | (1,001) | (484) |
| Change in time value related to principal goes to other comprehensive income or change in time value related to interest goes to earnings | | | | (140) | 140 |
| | (21,008) | - | - | (b) | - |

(a) The entry recording the $297 gain for the period ended December 31, 20X2, results from the spot exchange rate remaining unchanged from December 31, 20X1, and one less period remaining on the loan payable. The $117 principal portion of the gain goes to other comprehensive income because only principal is being hedged. The $180 interest portion of the gain goes to earnings because interest is not being hedged.

(b) See schedule 3 (paragraph 815-20-55-152) for income or expense for each period.

The following schedules support the preceding entries.

| Schedule 1 | Foreign Currency | Functional Currency at 12/31/X0 Spot Rate (1) | Functional Currency at Current Spot rate (2) | Transaction Gain or Loss | (2) – (1) | Change in Time Value |
|---|---|---|---|---|---|---|
| **12/31/X0** | | | | | | |
| Principal | 30,976 (a) | 32,234 | | | | |
| Interest | 14,024 (a) | 14,593 | | | | |
| Loan value | 45,000 | 46,827 | | | | |
| **12/31/X1** | | | | | | |
| Principal | 29,192 | 30,377 | 32,111 | 1,734 | | |
| Interest | 10,808 | 11,247 | 11,889 | 642 | | |
| Loan value | 40,000 | 41,624 | 44,000 | | | |
| **12/31/X2** | | | | | | |
| Principal | 27,222 | 28,328 | 29,945 | | 1,617 | 117 = (1,734 – 1,617) |
| Interest | 7,778 | 8,093 | 8,555 | | 462 | 180 = (642 – 462) |
| Loan value | 35,000 | 36,421 | 38,500 | | | |
| **12/31/X3** | | | | | | |
| Principal | 25,048 | 26,065 | 27,553 | | 1,488 | 129 = (1,617 – 1,488) |
| Interest | 4,952 | 5,153 | 5,447 | | 294 | 168 = (462 – 294) |
| Loan value | 30,000 | 31,218 | 33,000 | | | |
| **12/31/X4** | | | | | | |
| Principal | 22,649 | 23,568 | 24,913 | | 1,345 | 143 |
| Interest | 2,351 | 2,447 | 2,586 | | 140 | 154 |
| Loan value | 25,000 | 26,015 | 27,500 | | | |
| **12/31/X5** (before final principal payment is made) | | | | | | |
| Principal | 25,000 | 26,015 | 27,500 | | 1,485 | (140) |
| Interest | - | - | - | | | 140 |
| Loan value | 25,000 | 26,015 | 27,500 | | | |

(a) The value ascribed to the principal portion was determined by discounting the future principal payments at an annual rate of 10% compounded quarterly. The value ascribed to the interest portion was determined by discounting future quarterly interest accruals at an annual rate of 10%.

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

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

Schedule 3 provides a breakdown for each year-end reporting period.

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

| Schedule 3 | |
|---|---|
| (140) | Time value related to unhedged interest |
| $2,866 | Total expense |

**Case B: Foreign-Currency-Denominated Variable-Rate Debt**

Entity XYZ, a U.S. dollar (USD) functional entity issues a five-year foreign-currency-denominated variable-rate debt obligation that requires interest payments and partial principal payments annually in the foreign currency with the remaining principal due at the end of five years (maturity) in the foreign currency. More specifically, Entity XYZ issues an FC 45 million debt obligation on December 31, 20X0, with FC 5 million due on December 31 of each of the next 4 years and FC 25 million due on December 31, 20X5. Interest payments are paid annually based on LIBOR.

In this Case the guidance in paragraph 815-20-25-41 provides that Entity XYZ can use cash flow hedge accounting to hedge the variability in its functional-currency-equivalent cash flows associated with any the following:

a. All of the payments of both principal and interest of the debt

b. All of the payments of principal of the debt

c. All or a fixed portion of selected payments of either principal or interest of the debt

d. Selected payments of both principal and interest of the debt (such as principal and interest payments on December 31, 2001, and December 31, 2003).

An entity could use a receive-variable-rate, pay-fixed-rate cross-currency interest rate swap to eliminate variability attributable to interest rates and foreign exchange rates. In cash flow hedges of recognized foreign-currency-denominated assets and liabilities, the entity must assess whether the changes in cash flows attributable to the risk being hedged are expected to offset at the inception of the hedging relationship and on an ongoing basis. In a manner similar to that described beginning in paragraph 815-30-35-25, the entity would assess the effectiveness of the hedge using the hypothetical-derivative method. After the initial quantitative assessment of hedge effectiveness, the entity may elect to assess hedge effectiveness on a qualitative or quantitative basis.

**Example 8-5: Designation of an intra-entity loan or other payable as the hedging instrument in a fair value hedge of an unrecognized firm commitment (ASC 815-20-55-167 through 55-170)**

This Example illustrates the application of paragraph 815-20-25-60.

A parent entity (Parent A) with the U.S. dollar (USD) as both its functional currency and reporting currency has a subsidiary with a Euro (EUR) functional currency (Subsidiary B). Subsidiary B enters into an unrecognized firm commitment with a third party that will result in Japanese yen (JPY) cash inflows. Concurrent with Subsidiary B entering into the firmly committed contract, Parent A extends a loan to Subsidiary B denominated in JPY, which is funded by a third-party, JPY-denominated borrowing by Parent A. Subsidiary B wishes to designate its JPY-denominated intra-entity loan payable as the hedging instrument in consolidated financial statements in a fair value hedge of foreign currency exposure related to its JPY-denominated unrecognized firm commitment to a third party.

In accordance with paragraph 830-20-35-1, at each balance sheet date, Subsidiary B's JPY-denominated intra-entity loan payable would be remeasured from the foreign currency (JPY) into Subsidiary B's functional currency (EUR) at the current EUR/JPY spot rate. Similarly, Parent A's intra-entity JPY-denominated receivable and its third-party JPY-denominated loan payable are remeasured from the foreign currency (JPY) into Parent A's functional currency (USD) at the current USD/JPY spot rate. The

transaction gains or losses that are generated from remeasurement into functional currency are recorded in net income. If Subsidiary B designates its JPY-denominated intra-entity loan payable as the hedging instrument in consolidated financial statements, the transaction gains and losses related to the intra-entity loan payable would offset the change in fair value of the firm commitment attributable to changes in foreign exchange rates in the consolidated income statement.

In this Example, Subsidiary B's JPY-denominated intra-entity payable may be designated as a fair value hedge of the foreign exchange exposure arising from the third-party JPY-denominated firm commitment. Parent A has in place a third-party JPY-denominated borrowing that offsets the exposure of its JPY-denominated intra-entity receivable from Subsidiary B during the period the intra-entity loan receives hedge accounting.

**Example 8-6: Fair value hedge of a firm commitment denominated in a foreign currency with a forward to purchase a different foreign currency ( ASC 815-25-55-62 through 55-71)**

This Example illustrates application of the guidance in Sections 815-20-25, 815-20-35, and 815-25-35 to a fair value hedge of a firm commitment to purchase an asset for a price denominated in a foreign currency. In this Example, the hedging instrument and the firm commitment are denominated in different foreign currencies. Consequently, although the hedge is highly effective at achieving offsetting changes in fair value, the hedge is not perfectly effective, and there will be an earnings effect. (The entity in the Example could have designed a perfectly effective hedge by using a hedging instrument denominated in the same foreign currency as the firm commitment with terms that match the appropriate terms in the firm commitment) [**RSM Commentary:** For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.]

Entity MNO's functional currency is the U.S. dollar (USD). On February 3, 20X7, Entity MNO enters into a firm commitment to purchase a machine for delivery on May 1, 20X7. The price of the machine will be 270,000 Swiss francs (CHF 270,000). Also on February 3, 20X7, Entity MNO enters into a forward contract to purchase 240,000 Euros (EUR 240,000) on May 1, 20X7. Entity MNO will pay USD 0.6125 per EUR 1 (a total of USD 147,000), which is the current forward rate for an exchange on May 1, 20X7. Entity MNO designates the forward contract as a hedge of its risk of changes in the fair value of the firm commitment resulting from changes in the USD–CHF forward exchange rate.

Entity MNO will assess effectiveness by comparing the overall changes in the fair value of the forward contract to the changes in fair value in USD of the firm commitment due to changes in USD–CHF forward exchange rates. Entity MNO expects the forward contract to be highly effective as a hedge because all of the following conditions exist:

a. EUR 240,000 is approximately equal to CHF 270,000 at the May 1, 20X1, forward exchange rate in effect on February 3, 20X7.

b. Settlement of the forward contract and the firm commitment will occur on the same date.

c. In recent years, changes in the value in USD of EUR over three-month periods have been highly correlated with changes in the value in USD of CHF over those same periods.

Although the hedging relationship has been determined to be highly effective at achieving offsetting changes in fair value, the hedge will not be perfectly effective and the difference between changes in the USD equivalent of EUR 240,000 (the notional amount of the forward contract) and changes in the USD equivalent of CHF 270,000 (the amount to be paid for the machine) will affect earnings. The difference between the spot rate and the forward exchange rate is not excluded from the assessment of hedge effectiveness because changes in the fair value of the firm commitment are being measured using forward exchange rates. Therefore, the entire change in the fair value of the hedging instrument will be

presented in earnings in the same income statement line item as the earnings effect of the hedged item. If the hedged item were a foreign-currency-denominated available-for-sale debt security instead of a firm commitment, Topic 830 would have required its carrying value to be measured using the spot exchange rate. In that case, the spot-forward difference would have been recognized currently in earnings in the same income statement line item as the earnings effect of the hedged item if it was included in the assessment of effectiveness. The spot-forward difference also may be excluded from the assessment of effectiveness and accounted for through either an amortization approach or a mark-to-market approach in accordance with paragraph 815-20-25-83A or paragraph 815-20-25-83B.

The forward exchange rates in effect on certain key dates are assumed to be as follows.

| Date | USD-EUR Forward Exchange Rate for Settlement on 5/1/X7 | USD-CHF Forward Exchange Rate for Settlement on 5/1/X7 |
|---|---|---|
| Inception of the hedge—2/3/X7 | USD 0.6125 = EUR 1 | USD 0.5454 = CHF 1 |
| Quarter end—3/31/X7 | USD 0.5983 = EUR 1 | USD 0.5317 = CHF 1 |
| Machine purchase—5/1/X7 | USD 0.5777 = EUR 1 | USD 0.5137 = CHF 1 |

The USD equivalent and changes in the USD equivalent of the forward contract and the firm commitment, the changes in fair value of the forward contract and the firm commitment, and the earnings effect of the hedge on those same key dates are shown in the following table. A 6 percent discount rate is used in this Example.

| | | 2/3/X7 | | 3/31/X7 | | 5/1/X7 |
|---|---|---|---|---|---|---|
| **Forward contract** | | | | | | |
| USD-EUR forward exchange rate for settlement on May 1, 20X7 | USD | 0.61 | USD | 0.60 | USD | 0.58 |
| Units of currency (EUR) | | × 240,000 | | × 240,000 | | × 240,000 |
| Forward price of EUR 240,000 in USD | | 147,000 | | 143,592 | | 138,648 |
| Contract price in USD | | (147,000) | | (147,000) | | (147,000) |
| Difference | USD | - | USD | (3,408.00) | USD | (8,352.00) |
| Fair value (present value of the difference) | USD | - | USD | (3,391.00) | USD | (8,352.00) |
| Change in fair value during the period | | | USD | (3,391.00) | USD | (4,961.00) |
| **Firm commitment** | | | | | | |
| USD-CHF forward exchange rate for settlement on May 1, 20X7 | USD | 0.55 | USD | 0.53 | USD | 0.51 |
| Units of currency (CHF) | | × 270,000 | | × 270,000 | | × 270,000 |
| Forward price of CHF 270,000 in USD | | (147,258) | | (143,559) | | (138,699) |
| Initial forward price in USD | | 147,258 | | 147,258 | | 147,258 |
| Difference | USD | - | USD | 3,699.00 | USD | 8,559.00 |
| Fair value (present value of the difference) | USD | - | USD | 3,681.00 | USD | 8,559.00 |

| | | 2/3/X7 | | 3/31/X7 | | 5/1/X7 |
|---|---|---|---|---|---|---|
| Change in fair value during period | | | USD | 3,681.00 | USD | 4,878.00 |
| Difference between changes in the fair values of the forward contract denominated in EUR and the firm commitment denominated in CHF | | | USD | 290.00 | USD | (83.00) |

This Subtopic requires that Entity MNO recognize currently in earnings all changes in fair values of the forward contract. Because Entity MNO is hedging the risk of changes in fair value of the firm commitment attributable to changes in the forward exchange rates, this Subtopic also requires recognizing those changes currently in earnings. Section 815-20-45 requires that those changes be presented in earnings in the same income statement line item as the earnings effect of the hedged item.

On May 1, 20X7, Entity MNO fulfills the firm commitment to purchase the machine and settles the forward contract. The entries illustrating fair value hedge accounting for the hedging relationship and the purchase of the machine are summarized in the following table.

| | Debit (Credit) | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Cash | | Firm Commitment | | Forward Contract | | Machine | | Earnings | |
| March 31, 20X7 | | | | | | | | | | |
| Recognize change in fair value of firm commitment | | | USD | 3,681 | | | | | USD | (3,681) |
| Recognize change in fair value of forward contract | | | | | USD | (3,391) | | | | 3,391 |
| | | | | | | | | | | (290) |
| April 30, 20X7 | | | | | | | | | | |
| Recognize change in fair value of firm commitment | | | | 4,878 | | | | | | (4,878) |
| Recognize change in fair value of forward contract | | | | | | (4,961) | | | | 4,961 |
| | | | | | | | | | | 83 |
| May 1, 20X7 | | | | | | | | | | |
| Recognize settlement of forward contract | USD | (8,352) | | | | 8,352 | | | | |
| Recognize purchase of machine | | (138,699) | | (8,559) | | | USD | 147,258 | | |

| | Debit (Credit) | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Cash | | Firm Commitment | | Forward Contract | | Machine | | Earnings | |
| Total | USD | (147,051) | USD | - | USD | - | USD | 147,258 | USD | (207) |

To simplify this Example and focus on the effects of the hedging relationship, other amounts that would be involved in the purchase of the machine by Entity MNO (for example, shipping costs and installation costs) have been ignored.

The effect of the hedge is to recognize the machine at its price in CHF (CHF 270,000) translated at the forward rate in effect at the inception of the hedge (USD 0.5454 per CHF 1).

**Example 8-7: Effectiveness of cash flow hedge of forecasted sale with a forward contract (ASC 815-30-55-13 through 55-16)**

This Example illustrates the application of the guidance in Subtopic 815-20 and this Subtopic to assessing effectiveness for a cash flow hedge of a forecasted sale with a forward contract. Assume that the hedge satisfied all of the criteria for hedge accounting at inception.

Entity I, a U.S. dollar (USD) functional currency entity, forecasts the sale of 10,000 units in Euros (EUR) of its principal product in 6 months to French customers for EUR 500,000. Entity I wants to hedge the cash flow exposure of the EUR sale related to changes in the USD-EUR exchange rate. It enters into a 6-month forward contract to exchange the EUR 500,000 it expects to receive in the forecasted sale for the USD equivalent specified in the forward contract and designates the forward contract as a cash flow hedge of the forecasted sale.

Entity I chooses to assess hedge effectiveness at inception and during the term of the hedge based on the following amounts:

a. Changes in the fair value of the forward contract attributable to changes in the USD-EUR spot rate

b. Changes in the present value of the current USD equivalent of the forecasted receipt of EUR 500,000.

Because the critical terms of the forward contract and the forecasted transaction are the same, presumably there would be perfect offset unless there is a reduction in the expected sales proceeds from the forecasted sales. Because Entity I is assessing effectiveness based on spot rates, it would exclude the change in the fair value of the forward contract attributable to changes in the difference between the forward rate and spot rate from the assessment of effectiveness and account for it through an amortization approach in accordance with paragraph 815-20-25-83A or a mark-to-market approach in accordance with paragraph 815-20-25-83B. Under either approach, the portion of the excluded component recognized in earnings should be presented in the same income statement line item as the earnings effect of the hedged item in accordance with paragraph 815-20-45-1A.

**Example 8-8: Cash flow hedge of the foreign currency exposure in a royalty arrangement (ASC 815-30-55-67 through 55-76)**

This Example illustrates the application of the guidance in Subtopic 815-20 and this Subtopic to a hedging relationship involving a single hedging derivative and three separate forecasted transactions. The three transactions occur on three separate dates, but the payment on receivables related to all three occurs on the same date. The settlement of the hedging derivative will occur on the date the receivable is paid. For simplicity, commissions and most other transaction costs, initial margin, and income taxes are ignored

unless otherwise stated. Assume that there are no changes in creditworthiness that would alter the effectiveness of the hedging relationship.

Entity DEF's functional currency is the U.S. dollar (USD). Entity ZYX's functional currency is the euro (EUR). Effective January 1, 20X1, Entity DEF enters into a royalty agreement with Entity ZYX that gives Entity ZYX the right to use Entity DEF's technology in manufacturing Product X. On April 30, 20X1, Entity ZYX will pay Entity DEF a royalty of EUR 1 million for each unit of Product X sold by that date. Entity DEF expects Entity ZYX to sell one unit of Product X on January 31, one on February 28, and one on March 31. The forecasted royalty is probable because Entity ZYX has identified a demand for Product X and no other supplier has the capacity to fill that demand.

Also on January 1, 20X1, Entity DEF enters into a forward contract to sell EUR 3 million on April 30, 20X1, for a price equal to the forward price of USD 0.6057 per EUR. Entity DEF designates the forward contract as a hedge of the risk of changes in its functional-currency-equivalent cash flows attributable to changes in the EUR-USD exchange rates related to the forecasted receipt of EUR 3 million from the royalty agreement. The spot price and forward price of EUR at January 1, 20X1, and the USD equivalent of EUR 3 million at those prices are assumed to be as follows.

| Prices at January 1, 20X1 | USD per EUR | USD Equivalent of EUR 3 Million |
|---|---|---|
| Spot price | USD 0.6019 | USD 1,805,700 |
| 4-month forward price | 0.6057 | 1,817,100 |

Entity DEF will exclude from its assessment of effectiveness the portion of the fair value of the forward contract attributable to the spot-forward difference (the difference between the spot exchange rate and the forward exchange rate). Entity DEF elects to recognize changes in that portion of the derivative instrument's fair value currently in earnings in accordance with paragraph 815-20-25-83B. Entity DEF will estimate the cash flows on the forecasted transactions based on the current spot exchange rate and will discount that amount. Thus, Entity DEF will assess effectiveness by comparing the following amounts:

a. Changes in the fair value of the forward contract attributable to changes in the USD spot price of EUR

b. Changes in the present value of the forecasted cash flows based on the current spot exchange rate.

Those two changes will exactly offset because the currency and the notional amount of the forward contract match the currency and the total of the expected foreign currency amounts of the forecasted transactions. Thus, if Entity DEF dedesignates a proportion of the forward contract each time a royalty is recognized (as described in the following paragraph), the hedging relationship will meet the highly effective criterion.

As each royalty is recognized, Entity DEF recognizes a receivable and royalty income. The forecasted transaction (the recognition of royalty income) has occurred. The receivable is an asset, not a forecasted transaction, and would separately be eligible to be designated as a fair value hedge of foreign exchange risk or continue to be eligible as a cash flow hedge of foreign exchange risk. Consequently, if the variability of the functional currency cash flows related to the royalty receivable is not being hedged, Entity DEF will dedesignate a proportion of the hedging instrument in the original hedging relationship with respect to the proportion of the forward contract corresponding to the recognized royalty. As the royalty is recognized in earnings and each proportion of the derivative instrument is dedesignated, the related derivative instrument gain or loss in accumulated other comprehensive income is reclassified into earnings and presented in the same income statement line item as the earnings effect of the hedged item. After that date, any gain or loss on the dedesignated proportion of the derivative instrument and any transaction loss or gain on the royalty receivable will be recognized in earnings and may substantially offset each other.

Subtopic 830-20 requires immediate recognition in earnings of any foreign currency transaction gain or loss on a foreign-currency-denominated receivable that is not designated as a hedging instrument.

Therefore, the effect of changes in spot prices on the royalty receivable must be recognized immediately in earnings.

The spot prices and forward prices for settlement on April 30, 20X1, in effect at inception of the hedge (January 1, 20X1) and at the end of each month between inception and April 30, 20X1, are assumed to be as follows.

| | USD per EUR | |
|---|---|---|
| | Spot Price | Forward Price for Settlement on 4/30/X1 |
| January 1 | USD 0.6019 | USD 0.6057 |
| January 31 | 0.5970 | 0.6000 |
| February 28 | 0.5909 | 0.5926 |
| March 31 | 0.5847 | 0.5855 |
| April 30 | 0.5729 | 0.5729 |

The changes in fair value of the forward contract that are recognized each month in earnings and other comprehensive income are shown in the following table. Amounts reclassified from accumulated other comprehensive income to earnings and amounts excluded from the assessment of hedge effectiveness are presented in the same income statement line item as the earnings effect of the hedged item. The fair value of the forward is the present value of the difference between the USD to be received on the forward (USD 1,817,100) and the USD equivalent of EUR 3 million based on the current forward rate. A 6 percent discount rate is used in this Example.

| | Debit (Credit) | | |
|---|---|---|---|
| | Forward Contract | Earnings | Other Comprehensive Income |
| Fair value on January 1 | $ - | | |
| **Period ended January 31:** | | | |
| Change in spot-forward difference | 2,364 | ($2,364) | |
| Change in fair value of dedesignated proportion | - | - | |
| Change in fair value of designated proportion | 14,482 | | ($14,482) |
| Reclassification of gain | - | (4,827) | 4,827 |
| Fair Value on January 31 | 16,846 | | |
| **Period ended February 28:** | | | |
| Change in spot-forward difference | 3,873 | (3,873) | |
| Change in fair value of dedesignated proportion | 6,063 | (6,063) | |
| Change in fair value of designated proportion | 12,127 | | (12,127) |
| Reclassification of gain | - | (10,891) | 10,891 |
| Fair Value on February 28 | 38,909 | | |
| **Period ended March 31:** | | | |
| Change in spot-forward difference | 2,718 | ($2,718) | |
| Change in fair value of dedesignated proportion | 12,448 | (12,448) | |

| | Debit (Credit) | | |
|---|---|---|---|
| | Forward Contract | Earnings | Other Comprehensive Income |
| Change in fair value of designated proportion | 6,223 | | (6,223) |
| Reclassification of gain | - | (17,114) | 17,114 |
| Fair Value on March 31 | 60,298 | | |
| **Period ended April 30:** | | | |
| Change in spot-forward difference | 2,445 | (2,445) | |
| Change in fair value of dedesignated proportion | 35,657 | (35,657) | |
| Change in fair value of designated proportion | - | | - |
| Fair Value on April 30 | $98,400 | | |
| Cumulative effect | | ($98,400) | - |

The effect on earnings of the royalty agreement and hedging relationship illustrated in this Example is summarized by month in the following table.

| Period Ended | Amounts Recognized in Earnings Related to | | | | | Total Amount Reported in Earnings |
|---|---|---|---|---|---|---|
| | Receivable | | Forward Contract | | | |
| | USD Equivalent of EUR 1 Million Royalty | Foreign Currency Transaction Gain (Loss) | Amount Attributable to the Dedesignated Proportion | Reclassification from Other Comprehensive Income | Amount Attributable to the Difference between the Spot and Forward rates | |
| January 31 | $597,000 | $ - | $ - | $4,827 | $2,364 | $604,191 |
| February 28 | 590,900 | (6,100) | 6,063 | 10,891 | 3,873 | 605,627 |
| March 31 | 584,700 | (12,400) | 12,458 | 17,104 | 2,718 | 604,580 |
| April 30 | - | (35,400) | 35,657 | - | 2,445 | 2,702 |
| | $1,772,600 | ($53,900) | $54,178 | $32,822 | $11,400 | $1,817,100 |
| | | | | $98,400 | | |

**Example 8-9: Cash flow hedge of a fixed-rate foreign-currency-denominated loan eliminating variability in the functional-currency-equivalent cash flows (fixed-to-fixed scenario) (ASC 815-30-55-81 through 55-85)**

This Example illustrates the application of the guidance in Subtopic 815-20 and this Subtopic to accounting for a cash flow hedge of a fixed-rate foreign-currency-denominated debt in which all of the variability in the functional-currency-equivalent cash flows are eliminated by the effect of the hedge.

On July 1, 20X1, Entity DEF, a U.S. dollar (USD) functional currency entity, issues a zero-coupon debt instrument with a notional amount of FC 154,766.79 for FC 96,098.00. The interest rate implicit in the debt is 10 percent. The debt will mature on June 30, 20X6. Entity DEF enters into a forward contract to

buy FC 154,766.79 in 5 years at the forward rate of 1.090148194 (USD 168,718.74) and designates the forward contract as a hedge of the variability of the USD functional currency equivalent cash flows on the debt. Because the currency, notional amount, and maturity of the debt and the forward contract match, the entity concludes that the hedging relationship will achieve perfect offset. The USD interest rate implicit in the forward contract is 11.028 percent. The market data, period end balances, and journal entries from cash flow hedge accounting are as follows.

| Period | Spot Rate USD/ Functional Currency | Forward Rate USD/ Functional Currency | Forward Rate Difference | Foreign Currency Present Value | USD Spot Amounts | USD Debt (@11.028%) | Fair Value Forward USD |
|---|---|---|---|---|---|---|---|
| 0 | 1.040604383 | 1.090148194 | 0 | $96,098.00 | $100,000.00 | $100,000.00 | $ - |
| 1 | 1.1 | 1.184985966 | 0.094837771 | 105,707.80 | 116,278.58 | 111,028.04 | 9,327.97 |
| 2 | 1.1 | 1.163142906 | 0.072994712 | 116,278.58 | 127,906.44 | 123,272.25 | 8,041.09 |
| 3 | 1.1 | 1.141702484 | 0.051554290 | 127,906.44 | 140,697.08 | 136,866.76 | 6,360.72 |
| 4 | 1.1 | 1.120657277 | 0.030509083 | 140,697.08 | 154,766.79 | 151,960.48 | 4,215.89 |
| 5 | 1.1 | 1.1 | 0.009851806 | 154,766.79 | 170,243.47 | 168,718.74 | 1,524.73 |

| | | Cash | Forward | Debt | Other Comprehen-sive Income | Interest Expense | Transaction Loss |
|---|---|---|---|---|---|---|---|
| 7/1/20X1 | Borrow money | $100,000.00 | | ($100,000.00) | | | |
| 6/30/20X2 | Accrue interest on debt | | | (10,570.78) | | $10,570.78 | |
| 6/30/20X2 | Mark debt to spot | | | (5,707.80) | | | ($5,707.80) |
| 6/30/20X2 | Mark forward to fair value | | $9,327.97 | | ($4,077.43) | 457.26 | (5,707.80) |
| 6/30/20X2 | Balances | 100,000.00 | 9,327.97 | (116,278.58) | (4,077.43) | 11,028.04 | |
| 6/30/20X3 | Accrue interest on debt | | | (11,627.86) | | 11,627.86 | |
| 6/30/20X3 | Mark forward to fair value | | (1,286.88) | | 670.53 | 616.35 | |
| 6/30/20X3 | Balances | 100,000.00 | 8,041.08 | (127,906.44) | (3,406.90) | 23,272.25 | |
| 6/30/20X4 | Accrue interest on debt | | | (12,790.64) | | 12,790.64 | - |
| 6/30/20X4 | Mark forward to fair value | | (1,680.37) | | 876.50 | 803.87 | |
| 6/30/20X4 | Balances | 100,000.00 | 6,360.71 | (140,697.08) | (2,530.40) | 36,866.76 | |
| 6/30/20X5 | Accrue interest on debt | | | (14,069.71) | | 14,069.71 | |
| 6/30/20X5 | Mark forward to fair value | | (2,144.84) | | 1,120.83 | 1,024.01 | |
| 6/30/20X5 | Balances | 100,000.00 | 4,215.88 | (154,766.79) | (1,409.57) | 51,960.48 | |
| 6/30/20X6 | Accrue interest on debt | | | (15,476.68) | | 15,476.68 | |
| 6/30/20X6 | Mark forward to fair value | | (2,691.15) | | 1,409.57 | 1,281.58 | |
| 6/30/20X6 | Balances | $100,000.00 | $1,524.72 | ($170,243.47) | $ - | $68,718.74 | - |

Following are journal entries at inception of the loan and at the end of the first year.

| 7/1/20X1 | Debit | Credit |
|---|---|---|
| Cash | $100,000.00 | |
| Functional currency debt at spot | | $100,000.00 |
| To record FC borrowing in USD. | | |
| **6/30/20X2** | **Debit** | **Credit** |
| Interest expense | $10,570.78 | |
| Debt | | $10,570.78 |
| To accrue interest. Period end spot rate used for simplicity. | | |
| Transaction loss | $5,707.80 | |
| Debt | | $5,707.80 |
| To record a transaction loss on the debt. | | |
| Derivative asset | $9,327.97 | |
| Other comprehensive Income | | $9,327.97 |
| To record a derivative instrument at fair value and record the gain on the derivative in other comprehensive income. | | |
| Other comprehensive income | $5,250.54 | |
| Interest expense | 457.26 | |
| Transaction gain/loss | | $5,707.80 |
| To reclassify an amount out of accumulated other comprehensive income to do both of the following:<br>a. To increase interest expense to the USD yield of 11.028 percent<br>b. To offset the transaction loss on the debt. | | |

Journal entries for the remaining four years are not displayed.

This Example would also be relevant for a non-interest-bearing foreign-currency-denominated receivable or payable instrument. An amount based on the rate implicit in the forward contract would be reported in earnings each period. Given the short maturities of many receivables and payables, the amount reported in earnings each period may be small.

### Example 8-10: Reclassifying amounts from a cash flow hedge of a forecasted foreign-currency-denominated intra-entity sale (ASC 815-30-55-86 through 55-90)

This Example illustrates the application of paragraphs 815-20-25-30 and 815-20-25-39 through 25-41. This Example has the following assumptions:

a. Parent A is a multinational corporation that has the U.S. dollar (USD) as its functional currency.

b. Parent A has the following two subsidiaries:

   1. Subsidiary B, which has the Euro (EUR) as its functional currency

   2. Subsidiary C, which has the Japanese yen (JPY) as its functional currency.

c. Subsidiary B manufactures a product and has a forecasted sale of the product to Subsidiary C that will be transacted in JPY.

Eventually, Subsidiary C will sell the product to an unrelated third party in JPY. Subsidiary B enters into a forward contract with an unrelated third party to hedge the cash flow exposure of its forecasted intra-entity sale in JPY to changes in the EUR-JPY exchange rate.

The transaction in this Example meets the hedge criteria of paragraphs 815-20-25-30 and 815-20-25-39 through 25-41, which permits a derivative instrument to be designated as a hedge of the foreign currency exposure of variability in the functional-currency-equivalent cash flows associated with a forecasted intra-entity foreign-currency-denominated transaction if certain criteria are met. Specifically, the operating unit having the foreign currency exposure (Subsidiary B) is a party to the hedging instrument; the hedged transaction is denominated in JPY, which is a currency other than Subsidiary B's functional currency; and all other applicable criteria in Section 815-20-25 are satisfied.

Subsidiary B measures the derivative instrument at fair value and records the gain or loss on the derivative instrument in accumulated other comprehensive income. In the consolidated financial statements, the amount in other comprehensive income representing the gain or loss on a derivative instrument designated in a cash flow hedge of a forecasted foreign-currency-denominated intra-entity sale should be reclassified into earnings in the period that the revenue from the sale of the manufactured product to an unrelated third party is recognized and presented in earnings in the same income statement line item as the earnings effect of the hedged item. The reclassification into earnings in the consolidated financial statements should occur when the forecasted sale affects the earnings of Parent A. Because the consolidated earnings of Parent A will not be affected until the sale of the product by Subsidiary C to the unrelated third party occurs, the reclassification of the amount of derivative gain or loss from other comprehensive income into earnings in the consolidated financial statements should occur upon the sale by Subsidiary C to an unrelated third party.

This guidance is relevant only with respect to the consolidated financial statements. In Subsidiary B's separate entity financial statements, the reclassification of the amount of the derivative instrument gain or loss from other comprehensive income into earnings should occur in the period the forecasted intra-entity sale is recorded because Subsidiary B's earnings are affected by the change in the EUR-JPY exchange rate when the sale to Subsidiary C occurs.

**Example 8-11: Cash flow hedge of forecasted sale or purchase on credit (ASC 815-30-55-106 through 55-112)**

This Example illustrates the application of paragraphs 815-30-35-9 and 815-20-25-34 through 25-36, which permit an entity to designate a single cash flow hedge that encompasses the variability of functional-currency-equivalent cash flows attributable to foreign exchange risk related to the settlement of a foreign-currency-denominated receivable or payable resulting from a forecasted sale or purchase on credit.

[This example has the following assumptions:]

a. Entity A, a U.S. dollar (USD) functional currency entity, forecasts the purchase of inventory on credit for FC 100,000 in 182 days with settlement of the payable in 227 days. The purchase will occur July 15 on credit; the resulting payable will settle August 29.

b. Entity A enters into a forward contract to purchase FC 100,000 in 227 days at the forward rate of USD .6614 = FC 1.

c. Entity A designates a single cash flow hedge that encompasses the variability of functional-currency-equivalent cash flows attributable to foreign exchange risk related to the settlement of the foreign-currency-denominated payable resulting from the forecasted purchase on credit.

d. After the initial quantitative effectiveness test, Entity A elects to assess effectiveness on a quantitative basis based on forward rates.

Exchange rates are as follows.

| Period | Spot | 8/29 Forward | 7/15 Forward |
|---|---|---|---|
| 1/14 | 0.6575 | 0.6614 | 0.6605 |
| 3/31 | 0.6757 | 0.6793 | |
| 6/30 | 0.6689 | 0.6734 | |
| 7/15 | 0.6761 | 0.6767 | |
| 8/29 | 0.6798 | 0.6798 | |

Entity A would record the following journal entries.

| | Debit (Credit) | | | | | |
|---|---|---|---|---|---|---|
| | Cash | Inventory | Forward Contract | Accounts Payable | Earnings | Accum. Other Comprehen-sive Income |
| Inception 1/14 | - | - | - | - | - | - |
| March 31 entry (76 days): | | | | | | |
| Mark forward to fair value | | | $1,703 | | | ($1,703) |
| June 30 entry (91 days): | | | | | | |
| Mark forward to fair value | | | (526) | | | 526 |
| July 15 entries (15 days): | | | | | | |
| Inventory purchase | | $67,610 | | ($67,610) | | |
| August 29 entries (45 days): | | | | | | |
| Mark forward to fair value | | | 663 | | | (663) |
| Functional currency transaction loss on payable | | | | (370) | $370 | |
| Adjustment for paragraph 815-30-35-3(d)—offset the functional currency transaction loss | | | | | (370) | 370 |
| Adjustment for paragraph 815-30-35-3(d)—effect of hedge (based on implicit interest rate; see paragraph 815-30-55-112) | | | | | 78 | (78) |
| Settlement of payable | ($67,980) | | | 67,980 | | |
| Settlement of forward | 1,840 | | (1,840) | | | |
| Total | ($66,140) | $67,610 | $ - | $ - | $78 | ($1,548) |

Upon sale of the inventory, Entity A would record cost of goods sold of $67,610 and reclassify $1,548 from other comprehensive income to earnings to achieve a net cost of goods sold of $66,062. The effect of the hedge would result in a net cost to Entity A of $66,140 for the purchase of the inventory.

The amount of the adjustment under paragraph 815-30-35-3(d) is that amount needed to ensure that a net amount in earnings reflects the effect of the hedge through each reporting period up to and including the final settlement of the payable.

The amount of cost or income to be ascribed to each period is calculated as follows.

Daily interest rate implicit in the hedging relationship as a result of the forward contract: $65,750 PV, $66,140 FV, 227n, i = 0.0026053%

| | | |
|---|---|---|
| 1/14 | $65,750 | |
| 3/31 | 65,880 | $130 |
| 6/30 | 66,036 | 156 |
| 7/15 | 66,062 | 26 |
| 8/29 | 66,140 | 78 |
| | | $390 |

| **Method using two foreign currency forward exchange rates:** | |
|---|---|
| From 1/14 to 7/15 | |
| 7/15 Forward Rate .6605 | |
| $66,050 – $65,750 = | $300 |
| From 7/16 to 8/29 | |
| 8/29 Forward Rate .6614 | |
| $66,140 – $66,050 = | 90 |
| | $390 |
| **Pro rata method:** | |
| From 1/14 to 7/15: | |
| $390 × 182/227 = | $313 |
| From 7/16 to 8/29: | |
| $390 × 45/227 = | 77 |
| | $390 |

**Example 8-12: Hedge accounting in the consolidated financial statements applied to internal derivatives that are offset on a net basis by third-party contracts (ASC 815-30-55-113 through 55-125)**

This Example illustrates the application of paragraphs 815-20-25-61 through 25-63, specifically, the mechanism for offsetting risks assumed by a Treasury Center using internal derivatives on a net basis with third-party contracts. This Example does not demonstrate the computation of fair values and as such makes certain simplifying assumptions.

Entity XYZ is a U.S. entity with the U.S. dollar (USD) as both its functional currency and its reporting currency. Entity XYZ has three subsidiaries: Subsidiary A is located in Germany and has the Euro (EUR) as its functional currency, Subsidiary B is located in Japan and has the Japanese yen (JPY) as its functional currency, and Subsidiary C is located in the United Kingdom and has the pound sterling (GBP) as its functional currency. Entity XYZ uses its Treasury Center to manage foreign exchange risk on a centralized basis. Foreign exchange risk assumed by Subsidiaries A, B, and C through transactions with external third parties is transferred to the Treasury Center via internal contracts. The Treasury Center then offsets that exposure to foreign currency risk via third-party contracts. To the extent possible, the Treasury Center offsets exposure to each individual currency on a net basis with third-party contracts.

On January 1, Subsidiaries A, B, and C decide that various foreign-currency-denominated forecasted transactions with external third parties for purchases and sales of various goods are probable. Also on January 1, Subsidiaries A, B, and C enter into internal foreign currency forward contracts with the Treasury Center to hedge the foreign exchange risk of those transactions with respect to their individual functional currencies. The Treasury Center has the same functional currency as the parent entity (USD).

Subsidiaries A, B, and C have the following foreign currency exposures and enter into the following internal contracts with the Treasury Center.

| | | | | Internal Contracts with Treasury Center | |
|---|---|---|---|---|---|
| **Subsidiary** | **Functional Currency** | **Forecasted Exposures** | **Expected Transaction Date** | **Currency Received** | **Currency Paid** |
| A (German) | EUR | JPY payable 12,000 | Jun 1 | JPY 12,000 | EUR 115[(a)] |
| | | GBP receivable 50 | Jun 1 | EUR 80[(a)] | GBP 50 |
| B (Japanese) | JPY | USD payable 100 | Jun 15 | USD 100 | JPY 10,160[(a)] |
| | | EUR receivable 100 | Jun 15 | JPY 10,432[(a)] | EUR 100 |
| C (UK) | GBP | USD receivable 330 | Jun 30 | GBP 201[(a)] | USD 330 |

(a) Computed based on forward exchange rates as of January 1.

Subsidiaries A, B, and C designate the internal contracts with the Treasury Center as cash flow hedges of their foreign currency forecasted purchases and sales. Those internal contracts may be designated as hedging instruments in the consolidated financial statements if the requirements of this Subtopic are met. From the subsidiaries' perspectives, the requirements of paragraph 815-20-25-61 for foreign currency cash flow hedge accounting are satisfied as follows:

a. From the perspective of the hedging affiliate, the hedging relationship must meet the requirements of paragraphs 815-20-25-30 and 815-20-25-39 through 25-41 for cash flow hedge accounting. Subsidiaries A, B, and C meet those requirements. In each hedging relationship, the forecasted transaction being hedged is denominated in a currency other than the subsidiary's functional currency, and the individual subsidiary that has the foreign currency exposure relative to its functional currency is a party to the hedging instrument. In addition, the criteria in Section 815-20-25 are met. Specifically, each subsidiary prepares formal documentation of the hedging relationships, including the date on which the forecasted transactions are expected to occur and the amount of foreign currency being hedged. The forecasted transactions being hedged are specifically identified, are probable of occurring, and are transactions with external third parties that create cash flow exposure that would affect reported earnings. Each subsidiary also documents its expectation of high effectiveness based on the internal derivatives designated as hedging instruments.

b. The affiliate that issues the hedge must offset the internal derivative either individually or on a net basis. The Treasury Center determines that it will offset the exposure arising from the internal derivatives with Subsidiaries A, B, and C on a net basis with third-party contracts. Each currency for which a net exposure exists at the Treasury Center is offset by a third-party contract based on that currency.

To determine the net currency exposure arising from the internal contracts with Subsidiaries A, B, and C, the Treasury Center performs the following analysis.

| Subsidiary Perspective—Internal Contracts with the Treasury Center | | | | | |
|---|---|---|---|---|---|
| **Subsidiary** | **Contract with Treasury Center** | **Currency Received (Currency Paid)** | | | |
| | | **EUR** | **JPY** | **GBP** | **USD** |
| A (German) | Internal Contract 1 | (115) | 12,000 | | |
| | Internal Contract 2 | 80 | | (50) | |
| B (Japanese) | Internal Contract 3 | | (10,160) | | 100 |
| | Internal Contract 4 | (100) | 10,432 | | |
| C (UK) | Internal Contract 5 | | | 201 | (330) |
| **Net exposure** | | **(135)** | **12,272** | **151** | **(230)** |
| A (German) | Internal Contract 1 | 115 | (12,000) | | |
| | Internal Contract 2 | (80) | | 50 | |
| B (Japanese) | Internal Contract 3 | | 10,160 | | (100) |
| | Internal Contract 4 | 100 | (10,432) | | |
| C (UK) | Internal Contract 5 | | | (201) | 330 |
| **Net exposure** | | **135** | **(12,272)** | **(151)** | **230** |

For Subsidiaries A, B, and C to designate the internal contracts as hedging instruments in the consolidated financial statements, the Treasury Center must meet certain required criteria outlined in paragraphs 815-20-25-62 through 25-63 in determining how it will offset exposure arising from multiple internal derivatives that it has issued. Based on a determination that those requirements are satisfied (see the following paragraph, the Treasury Center determines the net exposure in each currency with respect to USD (its functional currency). The Treasury Center determines that it will enter into the following three third-party foreign currency forward contracts. The Treasury Center enters into the contracts on January 1. The contracts mature on June 30.

| Treasury Center's Contracts with Unrelated Third Parties | | | | | |
|---|---|---|---|---|---|
| | **Currency Bought (Currency Sold)** | | | | |
| | **EUR** | **JPY** | **BP** | **USD** | |
| Third-Party Contract 1 | (135) | | | 138 | (a) |
| Third-Party Contract 2 | | 12,272 | | (121) | (a) |
| Third-Party Contract 3 | | | 151 | (247) | (a) |
| **Net exposure** | **(135)** | **12,272** | **151** | **(230)** | |

(a) Computed based on forward exchange rates as of January 1.

From the Treasury Center's perspective, the required criteria in paragraphs 815-20-25-62 through 25-63 are satisfied as follows:

a. The issuing affiliate enters into a derivative instrument with an unrelated third party to offset, on a net basis for each foreign currency, the foreign exchange risk arising from multiple internal derivatives, and the derivative instrument with the unrelated third party generates equal or closely approximating gains and losses when compared with the aggregate or net losses and gains generated by the derivative instruments issued to affiliates. The Treasury Center enters into third-party derivative instruments to offset the exposure of each foreign currency on a net basis. The Treasury Center offsets 100 percent of the net exposure to each currency; that is, the Treasury Center does not selectively keep any portion of that exposure. In this Example, the Treasury Center's third-party

contracts generate losses that are equal to the losses on internal contracts designated as hedging instruments by Subsidiaries A, B, and C (see analysis beginning in the following paragraph).

b. Internal derivatives that are not designated as hedging instruments and all nonderivative instruments are excluded from the determination of the foreign currency exposure on a net basis that is offset by the third-party derivative instrument. The Treasury Center does not include in the determination of net exposure any internal derivatives not designated as hedging instruments or any nonderivative instruments.

c. Foreign currency exposure that is offset by a single net third-party contract arises from internal derivatives that involve the same currency and that mature within the same 31-day period. The offsetting net third-party derivative instrument related to that group of contracts must offset the aggregate or net exposure to that currency, must mature within the same 31-day period, and must be entered into within 3 business days after the designation of the internal derivatives as hedging instruments. The Treasury Center's third-party net contracts involve the same currency (that is, not a tandem currency) as the net exposure arising from the internal derivatives issued to Subsidiaries A, B, and C. The Treasury Center's third-party derivative instruments mature within the same 31-day period as the internal contracts that involve currencies that are offset on a net basis. In this Example, for simplicity, all internal contracts and third-party derivative instruments are entered into on the same date.

d. The issuing affiliate tracks the exposure that it acquires from each hedging affiliate and maintains documentation supporting linkage of each derivative instrument and the offsetting aggregate or net derivative instrument with an unrelated third party. The Treasury Center maintains documentation supporting linkage of third-party contracts and internal contracts throughout the hedge period.

e. The issuing affiliate does not alter or terminate the offsetting derivative instrument with an unrelated third party unless the hedging affiliate initiates that action. If the issuing affiliate does alter or terminate the offsetting third-party derivative (which should be rare), the hedging affiliate must prospectively cease hedge accounting for the internal derivatives that are offset by that third-party derivative. Based on Entity XYZ's policy, the Treasury Center may not alter or terminate the offsetting derivative instrument with an unrelated third party unless the hedging affiliate initiates that action.

f. If an internal derivative that is included in determining the foreign currency exposure on a net basis is modified or dedesignated as a hedging instrument, compliance must be reassessed. For simplicity, this Example does not involve a modification or dedesignation of an internal derivative.

At the end of the quarter, each subsidiary determines the functional currency gains and losses for each contract with the Treasury Center.

| Subsidiary | Contract with Treasury Center | Beginning of Period Functional Currency Amount Receive (Pay) [a] | End of Period Functional Currency Amount Receive (Pay) [a] | Functional Currency Gain (Loss) [b] | US Dollar Gain (Loss) [c] |
|---|---|---|---|---|---|
| A (German) | Internal Contract 1 | (115) | (115) | - | - |
| | Internal Contract 2 | 80 | 83 | (3) | (3) |
| B (Japanese) | Internal Contract 3 | (10,160) | (10,738) | 578 | 5 |
| | Internal Contract 4 | 10,432 | 10,421 | 11 | - |
| C (UK) | Internal Contract 5 | 201 | 204 | (3) | (5) |
| | | | | **Net USD Gain (Loss)** | **(3)** |

(a) Computed based on forward exchange rates as of January 1 and March 31.

(b) For simplicity, functional currency gains or losses are not discounted in this Example.

(c) Functional currency gains and losses converted to USD based on current spot rates.

At the end of the quarter, the Treasury Center determines its gains or losses on third-party contracts.

| Contract with Third Parties | Beginning of Period USD Amount Receive (Pay) [a] | End of Period USD Amount Receive (Pay) [a] | USD Gain (Loss) [b] |
|---|---|---|---|
| Third-Party Contract 1 | 138 | 131 | 7 |
| Third-Party Contract 2 | (121) | (114) | (7) |
| Third-Party Contract 3 | (247) | (244) | (3) |
| | | **Net USD Gain (Loss)** | **(3)** |

(a) Computed based on forward exchange rates as of January 1 and March 31.

(b) For simplicity, gains or losses are not discounted in this Example.

Journal Entries at March 31 (Note: All journal entries are in USD.)

| **Subsidiaries' Journal Entries** | | |
|---|---|---|
| German Subsidiary A | | |
| There is no entry for Contract 1 because the USD gain or loss is zero. | | |
| Other comprehensive income | $3 | |
| Derivative liability | | $3 |
| To record the loss on Internal Contract 2. | | |
| **Japanese Subsidiary B** | | |
| Derivative asset | $5 | |
| Other comprehensive income | | $5 |
| To record the gain on Contract 3. | | |
| There is no entry for Internal Contract 4 because the USD gain or loss is zero. | | |
| **UK Subsidiary C** | | |
| Other comprehensive income | $5 | |
| Derivative liability | | $5 |
| To record the loss on Internal Contract 5. | | |

| **Treasury Center's Journal Entries** | | |
|---|---|---|
| Journal Entries for Internal Contracts with Subsidiaries | | |
| There is no entry for Internal Contract 1 because the USD gain or loss is zero. | | |
| Derivative asset | $3 | |
| Earnings | | $3 |
| To record the gain on Internal Contract 2 with German Subsidiary A. | | |
| Earnings | 5 | |
| Derivative liability | | 5 |
| To record the loss on Internal Contract 3 with Japanese Subsidiary B. | | |
| There is no entry for Internal Contract 4 because the USD gain or loss is zero. | | |
| Derivative asset | 5 | |
| Earnings | | 5 |
| To record the gain on Internal Contract with UK Subsidiary C. | | |
| **Journal Entries for Third-Party Contracts** | | |
| Derivative asset | $7 | |
| Earnings | | $7 |
| To record the gain on Third-Party Contract 1. | | |

| Treasury Center's Journal Entries | | |
|---|---|---|
| Earnings | 7 | |
| Derivative liability | | 7 |
| To record the loss on Third-Party Contract 2. | | |
| Earnings | 3 | |
| Derivative liability | | 3 |
| To record the loss on Third-Party Contract 3. | | |
| **Results in Consolidation** | | |
| Derivative asset | $7 | |
| Other comprehensive income | 3 | |
| Derivative liability | | $10 |

In consolidation, the amounts in the balance sheets of Subsidiaries A, B, and C reflecting derivative instrument assets and derivative instrument liabilities arising from internal derivatives acquired from the Treasury Center eliminate against the Treasury Center's derivative instrument liabilities and derivative instrument assets arising from internal derivatives issued to the subsidiaries. The amount reflected in consolidated other comprehensive income reflects the net entry to other comprehensive income of Subsidiaries A, B, and C. The Treasury Center's gross derivative instrument asset and gross derivative instrument liability arising from third-party contracts are also reflected in the consolidated balance sheet. Based on the assumptions in this Example, the Treasury Center's net loss on third-party derivative instruments used to offset the exposure, on a net basis, of internal contracts with Subsidiaries A, B, and C equals the net loss on internal contracts with the subsidiaries. Therefore, within the Treasury Center, the gains on internal contracts issued to Subsidiaries A, B, and C, and the losses on third-party contracts are equal and offsetting. If the Treasury Center's net gain or loss on third-party contracts does not equal the net gain or loss on internal derivatives designated as hedging instruments by affiliates, the difference must be recognized in consolidated other comprehensive income.

The reclassification of amounts out of consolidated other comprehensive income is based on Subsidiaries A, B, and C's internal contracts with the Treasury Center. That is, the reclassification of amounts out of consolidated other comprehensive income into earnings is based on the timing and amounts of the individual subsidiaries' forecasted transactions. In this Example, at June 30, the forecasted transactions at Subsidiaries A, B, and C have been consummated and the net debit amount in consolidated other comprehensive income of 3 has been reversed.

# 9 Fair value hedge accounting

## 9.1 Overview

Fair value hedge accounting minimizes earnings volatility because both changes in the fair value of the derivative or other hedging instrument and changes in the fair value of the hedged item that are attributable to the hedged risk are recognized in earnings and offset one another. Specifically, the accounting for a fair value hedge, which is outlined in ASC 815-25, requires:

- The carrying amount of the derivative or other hedging instrument is adjusted to its fair value through earnings, with the exception of amounts that are excluded from the assessment of effectiveness and recognized in earnings through an amortization approach. Any difference between the change in fair value of the excluded component and amounts recognized in earnings through an amortization approach is recognized in other comprehensive income.
- The carrying amount of the hedged item is adjusted through earnings for changes in its fair value that are attributable to the hedged risk. It is important to keep in mind that this is not equivalent to adjusting the carrying amount of the hedged item to its fair value. For example, the carrying amount of a hedged item is only adjusted for changes in its fair value that occur during the period of the hedge. Additionally, when hedging a component or components of risk rather than total changes in fair value (refer to the table in Section 5.2.2 for permissible risks to hedge), the carrying amount of the hedged item is only adjusted for changes in its fair value that are specifically attributable to the hedged components during the term of the hedge. For example, if hedging interest rate risk associated with a fixed-rate loan, the carrying amount of the loan would be adjusted for changes in its fair value during the term of the hedge that are attributable to the benchmark interest rate. Other factors, such as credit risk, that would impact the fair value of the loan are ignored.

If the hedging instrument in a fair value foreign exchange hedge is a nonderivative instrument, its gain or loss attributable to foreign currency risk is the foreign currency transaction gain or loss determined in accordance with ASC 830-20-35-1 (i.e., the increase or decrease in functional currency cash flows attributable to the change in spot exchange rates between the functional currency and the currency in which the hedging instrument is denominated).

As it relates to amounts excluded from the assessment of effectiveness associated with a cross-currency interest rate swap, the initial cost (excluded component) of a cross-currency basis spread is typically embedded in the coupon payments that are paid to the counterparty. Consequently, it would be recognized in earnings each period through the typical swap accrual process, which, as noted in BC163 of ASU 2017-12, the FASB views as a systematic and rational method for recognizing the cost. As a result, when an election is made to exclude this component and recognize it in earnings on a systematic and rational basis, the change in fair value of the swap attributable to the cross-currency basis spread incorporated in the discount rates used to value the swap is deferred in other comprehensive income. No amounts related to the change in the value of the cross-currency basis spread need to be manually amortized to earnings because their effect on the swap discounting reverses to zero in accumulated other comprehensive income as the swap matures.

At its February 2018 meeting, the FASB discussed the amortization of excluded components when the hedging instrument is a cross-currency interest rate swap that is off-market at hedge inception, indicating that a method should be used that would not violate the guidance in ASC 815-35-35-6 through 35-7. In other words, the method used should ensure that only amounts of the swap related to spot changes on the notional amount of the net investment should remain in the currency translation adjustment at the end of the hedging relationship. Although any systematic and rational approach that results in the off-market nature of the swap equaling zero at the end of the hedging relationship is acceptable, structuring these swaps to achieve a specific accounting result is not considered rational and would therefore not be acceptable.

All amounts recognized in earnings as outlined in the preceding paragraphs are required to be presented in the same income statement line item. The paragraphs beginning at ASC 815-20-55-79W provide examples to illustrate this required presentation, including when the earnings effect of the hedged item is presented in two income statement line items.

If an entity designated and documented that it would assess effectiveness and measure hedge results on an after-tax basis as permitted by ASC 815-20-25-3(b)(2)(vi), any gain or loss on the hedging instrument that exceeds the loss or gain on the hedged item is recognized as an offset to the related tax effects in the period in which those tax effects are recognized.

There are various examples in Chapter 6, Chapter 7 and Chapter 8 that illustrate fair value hedge accounting.

## 9.2 Additional accounting considerations relevant to the hedged item in a fair value hedge

As indicated in Section 9.1, the carrying amount of the hedged item in a fair value hedge is adjusted for changes in fair value attributable to the hedged risk. Adjustments to the carrying amount of a hedged asset or liability should be accounted for in the same manner as other components of the carrying amount of that asset or liability. For example, in a fair value hedge of inventory, adjustments would impact the carrying amount of the inventory and would ultimately be recognized through cost of sales when the inventory item is sold.

### 9.2.1 Amortizing adjustments to the carrying amount of a debt instrument

In a fair value hedge where the hedged item is a debt instrument, hedge accounting adjustments to the carrying amount of the debt instrument should be amortized to earnings beginning no later than when the debt instrument ceases to be adjusted for changes in its fair value attributable to the risk being hedged (i.e., the hedging relationship is terminated). Example 7-12 illustrates an immediate amortization of adjustments to the carrying amount of a debt instrument, which is generally advantageous in terms of the amortization offsetting changes in the fair value of the interest rate swap that are attributable to interest accruals. Given complexities associated with recomputing a level-yield amortization of hedge accounting adjustments, some entities elect to wait until the termination of the hedging relationship to begin amortizing adjustments to the carrying amount. When hedging with an interest rate swap, as long as hedge accounting continues until the swap's expiration, the basis adjustments will generally reverse as the swap nears expiration and its fair value moves towards zero. The approach that will be taken in amortizing adjustments is a policy election that we believe should be documented in the inception date documentation discussed in Section 5.2 and consistently applied for similar hedges.

The period over which the adjustments should be amortized is the remaining life of the hedging relationship. If hedge accounting is discontinued, any remaining adjustments should be amortized over a period that is consistent with the amortization of other discounts or premiums.

ASC 815-25-35-13B permits using an assumed term when hedging select (rather than all) contractual cash flows to measure the change in the fair value of the hedged item attributable to interest rates. The assumed term begins when the first hedged cash flow begins to accrue and ends when the last hedged cash flow is due and payable. As noted in BC105 of ASU 2017-12, basis adjustments made to the hedged item in a partial-term hedge are typically amortized over the life of the hedging relationship when amortization is elected before hedge accounting is discontinued.

If an entity elects to amortize the basis adjustment during an outstanding partial-term hedge rather than waiting until hedge accounting is discontinued, that basis adjustment should be fully amortized on or before the hedged item's assumed maturity date.

#### 9.2.1.1 Special considerations for adjustments associated with portfolio layer method hedging relationships

As provided by ASC 815-25-35-1(c), basis adjustments associated with portfolio layer method hedging relationships (discussed in Section "Portfolio layer method") should not be allocated until hedge accounting is discontinued. This is because the basis adjustments relate to the hedged layers rather than the assets that make up the closed portfolio. In other words, if an asset is sold and the remaining balance of the portfolio exceeds the designated hedged layers, a portion of the remaining basis adjustment would not be allocated to the asset that was sold. An allocation process may be necessary, however, to comply with certain disclosure requirements.

In accordance with ASC 815-10-50-5B, an entity should not disclose the basis adjustment on a portfolio layer method hedge on a more disaggregated level than the portfolio level, unless that disaggregation is required by ASC 815-20-45-4. After an entity allocates a basis adjustment pursuant to ASC 815-20-45-4 (if applicable), if other Topics require disclosing the amortized cost basis of assets included in the closed portfolio on a basis that requires disaggregating the assets included in the closed portfolio, the entity should exclude the portfolio layer method basis adjustment from the amortized cost basis of those assets. In that case, the entity should disclose the total amount of the portfolio layer method basis adjustment excluded from the amortized cost basis of the assets included in the closed portfolio.

As indicated in ASC 815-25-35-10, when the basis adjustment is maintained at the portfolio level, the basis adjustment is not considered when assessing the individual assets of the closed portfolio for impairment. This guidance may not be applied by analogy in any other situations.

##### Breaches of the Closed Portfolio

In accordance with ASC 815-25-40-8, an entity should fully or partially discontinue hedge accounting for hedging relationships designated under the portfolio layer method in either of the following circumstances:

- The entity can no longer support that the hedged layer will remain outstanding for the entire hedged term (this is referred to as an anticipated breach). In this case, the entity should fully or partially discontinue hedge accounting for one or more hedging relationships for the portion of the hedged item that is no longer anticipated to be outstanding for the designated hedge period.
- If the outstanding amount of the closed portfolio of financial assets is less than the hedged layer (i.e., a breach has occurred), the entity should fully or partially discontinue hedge accounting for one or more hedging relationships for the portion of the hedged item that is no longer outstanding.

Pursuant to ASC 815-25-40-8A, if there is a breach or anticipated breach and multiple designated hedged layers are associated with a closed portfolio, an entity must determine which hedges to fully or partially discontinue in accordance with an accounting policy election. That accounting policy election must specify a systematic and rational approach for determining which hedges to fully or partially discontinue. An entity shall establish its accounting policy no later than when it first anticipates a breach or when a breach has occurred (whichever comes first). After an entity establishes its accounting policy, it must apply it consistently.

##### Voluntary dedesignations under the portfolio layer method

An entity may voluntarily discontinue any hedged layer prospectively in full or in part at any time if a breach has not occurred and is not anticipated to occur as described in ASC 815-25-40-7A.

##### Accounting for Basis Adjustments

In accordance with ASC 815-25-40-9, if a portfolio layer method hedging relationship is fully or partially discontinued voluntarily or in anticipation of a breach, the entity must allocate the outstanding basis adjustment associated with the dedesignated amount (or portion thereof) as of the discontinuation date to the remaining individual assets in the closed portfolio that supported the dedesignated hedged layer using a systematic and rational method.

The entity should amortize those amounts over a period that is consistent with the amortization of other discounts or premiums associated with the respective assets in accordance with other Topics (e.g., ASC 310-20, *Receivables — Nonrefundable Fees and Other Costs*).

As required by ASC 815-25-40-9A, when an entity discontinues a portfolio layer method hedging relationship because a breach has occurred, the entity, as of the discontinuation date, should:

- Use a systematic and rational method to determine the portion of the basis adjustment associated with the amount of the hedged layer that exceeds the closed portfolio and immediately recognize that amount in interest income, in accordance with ASC 815-20-45-1CC
- Disclose the information specified in ASC 815-10-50-5C for the breach; if a closed portfolio has a hedge layer that has been breached and may be also associated with an anticipated breach, the entity should apply the guidance in this paragraph for the breach that has occurred and the guidance in ASC 815-25-40-9 for the anticipated breach

### 9.2.2 Capitalized interest ramifications for assets under construction

When a financial liability is designated as the hedged item in a fair value hedge, as ASC 815-25-35-14 indicates, amounts in interest costs related to the amortization of the adjustments to the carrying amount of the hedged liability that are recognized during the period in which interest is eligible for capitalization are reflected in the capitalization rate under ASC 835-20.

### 9.2.3 Impairment considerations

Hedged items in a fair value hedge remain subject to any impairment or credit losses guidance that is relevant to the particular asset or liability. The relevant impairment or credit losses guidance should be applied after the carrying amount of the hedged item has been adjusted for changes in the fair value attributable to the hedged risk. When performing the impairment or credit losses analysis, no consideration is given to the hedging instrument (e.g., derivative instrument) because it is a separate asset or liability from the hedged item. When the hedged item is a loan receivable for which credit losses are recognized using a discounted cash flows approach, the effective rate used as the discount rate should be based on the amortized cost basis of the loan as adjusted for the application of fair value hedge accounting. Example 7-14 illustrates the interaction of fair value hedge accounting with loan impairment (and measurement of credit losses).

## 9.3 Discontinuing fair value hedge accounting

As outlined in ASC 815-25-40, once elected, hedge accounting should continue to be applied unless or until one of the following occurs:

- Any of the criteria to apply hedge accounting are no longer met (for example, the hedging relationship is no longer highly effective).
- The derivative instrument expires or is sold, terminated (including modified, as discussed later) or exercised.
- The hedge is dedesignated (i.e., management decides to remove the hedge designation prospectively).

At the point in time that a hedge is no longer highly effective, hedge accounting should be discontinued. If there is no identifiable event or change in circumstance that caused the hedging relationship to no longer be highly effective, hedge accounting should be discontinued after the last date on which compliance with the effectiveness criterion was established.

As pointed out in ASC 815-20-55-56, if any of the critical terms of the hedging relationship are changed, the hedge needs to be dedesignated, and hedge accounting discontinued unless a new hedging relationship is appropriately established. ASC 815-25-40-1A indicates that a change in the counterparty to a derivative instrument would not, in and of itself, be considered a termination of the derivative instrument or trigger the dedesignation of the hedge. (However, if there is a change in counterparty creditworthiness

or ability to perform, the effectiveness of the hedge could be impacted.) Examples of changes that could result in the need to dedesignate the hedge include a change to a critical term of the derivative instrument (e.g., to extend its maturity) or the item its hedging, a change to the hedged risk (unless it is a cash flow hedge of a forecasted transaction that remains highly effective) or a change to the method of assessing effectiveness.

Nonetheless, after the adoption of ASU 2025-09, ASC 815-20-55-56 states, as discussed in ASC 815-30-35-37B through 35-37M, "for a cash flow hedge of forecasted interest payments on choose-your-rate debt (and related replacement debt), a change in the contractually specified interest rate (and associated change in the number and timing of forecasted interest payments within the hedged period, if any) does not result in an automatic dedesignation of the hedging relationship if the conditions in those paragraphs are met."

As pointed out in ASC 815-25-40, in the event hedge accounting is discontinued, a new hedging relationship can be designated prospectively with the same or a different hedging instrument, hedged item or transaction, as long as the newly designated hedging relationship meets the relevant criteria in ASC 815-20-25 (including appropriate documentation) as outlined in Chapter 5. If an existing derivative instrument is redesignated, its fair value will likely be off market (i.e., no longer zero) at the time of the redesignation. Consideration should be given to the ramifications of its off-market nature to the assessment of the effectiveness of the newly designated hedging relationship.

Upon termination of hedge accounting, the derivative instrument (if it continues to exist) would need to continue to be accounted for at fair value, with changes in fair value reported in earnings; however, the hedged item's carrying amount should no longer be adjusted for changes in fair value attributable to the hedged risk. (Refer to Section 9.2 for additional considerations relevant to the hedged item.) For those hedges for which an election is made to amortize the value of components that are excluded from the assessment of effectiveness over the life of the hedging instrument, as outlined in Section 5.2.4.4, unamortized amounts remaining in accumulated other comprehensive income at the time a hedged item is derecognized should be reported in earnings. Any amount remaining in accumulated other comprehensive income for all other discontinued fair value hedges should be recognized in earnings in the same manner as other components of the carrying amount of the hedged asset or liability in accordance with Section 9.2.

### 9.3.1 Termination of fair value hedge of firm commitment

A fair value hedge of a firm commitment should be terminated if the hedged item no longer meets the definition of a firm commitment. Upon termination, the asset or liability associated with the adjustment to the carrying amount of the firm commitment should be removed from the balance sheet and a corresponding gain or loss recognized in earnings. As noted in ASC 815-25-40-6, a pattern of discontinuing hedge accounting for this reason would call into question the firmness of future hedged commitments and the ability to apply hedge accounting.

# 10 Cash flow hedge accounting

## 10.1 Overview

Cash flow hedge accounting minimizes earnings volatility because changes in the fair value of the derivative or other hedging instrument are recognized in other comprehensive income and reclassified into earnings when the hedged transaction impacts earnings. Specifically, the accounting for a cash flow hedge, which is outlined in ASC 815-30, requires:

- All changes in the fair value of a derivative instrument that are included in the assessment of hedge effectiveness are recognized in other comprehensive income.
- Any components that are excluded from the assessment of effectiveness are recognized in earnings (in the same income statement line item as the effect of the hedged item), either through an amortization or mark-to-market approach.
- The gain or loss in other comprehensive income associated with amounts included in the assessment of hedge effectiveness is reclassified into earnings (in the same income statement line item as the effect of the hedged item) in the same period or periods during which the hedged forecasted transaction affects earnings.

Examples are provided beginning at ASC 815-20-55-79W to illustrate income statement presentation, including when the earnings effect of the hedged item is presented in two income statement line items.

If an entity designated and documented that it would assess effectiveness and measure hedge results on an after-tax basis as permitted by ASC 815-20-25-3(b)(2)(vi), any gain or loss on the hedging instrument that exceeds the loss or gain on the hedged item are recognized as an offset to the related tax effects in the period in which those tax effects are recognized.

There are various examples in Chapter 6, Chapter 7 and Chapter 8 that illustrate cash flow hedge accounting.

## 10.2 Reclassification of amounts in other comprehensive income to earnings

The following table illustrates how gains and losses associated with the derivative instrument in a cash flow hedging relationship are generally reclassified out of other comprehensive income and into earnings for certain common types of hedged items. (For additional considerations, refer to the relevant sections that follow.)

| | |
|---|---|
| Forecasted purchase of depreciable fixed asset | Amounts in other comprehensive income are reclassified into earnings over the period that the asset is depreciated. |
| Forecasted purchase of inventory | Amounts in other comprehensive income are reclassified into earnings when the inventory is sold and the sale is recognized in earnings. |
| Forecasted sale | Amounts in other comprehensive income are reclassified into earnings when the sale is recognized in earnings. Example 8-10 illustrates this process when the hedged transaction is a foreign-currency-denominated intra-entity sale. |
| Interest payments on a debt instrument | Amounts in other comprehensive income are reclassified into earnings as the hedged variable interest payments on the debt instrument impact earnings. This is illustrated in ASC 815-30-35-41B in the context of an interest rate cap and in Example 7-5 in the context of an interest rate swap. See ASC 815-30-35-45 for situations where the hedged interest payments are capitalized for an asset under construction (amounts in other comprehensive income are reclassified into earnings over the depreciable life of the constructed asset to |

| | |
|---|---|
| | coincide with the amortization period for the capitalized interest cost on the debt). |
| Functional-currency-equivalent cash flows associated with a recognized foreign-currency-denominated asset or liability remeasured at spot exchange rates in accordance with ASC 830 | ASC 815-30-35-3(d) indicates that if the hedging instrument is a non-option-based contract, the amount that should be reclassified each period from other comprehensive income to earnings is the amount that will both:<br>• Offset the related transaction gain or loss arising from the remeasurement of the asset or liability<br>• Adjust earnings for that period's allocable portion of the initial spot-forward difference associated with the hedging instrument (if the assessment of effectiveness is based on total changes in cash flows)<br>If the hedging instrument is an option contract, the amount that should be reclassified each period to or from other comprehensive income to earnings is determined with respect to changes in the underlying that result in a change to the option's intrinsic value. If hedge effectiveness is assessed based on total changes in the option's cash flows, the amount reclassified each period should also include the amortization of the cost of the option on a rational basis. |

### 10.2.1 Derivative instrument with nonzero fair value at hedge inception

ASC 815-30-35-41A requires that any amounts that are reported in other comprehensive income for the initial fair value of a derivative instrument designated in a cash flow hedging relationship that did not have a zero fair value at inception should be reclassified to earnings on a systematic and rational basis over the periods during which the hedged forecasted transactions affect earnings and presented in the same income statement line item as the earnings effect of the hedged item.

In practice, periodic cash settlements associated with an interest rate swap are reported in earnings, while the change in value of all future periodic settlements (i.e., the clean value) is deferred in other comprehensive income. Absent reclassifying the inception date fair value of the derivative instrument in accordance with the preceding paragraph, the initial fair value or some portion of it would remain in accumulated other comprehensive income when the hedging instrument matures.

### 10.2.2 Gains or losses from cash flow hedges of debt that is extinguished

ASC 815-30-35-44 addresses the ramifications of the extinguishment of debt that has been designated in a cash flow hedge. Namely, any amounts reclassified out of accumulated other comprehensive income to earnings pertaining to a cash flow hedge of debt that is extinguished should not be included in the debt extinguishment gain or loss.

## 10.3 Impairment considerations associated with hedged items or transactions

ASC 815-30-35-40 requires immediate loss recognition if and to the extent losses in accumulated other comprehensive income are expected to result in the recognition of a net loss on the combination of the hedging instrument and the hedged transaction (and the related asset acquired or liability incurred). An example is provided in ASC 815-30-35-41 in the context of hedging the forecasted purchase of inventory. (A loss should be recognized in earnings to the extent that the cost basis of the inventory plus the related loss reported in accumulated other comprehensive income exceeds the amount expected to be recovered through sales of that inventory). Additionally, as noted in ASC 815-30-35-42 through 35-43, assets and liabilities that are designated as the hedged item in a cash flow hedge remain subject to impairment assessments and recognition of credit losses when required by other U.S. GAAP. Relevant impairment or credit loss requirements should be applied after hedge accounting has been applied for the period. No consideration should be given to the fair value or expected cash flows of the derivative or other hedging instrument when evaluating the hedged item for impairment. If an asset impairment loss or writeoff due to credit losses is recognized, or an impairment obligation associated with an asset or liability to which a hedged forecasted transaction relates is recognized, any offsetting net gain related to that transaction in

accumulated other comprehensive income should be reclassified immediately into earnings. Similarly, if a recovery is recognized on the asset or liability to which the forecasted transaction relates, any offsetting net loss in accumulated other comprehensive income should be reclassified immediately into earnings.

## 10.4 Discontinuing cash flow hedge accounting

As outlined in ASC 815-30-40-1, hedge accounting should be discontinued prospectively upon the occurrence of any of the following:

- Any criterion to apply hedge accounting is no longer met.
- The derivative instrument expires, is sold, terminated (including modified) or exercised.
- The hedge designation is removed (refer to Example 6-6 for an illustration).

As part of the ongoing monitoring of a hedge, consideration needs to be given to whether the criteria for applying hedge accounting (as summarized in Chapter 5) continue to be met; if any criterion is not met, hedge accounting should be discontinued. For example, at the point in time that a hedge is no longer highly effective, hedge accounting should be discontinued. If there is no identifiable event or change in circumstance that caused the hedging relationship to no longer be effective, hedge accounting should be discontinued after the last date on which compliance with the effectiveness criterion was established. As another example, in a hedge of forecasted transactions as the hedged item, in the event those forecasted transactions are no longer probable of occurring, hedge accounting should be discontinued. (Refer to the related discussion in Section "Probability of the hedged forecasted transaction.")

As pointed out in ASC 815-20-55-56, if any of the critical terms of the hedging relationship are changed, the hedge needs to be dedesignated, and hedge accounting discontinued unless a new hedging relationship is appropriately established. ASC 815-30-40-1A indicates that a change in the counterparty to a derivative instrument would not, in and of itself, be considered a termination of the derivative instrument or trigger the dedesignation of the hedge. (If, however, it is no longer probable that the counterparty will be able to perform in accordance with the contractual provisions of the derivative instrument, hedge accounting would need to be discontinued.) Examples of changes that could result in the need to dedesignate the hedge include a change to a critical term of the derivative instrument (e.g., to extend its maturity) or the item its hedging that makes it no longer probable that the forecasted hedged transactions as described are going to occur, or a change to the method of assessing effectiveness. As noted in ASC 815-30-35-37A and illustrated through Example 6-2 and Example 7-6, hedge accounting can continue to be applied if there is a change to the designated hedged risk as long as the hedging instrument is highly effective at achieving offsetting cash flows attributable to the revised hedged risk. The amendments in ASU 2025-09 supersede ASC 815-30-35-37A and add ASC 815-30-35-37B through 35-37M to provide guidance for changing the contractually specified interest rate for hedges of forecasted interest payments on choose-your-rate debt instruments.

Upon discontinuing hedge accounting, the derivative instrument (if it continues to exist) would need to continue to be accounted for at fair value; however, all changes in fair value are reported in earnings rather than other comprehensive income. As indicated in ASC 815-30-40-4, the net derivative gain or loss that was accumulated in other comprehensive income during the period of time that the cash flow hedge was effective should continue to be reported in accumulated other comprehensive income and reclassified into earnings in accordance with Section 10.2, unless it is probable that the hedged forecasted transaction will not occur by the end of the originally specified time period (documented at the inception of the hedging relationship) or within an additional two-month period of time thereafter. In other words, absent the existence of extenuating circumstances elaborated in ASC 815-30-40-4, any amounts in other comprehensive income associated with a cash flow hedge would be immediately reclassified to earnings if it is no longer probable that the hedged forecasted transaction would occur by the end of the originally specified time period, or within an additional two-month period of time thereafter. (There is no guidance addressing where on the income statement such amounts should be reported.) As noted in Section "Probability of the hedged forecasted transaction," a pattern of determining that hedged forecasted transactions are probable of not occurring would call into question both the entity's ability to

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

Various examples within ASC 815 illustrate the ramifications of hedged forecasted transactions no longer being probable and the discontinuation of hedge accounting, including certain of the cash flow hedge examples incorporated in Chapter 6 and Chapter 7 and the following example from ASC 815-30-55-100 through 55-105.

**Example 10-1: Discontinuation of a cash flow hedge (ASC 815-30-55-100 through 55-105)**

The following Cases illustrate the application of paragraphs 815-30-40-4 through 40-5 to changes in timing of a forecasted transaction in relation to an originally specified time period:

a. Transactions to occur within two months of end of originally specified time period (Case A)

b. Transactions not to occur within two months of end of originally specified time period (Case B).

On January 1, an entity enters into a hedge of the variability in the total cash flows of a forecasted sale of the first 100 units of a specified product during the 3-month period from February 1 to April 30. Gains and losses on the hedging instrument are accumulated in other comprehensive income and reclassified into earnings as sales occur and are presented in the same income statement line item as the earnings effect of the hedged item. However, as of March 10, only 60 units of the product have been sold and the entity determines that it is probable that the sale of the remaining 40 units will not occur by April 30. As a result, the entity must discontinue cash flow hedge accounting under the originally designated hedging relationship as of March 10 (pursuant to paragraph 815-30-40-1(a)).

**Case A: Transactions to Occur within Two Months of End of Originally Specified Time Period**

In this Case, the entity determines that it is probable that the sale of the remaining 40 units will occur by June 20. Based on this new information, the entity is permitted to designate a new cash flow hedge under which subsequent derivative instrument gains and losses would receive cash flow hedge accounting. This Example focuses on the derivative instrument gains and losses that have been accumulated in other comprehensive income at March 10 with respect to the remaining 40 unsold units. The derivative instrument gains or losses accumulated in other comprehensive income related to the sale of the remaining 40 units should not be reclassified into earnings as of March 10 because the entity determined on that date that it is at least reasonably possible that the forecasted transactions will occur within the two-month period following April 30 (the end of the originally specified time period).

**Case B: Transactions Not to Occur within Two Months of End of Originally Specified Time Period**

In this Case, the entity determined on March 10 that it is probable that the sale of the remaining 40 units will not occur by June 30 but it was reasonably possible that the sale would occur in July or August.

In that circumstance, the derivative instrument gains or losses accumulated in other comprehensive income related to the sale of the remaining 40 units must be reclassified into earnings as of March 10 because the entity would have determined on that date that it is probable that the forecasted transactions will neither occur by the end of the originally specified time period (that is, April 30) nor within the allowable additional two-month period of time (ending on June 30).

Furthermore, the example indicates no extenuating circumstances that could justify applying the exception related to a forecasted transaction that is probable of occurring on a date beyond the additional two-month period of time.

### 10.4.1 Designating a new hedge

As pointed out in ASC 815-30-40, in the event hedge accounting is discontinued, a new hedging relationship can be designated prospectively with the same or different hedging instrument, hedged item or transaction, as long as the newly designated hedging relationship meets the relevant criteria in ASC 815-20-25 (including appropriate documentation) as outlined in Chapter 5. If an existing derivative instrument is redesignated, its fair value will likely be off market (i.e., no longer zero) at the time of the redesignation. Consideration should be given to the ramifications of its off-market nature to the assessment of the effectiveness of the newly designated hedging relationship. For example, if the hypothetical-derivative method discussed in Section "Hypothetical-derivative method" is elected to assess the effectiveness of a hedge involving an off-market interest rate swap, the fixed interest rate on the hypothetical interest rate swap would be the rate that would result in the hypothetical swap having a zero fair value on the redesignation date. Additionally, as noted in Section 10.2.1, any amounts that are reported in other comprehensive income for the initial fair value of a derivative instrument designated in a cash flow hedging relationship that did not have a zero fair value at inception should be reclassified to earnings on a systematic and rational basis over the periods during which the hedged forecasted transactions affect earnings and presented in the same income statement line item as the earnings effect of the hedged item.

# 11 Presentation and disclosure

## 11.1 General presentation requirements

Questions have arisen about the line-item presentation of derivative instruments in the financial statements. ASC 815 addresses the presentation of hedging results in the balance sheet but is otherwise not prescriptive on financial statement presentation. The following discussion summarizes the guidance that is available about the presentation of derivative instruments and includes observations of what we have seen in practice.

### 11.1.1 Presentation on the balance sheet

Derivative instruments should be recognized at their fair value on the balance sheet (unless the derivative instrument is an interest rate swap and the reporting entity qualifies for and elects to carry it at settlement value under the Private Company Counsel's simplified approach). Non-option derivative instruments can generally be either an asset or liability depending on whether the derivative instrument is in a favorable or unfavorable position to the reporting entity as of the reporting date. Derivative assets and liabilities are distinct from the assets or liabilities that they may hedge. Therefore, as noted in ASC 815-10-45-2, there is no support to net derivative assets or liabilities on the balance sheet against the items they hedge. For example, given that an interest rate swap is a separate financial instrument from the debt that it may hedge, it would not be appropriate to report the swap's carrying amount in the same line item as the debt.

ASC 815-20-45-4 addresses the classification on the balance sheet for portfolio layer method hedges and indicates that if the hedged assets that are included in the same closed portfolio are presented in different line items on the balance sheet (e.g., debt securities and loans), the portfolio layer method basis adjustment should be allocated to the assets' associated line items using a systematic and rational method.

#### 11.1.1.1 Classification

An entity that prepares classified statements of financial position needs to determine the amount of derivative assets and liabilities that it should classify as current. ASC 815 does not provide guidance for making this determination. As a result, an entity should consider the general guidance in ASC 210-10 for classifying current assets and liabilities. A somewhat unique aspect of derivative instruments is that the expected cash flows that drive their fair value, and therefore carrying amount, may contractually occur on multiple settlement dates and include a combination of inflows and outflows. As a consequence, the carrying amount of individual derivative instruments may need to be broken out between current and noncurrent classification, as well as between asset and liability classification on the balance sheet.

We believe an entity should classify a derivative instrument based on the timing of its cash flows, which typically occur on a stated contractual settlement date or dates. However, an entity should consider all factors when determining the appropriate classification because there may be situations in which using the stated contractual settlement date would not be appropriate. For example, we believe current liability classification would be appropriate under ASC 210-10-45-7, regardless of the contractual settlement date, for a derivative instrument that is in a net liability position and is due on demand (e.g., in the case of a default that makes all amounts currently due and payable).

The following table addresses classification as current or noncurrent based on the contractual settlement date or dates.

| Settlement date | Classification on the balance sheet |
|---|---|
| Within 12 months of the reporting period end | Current |
| More than 12 months from the reporting period end | Noncurrent |
| Multiple settlements, both within and after 12 months | Generally, the reported amount is separated into current and noncurrent portions, based on the expected timing and direction of future cash flows. For example:<br>Entity A holds a pay fixed, receive variable interest rate swap that matures in five years and has a positive fair value of $10 million as of the reporting date. Entity A reviews the expected cash flows computation that underlies the valuation of the swap and determines that the $10 million positive value is a net number that includes:<br>• Gross expected cash outflows with a net present value of approximately $3 million in the next 12 months<br>• Gross expected cash inflows with a net present value of approximately $13 million for the remaining term of the interest rate swap (given that the variable interest rate is expected to rise after 12 months)<br>Entity A reports this interest rate swap as a $3 million current liability and $13 million noncurrent asset in its classified balance sheet. |

### 11.1.1.2 Offsetting

It is not uncommon for an entity to have multiple derivative instruments outstanding with one or more counterparties, some of which may be in an asset position and some of which may be in a liability position at any given time. Although an entity may desire to record all similar derivative assets and liabilities net on the same line item on the balance sheet, it is not appropriate to offset derivative assets against derivative liabilities and report the net amount unless a legal right of setoff exists and other requirements beginning in ASC 815-10-45-5 are met. The following example illustrates this concept.

**Example 11-1: Net presentation of derivative instruments**

Bank A is a party to interest rate swaps with multiple loan customers, as well as with various dealers. Bank A has no legal right to offset amounts owed to or from its loan customers against amounts owed to or from the dealers on their respective swaps, nor can it legally offset amounts owed to or from one dealer to another. However, its contractual arrangement with each dealer does give it a legally enforceable right to offset amounts owed to and from that dealer.

The following table summarizes the fair values of the various swaps that are outstanding at the reporting date and the balance sheet presentation, assuming that Bank A qualifies and elects to offset the amounts related to derivative contracts with the same counterparty. For simplicity, possible collateral requirements related to the interest rate swaps are ignored in this example.

| | Swaps with individual loan customers | Swaps with Dealer A | Swaps with Dealer B | Total |
|---|---|---|---|---|
| Asset position | $20,000,000 | $2,000,000 | $6,000,000 | $28,000,000 |
| Liability position | 5,000,000 | 10,000,000 | 7,000,000 | 22,000,000 |
| Net asset position | | | | 6,000,000 |
| Balance sheet presentation | Assets of $20 million and liabilities of $5 million | Net liability of $8 million | Net liability of $1 million | Assets of $20 million and liabilities of $14 million |

Because Bank A's accounting policy is to offset derivative instruments with the same counterparty under a master netting arrangement on the balance sheet in accordance with ASC 815-10-45-5, Bank A would present $20 million of assets and $14 million of liabilities associated with the interest rate swaps. Conversely, if Bank A's accounting policy was not to offset, it would present $28 million of assets and $22 million of liabilities associated with the interest rate swaps. In either case, it would not be appropriate to simply present a net asset of $6 million.

If an entity wishes to offset contracts with the same counterparty, it must make an accounting policy election to do so and meet certain criteria. Specifically, offsetting the fair value of derivative contracts in a loss position (liabilities) against the fair value of derivative contracts in a gain position (assets) on the balance sheet is permitted if the "right of setoff" conditions from ASC 210-20-45-1 are met.

**ASC 210-20-45-1**

a. Each of two parties owes the other determinable amounts.

b. The reporting party has the right to set off the amount owed with the amount owed by the other party.

c. The reporting party intends to set off.

d. The right of setoff is enforceable at law.

The preceding conditions are the general requirements for offsetting. ASC 815-10-45-5 indicates that an entity need not have the intent to set off (i.e., criterion (c) above) when evaluating if derivative instruments and fair value amounts recognized for rights or obligations to cash collateral with the same counterparty that are subject to the same master netting arrangement can be offset. A master netting arrangement exists (as described in ASC 815-10-45-5) if an entity has multiple contracts, whether for the same type of derivative instrument or for different types of derivative instruments, with a single counterparty that are subject to a contractual agreement that provides for the net settlement of all contracts through a single payment in a single currency in the event of default on, or termination of, any one contract. Standard ISDA master agreements typically contain such provisions and would thus constitute a master netting arrangement if they are enforceable at law in the jurisdiction in which they are transacted.

If the above conditions are met, ASC 815-10-45-5 permits (but does not require) offsetting of fair value amounts recognized for multiple derivative instruments and fair value amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) arising from the same master netting arrangement as the derivative instruments. Fair value amounts for this purpose include amounts that approximate fair value. The fair value recognized for some contracts may include an accrual component for the periodic unconditional receivables and payables resulting from the contract, which also may be offset.

As indicated in ASC 815-10-45-6, an entity makes an accounting policy election to offset fair value amounts in accordance with the preceding paragraphs. Once an entity establishes its accounting policy for offsetting, the entity must apply its policy consistently. An entity should not offset the fair value amounts recognized for derivative instruments without also offsetting the fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral (or vice versa). An entity that establishes an accounting policy to offset the fair value amounts recognized for derivative instruments but concludes that the amount recognized for the right to reclaim cash collateral or the obligation to return cash collateral is not a fair value amount would still offset the derivative instruments.

ASC 815-10-45-7 explains that an entity that has established an accounting policy to offset fair value amounts is not permitted to offset amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral against net derivative instrument positions in either of the following situations:

- The cash collateral amounts are not fair value amounts.
- The cash collateral amounts arose from instruments in a master netting arrangement that are not eligible to be offset.

#### 11.1.1.3 Special considerations for certain centrally cleared derivative instruments

Regulations, such as the Dodd-Frank Wall Street Reform and Consumer Protection Act and the European Market Infrastructure Regulation, require certain over-the-counter derivative instruments to be centrally cleared. Entities that enter into derivative transactions that are required to be centrally cleared typically make variation margin payments to a margin account to provide credit risk protection to the other party. On a given day, the party to the derivative instrument that is in a loss position will post payments to that account, equal to that loss position, for the benefit of the other party. The margin account related to these payments had historically been legally structured and documented as collateral by the clearing exchanges and such contracts have been referred to as “collateralized to market” (CTM). In the 2016 and 2017 timeframe, two of the major exchanges, namely the Chicago Mercantile Exchange (CME) and LCH Limited (LCH), began structuring certain contracts as settled to market (STM), and other exchanges have followed suit. A change in the legal characterization of margin payments from collateral to settlement has accounting and disclosure ramifications for impacted entities’ financial statements. On January 4, 2017, the ISDA’s Accounting Policy Committee issued a confirmation letter to the Office of the Chief Accountant of the SEC related to an ISDA whitepaper and follow-up submissions on the accounting impact of these changes. Per the confirmation letter, it is the ISDA’s understanding that the SEC staff does not object to the following conclusions:

- The changes to the rulebooks of LCH and CME, as supported by legal opinions from external counsel, should result in the presentation of variation margin amounts as settlement of the derivative exposure and not collateral against it because the timing, amount, and uncertainty of cash flows related to the STM derivative contract is considered a single unit-of-account for purposes of applying the accounting and presentation guidance in ASC 815.
- The derivative disclosure requirements in ASC 815 would continue to apply for STM derivative contracts given that STM derivative contracts remain term instruments and that daily settlement of the derivative exposure does not change or reset the contractual terms of the instrument. Such disclosures would be applicable over the remaining term of the STM derivative contract.
- The disclosure requirements in 815-10-50-4B(b), regarding cash collateral disclosures, should not be applied to variation margin amounts for the STM derivative contracts.
- The de-designation and re-designation of existing hedging relationships under ASC 815 would not be required solely because of the amendment described in the Submission to the respective CME and LCH rulebooks.
- The daily settlement of the derivative exposure through daily payment or receipt of variation margin amounts for the STM derivative contracts described in the Submission would not require a daily de-designation and re-designation of hedging relationships under ASC 815.

- The inclusion of price alignment amount and variation margin in the single unit-of-account with the derivative exposure would not prohibit application of the 'short-cut method' under ASC 815.

Given that STM derivative exposures are legally deemed settled such that the settlement payments and related derivative instrument are considered a single unit of account, we would expect the derivative instrument carrying amounts for STM transactions to be at or near zero. This will constitute a difference for reporting entities that do not qualify or elect to net derivative instrument carrying amounts with collateral on CTM transactions as permitted by ASC 210-20.

### 11.1.2 Presentation on the income statement

If an entity holds derivative instruments for trading purposes, ASC 815-10-45-9 requires the gains and losses (whether realized or unrealized) related to those derivative instruments to be shown net on the income statement, regardless of whether they are settled physically. Reclassifications into and out of the trading category should be rare.

In accordance with ASC 815-10-55-62, when determining whether realized gains and losses on physically settled derivative instruments that are not held for trading purposes should be reported on the income statement on a gross or net basis, an entity should use judgment and consider the relevant facts and circumstances in the context of its various activities as well as the terms of the derivative contracts. An entity may consider the derivative instrument's economic substance, as well as principal versus agent considerations in ASC 606-10-55-36 through 55-40 and, if the arrangement involves the exchange of nonmonetary assets, the guidance in ASC 845.

#### 11.1.2.1 Presentation of the results of economic hedging

It is generally not appropriate to recognize the earnings impact of a derivative instrument that is used for economic hedging purposes in multiple line items on the income statement. An example of this would be an entity that enters into an interest rate swap to economically hedge its variable rate debt (presentation for accounting hedges is discussed later in this section). It would not be appropriate for the entity to report the change in fair value of the interest rate swap in a line item (e.g., other gain or loss) different from where it reports the cash settlements on the interest rate swap (e.g., interest expense). This is referred to as synthetic instrument accounting, which the FASB intended to eliminate with the issuance of Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

In Section II.M.3 of *Current Accounting and Disclosure Issues in the Division of Corporate Finance*, the SEC indicated:

> We generally believe that a presentation that splits the components of a derivative into different line items on the income statement or that reclassifies realized gains and losses of a derivative out of the line item that included unrealized gains and losses of the same derivative is inappropriate. For example, if a registrant classifies changes in fair value of economic hedges (unrealized gains and losses) in a single line item such as "risk management activities", a registrant should not reclassify realized gains and losses (the periodic or final cash settlements from these economic hedges) in the period realized out of risk management activities and into revenue or expense lines associated with the related exposure.

#### 11.1.2.2 Employee and nonemployee stock options

Regarding options granted to employees and nonemployees in exchange for goods or services that are required to be accounted for as a derivative instrument, ASC 815-10-45-10 requires the change in the option award's fair value prior to vesting to be recognized as compensation expense in its income statement. Once the option award vests, the grantor can recognize the change in the option award's fair value elsewhere (e.g., other gain or loss).

### 11.1.2.3 Hedging instruments

The following table summarizes the presentation of derivative instruments and other hedging instruments that have been designated as the hedging instrument in each of the three types of accounting hedges.

| Type of hedge | Presentation in comprehensive income |
|---|---|
| Fair value hedge (ASC 815-25) | • The carrying amount of the derivative or other hedging instrument is adjusted to its fair value through earnings, with the exception of amounts that are excluded from the assessment of effectiveness and recognized in earnings through an amortization approach. (Any difference between the change in fair value of the excluded component and the initial value of the excluded component recognized in earnings through an amortization approach is recognized in OCI.)<br>• Amounts recognized in earnings for the derivative or other hedging instrument are required to be presented in the same line item on the income statement as the earnings effect of the hedged item (the carrying amount of which is adjusted for changes in its fair value that are attributable to the hedged risk). This is illustrated in the examples in ASC 815-20-55-79W through 55-79AD.<br>• As it relates to existing portfolio layer method hedges of interest rate risk, ASC 815-20-45-1CC requires the basis adjustment associated with the hedged layer (or portion thereof) that is no longer outstanding when a breach occurs to be presented in interest income. |
| Cash flow hedge (ASC 815-30) | • All changes in the fair value of a derivative instrument that are included in the assessment of hedge effectiveness are recognized in OCI.<br>• Any components that are excluded from the assessment of effectiveness are recognized in earnings (in the same line item on the income statement as the effect of the hedged item), either through an amortization or mark-to-market approach.<br>• The gain or loss in OCI associated with amounts included in the assessment of hedge effectiveness is reclassified into earnings (in the same line item in the statements of financial performance as the effect of the hedged item) in the same period or periods during which the hedged forecasted transaction affects earnings. (Refer to Section 10.2 for illustrations for certain common types of hedged items).<br>• As noted in ASC 815-20-45-1B, ASC 815 does not prescribe the classification on the income statement for amounts that are reclassified out of accumulated other comprehensive income (AOCI) and into earnings because a hedged forecasted transaction is not probable. |
| Net investment hedge of a foreign operation (ASC 815-35) | • All changes in the fair value of a derivative instrument that are included in the assessment of hedge effectiveness are recognized in OCI as part of the cumulative translation adjustment.<br>• If an election is made to assess effectiveness on an after-tax basis, the portion of the gain or loss on the hedging instrument in excess of the loss or gain on the hedged item is recognized as an offset to the related tax effects when recognized.<br>• Any components that are excluded from the assessment of effectiveness are recognized in earnings (ASC 815 does not prescribe the line item in which this should be presented), either through an amortization or mark-to-market approach. Any difference between the change in fair value of the excluded component and amounts recognized in earnings under a systematic and |

| Type of hedge | Presentation in comprehensive income |
|---|---|
| | rational method is also reported in the cumulative translation adjustment section of OCI.<br>• The gain or loss in OCI associated with amounts included in the assessment of hedge effectiveness is reclassified into earnings (in the same line item on the income statement as the effect of the hedged item) in the same period or periods during which the hedged forecasted transaction affects earnings. |

### 11.1.3 Presentation of hybrid instruments and a derivative instrument that has been bifurcated from a host contract

ASC 815-15-45-1 requires an entity to report hybrid financial instruments that are measured at fair value in their entirety, under either the practicability exception or fair value election at ASC 815-15-30-1, "in a manner that separates those reported fair values from the carrying amounts of assets and liabilities subsequently measured using another measurement attribute on the face of the statement of financial position." This can be accomplished by either:

- Presenting hybrid financial instruments measured at fair value in separate line items from similar instruments that do not have fair-value carrying amounts
- Presenting the aggregate of the hybrid financial instruments measured at fair value and similar instruments that do not have fair-value carrying amounts on the same line item and parenthetically disclosing the amount of fair value carrying amounts included in the aggregate amount

ASC 815 does not specifically address the presentation of a derivative instrument that has been bifurcated from the host contract.

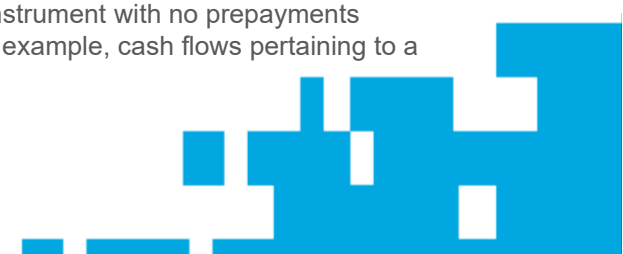
General practice and SEC preference is for bifurcated derivative instruments to be presented on the same balance sheet line item as the host contract if the host contract is classified as an asset or liability. If, for example, a put option embedded in a debt instrument requires separate recognition as a derivative instrument, it would be appropriate to present the combined carrying amounts of the debt host and put option derivative instrument as debt, with separate footnote disclosure of the components, as required. If, however, the host contract is reported in shareholders' equity, it would not be possible to combine the host contract and a separately recognized bifurcated derivative instrument on the same line item on the balance sheet because the derivative instrument is required to be recognized as an asset or liability, as opposed to shareholders' equity. As it relates to presentation on the income statement, an entity should exercise judgment when determining whether it should report changes in the fair value of a bifurcated derivative instrument separately from the activity associated with its host contract. An example of this would be considering if the changes in fair value of a derivative instrument that is bifurcated from a debt host contract should be classified in other income or loss or interest expense.

### 11.1.4 Presentation of derivative transactions on the statement of cash flows

A statement of cash flows classifies cash receipts and cash payments as resulting from operating, investing or financing activities. ASC 815-10-45 indicates how a derivative instrument that has an other-than-insignificant financing element should be presented on the statement of cash flows.

Generally, under ASC 230, an entity classifies each cash receipt or payment according to its nature without regard to whether it is intended as a hedge of another item. Cash flows from derivative instruments held for trading purposes are generally presented within operating activities in accordance with ASC 230-10-45-20. As an exception to classifying cash flows by their nature, ASC 230-10-45-27 permits cash flows from derivative instruments that are accounted for as fair value hedges or cash flow hedges to be classified with the cash flows from the item being hedged, provided that the derivative instrument does not include an other-than-insignificant financing element at inception, other than a financing element inherently included in an at-the-market derivative instrument with no prepayments (such as the forward points in an at-the-money forward contract). For example, cash flows pertaining to a





fair value hedge using a futures contract or an option contract to hedge inventories would be reported with the cash flows related to inventories. If cash flows from a derivative instrument are classified with the cash flows from the item being hedged, this represents an accounting policy that should be disclosed. If hedge accounting is discontinued for any reason, subsequent cash flows should be classified in a manner consistent with the nature of the derivative instrument rather than with the cash flows from the item that was previously hedged.

As indicated in ASC 815-10-45-11, an instrument accounted for as a derivative that at its inception includes off-market terms, or requires an up-front cash payment, often contains a financing element. Identifying such a financing element is a matter of judgment that depends on facts and circumstances. If a derivative instrument includes an other-than-insignificant financing element at inception, generally all cash inflows and outflows of the derivative instrument should be considered cash flows from financing activities by the borrower. See ASC 230-10-45-14 through 45-15 for further guidance.

**ASC 815-10-45-13**

An at-the-money plain-vanilla interest rate swap that involves no payments between the parties at inception would not be considered as having a financing element present at inception even though, due to the implicit forward rates derived from the yield curve, the parties to the contract have an expectation that the comparison of the fixed and variable legs will result in payments being made by one party in the earlier periods and being made by the counterparty in the later periods of the swap's term.

**ASC 815-10-45-14**

If a derivative instrument is an at-the-money or out-of-the-money option contract or contains an at-the-money or out-of-the-money option contract, a payment made at inception to the writer of the option for the option's time value by the counterparty shall not be viewed as evidence that the derivative instrument contains a financing element.

**ASC 815-10-45-15**

In contrast, if the contractual terms of a derivative instrument have been structured to ensure that net payments will be made by one party in the earlier periods and subsequently returned by the counterparty in the later periods of the derivative instrument's term, that derivative instrument shall be viewed as containing a financing element even if the derivative instrument has a fair value of zero at inception.

## 11.2 General disclosure requirements

Disclosures for derivative instruments, and in some cases their related hedging activity, are required in various notes accompanying the financial statements, including:

- Significant accounting policies (ASC 235-10-50)
- Derivatives (ASC 815-10-50)
- Disclosures on contracts in an entity’s own equity (ASC 815-40-50)
- Fair value measurements (ASC 820-10-50 and ASC 825-10-50)
- Balance sheet offsetting (ASC 210-20-50)
- Reporting comprehensive income (ASC 220-10-50)

Although this section focuses on the disclosure requirements of ASC 815-10-50 and ASC 815-30-50, the other disclosures noted above are equally important and should not be overlooked. Additionally, SEC reporting entities should consider any additional disclosures that may be required by the SEC.

Significant accounting policies are required to be disclosed under ASC 235. ASU 2023-06 added ASC 230-10-50-9, which states, “an entity shall disclose its accounting policy for where cash flows associated with derivative instruments and their related gains and losses are presented.” ASU 2023-06 should be applied prospectively and is effective for PBEs on the effective date for when the SEC updates Regulation S-X or Regulation S-K for the related amendment. For all other entities, the effective date is two years later. If the related SEC guidance has not been updated by June 30, 2027, the amendment will be removed from the ASC and will not become effective.

### 11.2.1 ASC 815-10 disclosure requirements for derivative instruments and related hedging activities

ASC 815 requires extensive financial statement disclosures for derivative instruments and related hedging activity. When an entity holds or issues derivative instruments, it is important that financial statement users can understand:

- How and why the entity uses derivative instruments
- How derivative instruments and related hedged items are accounted for
- How derivative instruments and related hedged items affect the entity’s financial position, financial performance and cash flows as discussed in ASC 815-10-50-1

ASC 815 permits an entity to designate a nonderivative as a hedging instrument in certain situations. In these cases, the disclosure requirements apply to the nonderivative hedging instrument in the same manner that they apply to a derivative hedging instrument. Additionally, the derivative disclosure requirements also apply to features within a hybrid instrument that require separate recognition as a derivative instrument.

If an entity presents any of the required derivative disclosures in more than a single footnote, it should cross-reference from one footnote to the other as required by ASC 815-10-50-4I.

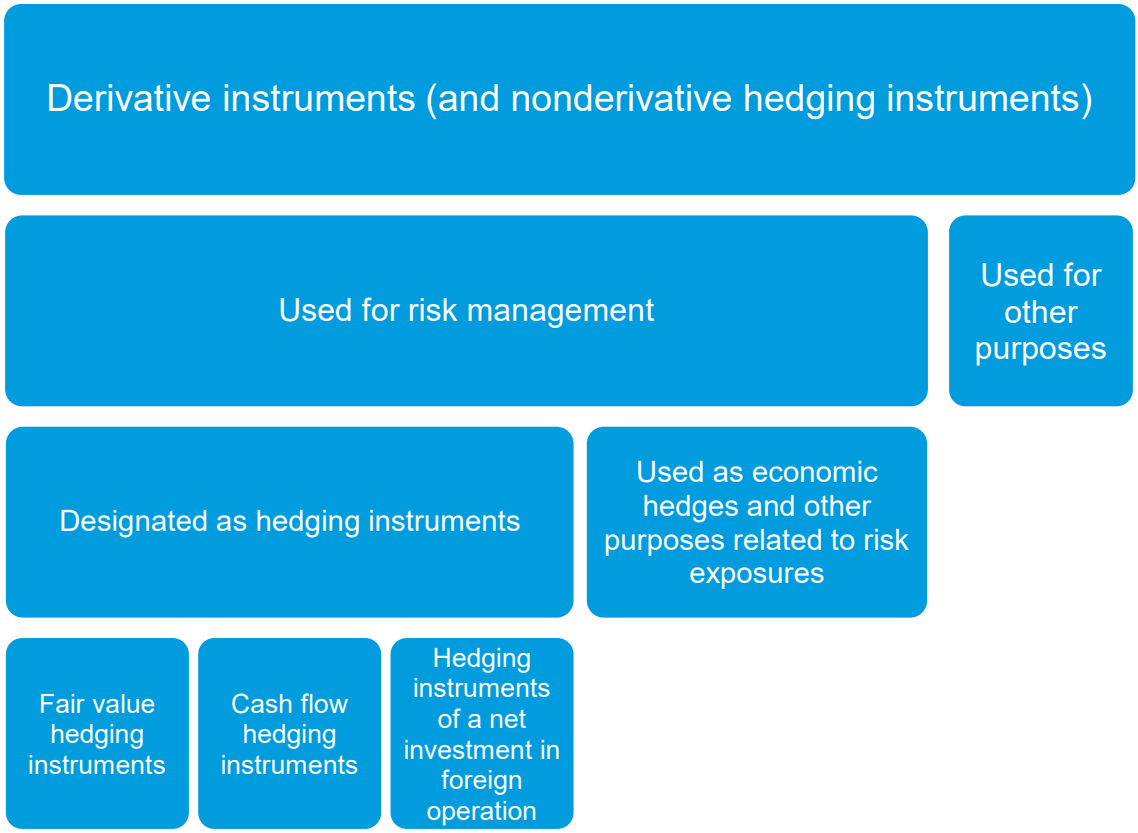
#### 11.2.1.1 Qualitative disclosures: How and why the entity uses derivative instruments

In accordance with ASC 815-10-50-1A through 50-1B, an entity that holds or issues derivative instruments (or nonderivative hedging instruments) must disclose in its annual and interim financial statements:

- Its objectives for holding or issuing the derivative (or such nonderivative) instruments
- The context needed to understand the above objectives
- Its strategies for achieving the above objectives
- Information that would allow the users of its financial statements to understand the volume of its activity in those instruments, using the format and the specifics of disclosures that are most relevant and practicable given the circumstances

The first three of the four requirements should be disclosed in the context of each instrument’s primary underlying risk exposure (e.g., interest rate, credit, foreign exchange rate, interest rate and foreign exchange rate [i.e., cross-currency interest rate risk], overall price).

As explained in ASC 815-10-50-2, in these disclosures, an entity should distinguish between derivative instruments (and nonderivative hedging instruments) used for risk management purposes and those used for other purposes in the level of disaggregation displayed in the following graphic.




As explained in ASC 815-10-50-5, qualitative disclosures about an entity's objectives and strategies for using derivative instruments (and nonderivative hedging instruments) may be more meaningful if the objectives and strategies are described in the context of the entity's overall risk exposures relating to interest rate risk, foreign exchange risk, commodity price risk, credit risk and equity price risk and how they are managed. While not required, if an entity makes these additional qualitative disclosures, it should include a discussion of these exposures, even if it does not manage some of these exposures by using derivative instruments. ASC 815-10-50-4 requires the purpose of derivative activity to be disclosed for derivative instruments that are not designated as hedging instruments.

**Example 11-2: Objectives and strategies for using derivative instruments**

This example illustrates the disclosure of objectives and strategies for using derivative instruments and information about the volume of activity in those instruments.

**Note X. Derivatives (in part)**

**Objectives and strategies for using derivative instruments:** The Company is exposed to certain risks relating to its ongoing business operations. The primary risks managed through derivative instruments are commodity price risk and interest rate risk. All derivative instruments are recognized as either assets or liabilities at fair value on the balance sheet. The Company designates the derivative instruments used to manage both commodity price risk and interest rate risk as cash flow hedges. As a result, the gain or loss on each derivative instrument is reported as a component of other comprehensive income and reclassified into earnings in the same line item on the income statement as the earnings effect of the hedged item, and in the same period or periods during which the hedged transaction affects earnings.

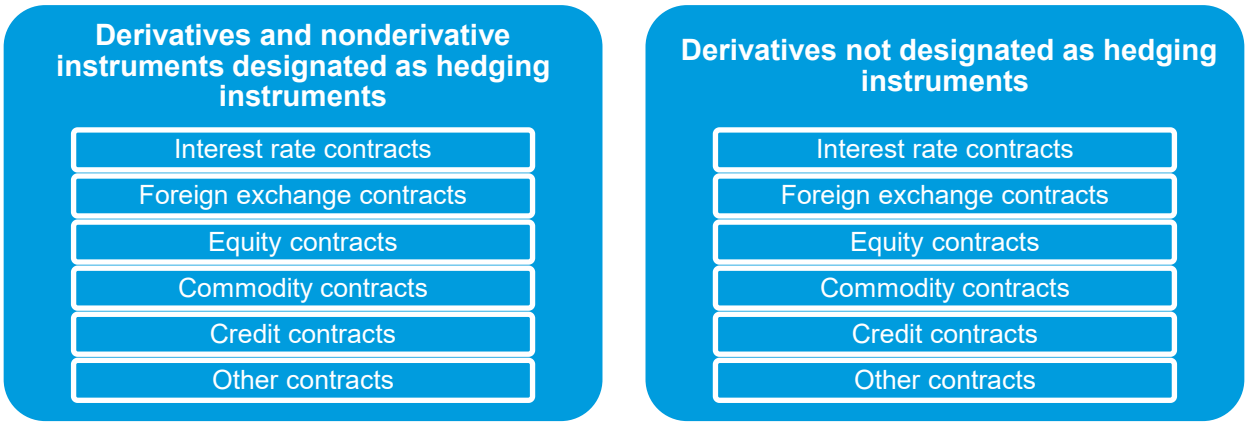
**Cash flow hedges of commodity price risk:** The Company manages its commodity price risk by entering into forward contracts to hedge the risk of variability in cash flows attributable to changes in a

contractually specified component associated with forecasted fuel purchases. As of December 31, 20X2, and 20X1, the Company had forward contracts outstanding to purchase XXX and XXX gallons of diesel fuel, respectively, over the course of the next 12 months.

**Cash flow hedges of interest rate risk:** The Company enters into interest rate swaps to manage the interest rate risk associated with its variable rate debt. Specifically, the Company is hedging the risk of variability in its cash flows attributable to changes in the contractually specified interest rate of three-month SOFR. As of December 31, 20X2, and 20X1, the Company had outstanding interest rate swaps with combined notional amounts of $XXX and $XXX, respectively, that mature through various dates in 20X6. While the notional amount does not exchange hands, each quarter during the terms of the swaps, the Company pays the counterparty payments based on a fixed rate and receives payments based on the current three-month SOFR rate, with both rates applied to the notional amount.

### 11.2.1.2 Overall quantitative disclosures

ASC 815 contains extensive quantitative disclosure requirements regarding the location and fair value amounts of derivative instruments and their associated gains and losses recognized in the financial statements. As noted in ASC 815-10-50-4E, these disclosures are required to be in tabular format. They are also largely required to be segregated based on whether the derivative instruments are designated as hedging instruments and by type of contract, with the following contract types specifically listed as examples in ASC 815-10-50-4D.




Example 21 in ASC 815-10-55 provides an illustration of a tabular disclosure for the requirements in ASC 815-10-50-4A through 50-4E. While not required, ASC 815-10-50-5A explains that quantitative disclosures about derivative instruments may be more useful, and less likely to be perceived to be out of context or misunderstood, if the entity discloses similar information by activity about related financial instruments or nonfinancial assets and liabilities.

Examples may include disclosing similar information for:

- Servicing assets and liabilities and the derivative instruments used to mitigate the earnings volatility risk they pose
- Mortgage loans held for sale and related loan commitments and the derivative instruments used to mitigate the earnings volatility risk they pose

As indicated in ASC 815-10-50-4A and 50-4B, an entity that holds or issues derivative instruments (and/or nonderivative hedging instruments) should disclose the following for each annual and interim reporting period for which it presents a balance sheet and income statement:

- The location (line item) and fair value amounts of derivative instruments and nonderivative hedging instruments reported on the balance sheet in accordance with the following requirements:

  - Fair value amounts should be presented on a gross basis, even if the instruments qualify for net presentation on the balance sheet.
  - Cash collateral should not be added to or netted against the fair value amounts.
  - The fair value asset and liability amounts should be segregated between:
    - Derivative and nonderivative hedging instruments, presented separately by contract type (e.g., interest rate contracts, foreign exchange contracts)
    - Derivative instruments not designated as hedging instruments, presented separately by contract type
  - A nonderivative hedging instrument that may give rise to a foreign currency gain or loss should be reported at its carrying amount, inclusive of its foreign currency transaction gain or loss.
  - Private companies that elect and qualify to use the settlement value in place of fair value under the simplified hedge accounting approach described beginning at ASC 815-20-25-133 should clearly state that the carrying amount is settlement value and disclose it separately from amounts disclosed at fair value as discussed in ASC 815-10-50-3.

- The location (line item) and amount of the gains and losses reported on the income statement and the balance sheet (e.g., gains and losses initially recognized in OCI) on derivative instruments (and nonderivative hedging instruments) and related hedged items. This disclosure is required to be presented by type of contract.

  Additionally, in accordance with ASC 815-10-50-4C, gains and losses for qualifying fair value and cash flow hedges must also be presented separately by income and expense line item for:

  - Derivative instruments (and nonderivative hedging instruments) in fair value hedges and related hedged items.
  - The gains and losses on cash flow hedging derivative instruments that were included in the effectiveness assessment and recognized in OCI during the current period
  - Amounts excluded from the effectiveness assessment that were recognized in OCI during the period for which an amortization approach is applied under ASC 815-20-25-83A
  - The gains and losses on cash flow hedging derivative instruments that were included in the effectiveness assessment and reported in AOCI during the hedging relationship and reclassified into earnings during the current period
  - The portion of gains and losses on fair value hedging derivative instruments and cash flow hedging derivative instruments representing the amount (if any) excluded from the effectiveness assessment that is recognized in earnings, detailed by amounts recognized in earnings through an amortization approach and amounts recognized through changes in fair value in earnings
    - Note that ASC 815-10-50-4EEEE requires an entity to disclose in its summary of significant accounting policies its election to record changes in the fair value of amounts excluded from the effectiveness assessment currently in earnings
  - The gains and losses reclassified into earnings as a result of discontinuing cash flow hedges because it is probable that the original hedged forecasted transactions will not occur by the end of the originally specified or additional time periods discussed at ASC 815-30-40-4 through 40-5
  - The amount of net gain or loss recognized in earnings when a hedged firm commitment no longer qualifies as a fair value hedge
  - The total amount of each income and expense line item presented on the income statement where the results of fair value or cash flow hedges are reported

**RSM COMMENTARY: Frequently overlooked disclosure requirement**

The requirement in ASC 815-10-50-4A(c) to disclose the total amount of each income or expense line item presented on the income statement where the results of fair value or cash flow hedges are reported is frequently overlooked.

**Example 11-3: Sample portion of footnote illustrating only the tabular disclosure of fair values of derivative instruments in a statement of financial position – adapted from ASC 815-10-55-182**

**Note X. Derivatives (in part)**

| Fair Values of Derivative Instruments *(in millions of dollars)* | | | | |
|---|---|---|---|---|
| | Derivative Assets | | | |
| | December 31, 20X0 | | December 31, 20X9 | |
| | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| **Derivatives designated as hedging instruments** | | | | |
| Interest rate contracts | Other assets | $ XX,XXX | Other assets | $ XX,XXX |
| Foreign exchange contracts | Other assets | XX,XXX | Other assets | XX,XXX |
| Commodity contracts | Other assets | XX,XXX | Other assets | XX,XXX |
| Credit contracts | Other assets | XX,XXX | Other assets | XX,XXX |
| Other contracts | Other assets | XX,XXX | Other assets | XX,XXX |
| **Total derivatives designated as hedging instruments** | | $ XX,XXX | | $ XX,XXX |
| **Derivatives not designated as hedging instruments** | | | | |
| Interest rate contracts | Other assets | $ XX,XXX | Other assets | $ XX,XXX |
| Foreign exchange contracts | Other assets | XX,XXX | Other assets | XX,XXX |
| Equity contracts | Other assets | XX,XXX | Other assets | XX,XXX |
| Commodity contracts | Other assets | XX,XXX | Other assets | XX,XXX |
| Credit contracts | Other assets | XX,XXX | Other assets | XX,XXX |
| Other contracts | Other assets | XX,XXX | Other assets | XX,XXX |
| **Total derivatives not designated as hedging instruments** | | $XX,XXX | | $XX,XXX |
| **Total derivative assets** | | $ XX,XXX | | $ XX,XXX |

| Fair Values of Derivative Instruments *(in millions of dollars)* | | | | |
|---|---|---|---|---|
| | Derivative Liabilities | | | |
| | December 31, 20X0 | | December 31, 20X9 | |
| | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| **Derivatives designated as hedging instruments** | | | | |
| Interest rate contracts | Other liabilities | $XX,XXX | Other liabilities | $XX,XXX |
| Foreign exchange contracts | Other liabilities | XX,XXX | Other liabilities | XX,XXX |
| Commodity contracts | Other liabilities | XX,XXX | Other liabilities | XX,XXX |
| Credit contracts | Other liabilities | XX,XXX | Other liabilities | XX,XXX |
| Other contracts | Other liabilities | XX,XXX | Other liabilities | XX,XXX |
| **Total derivatives designated as hedging instruments** | | $XX,XXX | | $XX,XXX |
| **Derivatives not designated as hedging instruments** | | | | |
| Interest rate contracts | Other liabilities | $XX,XXX | Other liabilities | $XX,XXX |
| Foreign exchange contracts | Other liabilities | XX,XXX | Other liabilities | XX,XXX |
| Equity contracts | Other liabilities | XX,XXX | Other liabilities | XX,XXX |
| Commodity contracts | Other liabilities | XX,XXX | Other liabilities | XX,XXX |
| Credit contracts | Other liabilities | XX,XXX | Other liabilities | XX,XXX |
| Other contracts | Other liabilities | XX,XXX | Other liabilities | XX,XXX |
| **Total derivatives not designated as hedging instruments** | | $XX,XXX | | $XX,XXX |
| **Total derivative liabilities** | | $XX,XXX | | $XX,XXX |

ASC 815-10-50-4CCC explains that the gains and losses from hedging instruments in net investment hedges must be presented separately by type of contract:

**ASC 815-10-50-4CCC**

For qualifying net investment hedges, an entity shall present the gains and losses disclosed in accordance with paragraph 815-10-50-4A(b) separately for all of the following by type of contract (as discussed in paragraph 815-10-50-4D):

a. The gains and losses on derivative instruments (and nonderivative instruments) designated and qualifying in net investment hedges that were recognized in the cumulative translation adjustment section of other comprehensive income during the current period

b. The gains and losses on derivative instruments (and nonderivative instruments) designated and qualifying in net investment hedges recorded in the cumulative translation adjustment section of accumulated other comprehensive income during the term of the hedging relationship and reclassified into earnings during the current period

c. The portion of gains and losses on derivative instruments (and nonderivative instruments) designated and qualifying in net investment hedges representing the amount, if any, excluded from the assessment of hedge effectiveness.

As indicated in ASC 815-10-50-4E, if a proportion of a derivative instrument is designated as a hedging instrument and a proportion is not so designated, an entity should allocate the related amounts to the proper categories within the disclosure tables.

**Example 11-4: Sample portion of footnote illustrating only the tabular disclosure of gains and losses from derivative instruments – adapted from ASC 815-10-55-182**

| The Effect of Fair Value and Cash Flow Hedge Accounting on Accumulated Other Comprehensive Income for the Years Ended December 31, 2010 and 2009 | | | | | |
|---|---|---|---|---|---|
| **Derivatives in Subtopic 815-20 Hedging Relationships** | **Amount of Gain or (Loss) Recognized in Other Comprehensive Income on Derivative** | **Location of Gain or (Loss) Reclassified from Accumulated Other Comprehensive Income into Income[(a)]** | **Amount of Gain or (Loss) Reclassified from Accumulated Other Comprehensive Income into Income** | | |
| | **2010** | **2009** | | **2010** | **2009** |
| Derivatives in Cash Flow Hedging Relationships | | | | | |
| Interest rate contracts | $XX,XXX | $XX,XXX | Interest income/(expense) | $XX,XXX | $XX,XXX |
| Foreign exchange contracts | XX,XXX | XX,XXX | Sales/Revenue | XX,XXX | XX,XXX |

| The Effect of Fair Value and Cash Flow Hedge Accounting on Accumulated Other Comprehensive Income for the Years Ended December 31, 2010 and 2009 | | | | | |
|---|---|---|---|---|---|
| **Derivatives in Subtopic 815-20 Hedging Relationships** | **Amount of Gain or (Loss) Recognized in Other Comprehensive Income on Derivative** | **Location of Gain or (Loss) Reclassified from Accumulated Other Comprehensive Income into Income[a]** | **Amount of Gain or (Loss) Reclassified from Accumulated Other Comprehensive Income into Income** | | |
| | **2010** | **2009** | | **2010** | **2009** |
| Commodity contracts | XX,XXX | XX,XXX | Cost of sales | XX,XXX | XX,XXX |
| Credit derivatives | XX,XXX | XX,XXX | Other income/(expense) | XX,XXX | XX,XXX |
| Other contracts | XX,XXX | XX,XXX | Other income/(expense) | XX,XXX | XX,XXX |
| Total | $XX,XXX | $XX,XXX | | $XX,XXX | $XX,XXX |
| Derivatives in Fair Value Hedging Relationships[b] | | | | | |
| Interest rate contracts | $XX,XXX | $XX,XXX | | | |
| Foreign exchange contracts | XX,XXX | XX,XXX | | | |
| Commodity contracts | XX,XXX | XX,XXX | | | |
| Credit derivatives | XX,XXX | XX,XXX | | | |
| Other contracts | XX,XXX | XX,XXX | | | |
| Total | $XX,XXX | $XX,XXX | | | |

(a) If gains and losses associated with a type of contract (for example, interest rate contracts) are displayed in multiple line items on the income statement, the entity is required to disclose the amount included in each line item.

(b) Represents amounts excluded from the assessment of effectiveness for which the difference between changes in fair value and periodic amortization is reported in other comprehensive income.

| The Effect of Fair Value and Cash Flow Hedge Accounting on the Income Statement for the Years Ended December 2010 and 2009 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Location and Amount of Gain or (Loss) Recognized in Income on Fair Value and Cash Flow Hedging Relationships[a] | | | | | | | |
| | 2010 | | | | 2009 | | | |
| | Revenue | Cost of Goods Sold | Interest Income (Expense) | Other Income (Expense) | Revenue | Cost of Goods Sold | Interest Income (Expense) | Other Income (Expense) |
| **Total amounts of income and expense line items presented in the income statement in which the effects of fair value or cash flow hedges are recorded** | $ XX,XXX | $ XX,XXX | $ XX,XXX | $ XX,XXX | $ XX,XXX | $ XX,XXX | $ XX,XXX | $ XX,XXX |
| The effects of fair value and cash flow hedging: | | | | | | | | |
| **Gain or (loss) on fair value hedging relationships in Subtopic 815-20:** | | | | | | | | |
| Interest contracts: | | | | | | | | |
| Hedged items | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX |
| Derivatives designated as hedging instruments | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX |
| Commodity contracts: | | | | | | | | |
| Hedged items | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX |
| Derivatives designated as hedging instruments | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX |
| Amount excluded from effectiveness testing recognized in earnings based on an amortization approach | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX |
| Foreign exchange contracts: | | | | | | | | |
| Hedged items | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX |
| Derivatives designated as hedging instruments | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX |
| Amount excluded from effectiveness testing recognized in earnings based | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX |

| The Effect of Fair Value and Cash Flow Hedge Accounting on the Income Statement for the Years Ended December 2010 and 2009 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Location and Amount of Gain or (Loss) Recognized in Income on Fair Value and Cash Flow Hedging Relationships[a] | | | | | | | |
| | 2010 | | | | 2009 | | | |
| | Revenue | Cost of Goods Sold | Interest Income (Expense) | Other Income (Expense) | Revenue | Cost of Goods Sold | Interest Income (Expense) | Other Income (Expense) |
| on an amortization approach | | | | | | | | |
| Credit contracts: | | | | | | | | |
| Hedged items | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX |
| Derivatives designated as hedging instruments | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX |
| Amount excluded from effectiveness testing recognized in earnings based on an amortization approach | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX |
| **Gain or (loss) on cash flow hedging relationships in Subtopic 815-20:** | | | | | | | | |
| Interest contracts: | | | | | | | | |
| Amount of gain or (loss) reclassified from accumulated other comprehensive income into income | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX |
| Amount of gain or (loss) reclassified from accumulated other comprehensive income into income as a result that a forecasted transaction is probable of not occurring | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX |

| The Effect of Fair Value and Cash Flow Hedge Accounting on the Income Statement for the Years Ended December 2010 and 2009 | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Location and Amount of Gain or (Loss) Recognized in Income on Fair Value and Cash Flow Hedging Relationships[(a)] | | | | | | | |
| | 2010 | | | | 2009 | | | |
| | Revenue | Cost of Goods Sold | Interest Income (Expense) | Other Income (Expense) | Revenue | Cost of Goods Sold | Interest Income (Expense) | Other Income (Expense) |
| Commodity contracts: | | | | | | | | |
| Amount of gain or (loss) reclassified from accumulated other comprehensive income into income | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX |
| Amount excluded from effectiveness testing recognized in earnings based on changes in fair value | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX |
| Foreign exchange contracts: | | | | | | | | |
| Amount of gain or (loss) reclassified from accumulated other comprehensive income into income | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX |
| Amount excluded from effectiveness testing recognized in earnings based on changes in fair value | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX |
| Credit contracts: | | | | | | | | |
| Amount of gain or (loss) reclassified from accumulated other comprehensive income into income | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX |
| Amount excluded from effectiveness testing recognized in earnings based on changes in fair value | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX | XX,XXX |

(a) If gains and losses associated with a type of contract (for example, interest rate contracts) are displayed in multiple line items in the income statement, the entity is required to disclose the amount included in each line item.

| Effect of Net Investment Hedges on Accumulated Other Comprehensive Income and the Income Statement | | |
|---|---|---|
| **Derivatives in Subtopic 815-20 Net Investment Hedging Relationships** | **Amount of Gain or (Loss) Recognized in Other Comprehensive Income on Derivative** | |
| | **2010** | **2009** |
| Foreign exchange contracts | $ XX,XXX | $ XX,XXX |
| | | |
| **Location of Gain or (Loss) Reclassified from Accumulated Other Comprehensive Income into Income[(a)]** | **Amount of Gain or (Loss) Reclassified from Accumulated Other Comprehensive Income into Income** | |
| | **2010** | **2009** |
| Gain or (loss) on sale of subsidiary | $ XX,XXX | $ XX,XXX |
| | | |
| **Location of Gain or (Loss) Recognized in Income on Derivative (Amount Excluded from Effectiveness Testing)[(a)]** | **Amount of Gain or (Loss) Recognized in Income on Derivative (Amount Excluded from Effectiveness Testing)** | |
| | **2010** | **2009** |
| Other income/(expense) | $ XX,XXX | $ XX,XXX |

(a) If gains and losses associated with a type of contract (for example, interest rate contracts) are displayed in multiple line items in the statement of financial performance, the entity is required to disclose the amount included in each line item.

| Effect on Derivatives Not Designated as Hedging Instruments on the Income Statement | | | |
|---|---|---|---|
| **Derivatives Not Designated as Hedging Instruments under Subtopic 815-20[(b)(c)]** | **Location of Gain or (Loss) Recognized in Income on Derivative[(a)]** | **Amount of Gain or (Loss) Recognized in Income on Derivative** | |
| | | **2010** | **2009** |
| Interest rate contracts | Other income/(expense) | $ XX,XXX | $ XX,XXX |
| Foreign exchange contracts | Other income/(expense) | XX,XXX | XX,XXX |
| Equity contracts | Other income/(expense) | XX,XXX | XX,XXX |
| Commodity contracts | Other income/(expense) | XX,XXX | XX,XXX |
| Credit derivatives | Other income/(expense) | XX,XXX | XX,XXX |
| Other contracts | Other income/(expense) | XX,XXX | XX,XXX |
| Total | | $ XX,XXX | $ XX,XXX |

(a) If gains and losses associated with a type of contract (for example, interest rate contracts) are displayed in multiple line items on the income statement, the entity is required to disclose the amount included in each line item.

(b) See note XX for additional information on the ABC Entity's purpose for entering into derivative instruments not designated as hedging instruments and its overall risk management strategies.

(c) For alternative disclosures about "trading derivatives," see separate table for trading activities in notes to financial statements.

(d) Footnote superseded by Accounting Standards Update No. 2017-12.

ASC 815-10-50-4EE requires the following tabular disclosure for hedged items in fair value hedges.

**ASC 815-10-50-4EE**

An entity shall disclose in tabular format the following for items designated and qualifying as hedged items in fair value hedges:

a. The carrying amount of hedged assets and liabilities recognized on the statement of financial position. For an available-for-sale debt security, the amount disclosed is the amortized cost basis.

b. The cumulative amount of fair value hedging adjustments to hedged assets and liabilities included in the carrying amount of the hedged assets and liabilities recognized on the statement of financial position.

c. The line item in the statement of financial position that includes the hedged assets and liabilities.

d. The cumulative amount of fair value hedging adjustments remaining for any hedged assets and liabilities for which hedge accounting has been discontinued.

The disclosures required by (b) and (d) shall exclude cumulative basis adjustments related to foreign exchange risk.

## Example tabular disclosure for hedged items in fair value hedges

**Example 11-5: Example tabular disclosure for hedged items in fair value hedges – adapted from ASC 815-10-55-181**

**Fair value hedges**

For derivative instruments that are designated and qualify as a fair value hedge, the gain or loss on the derivative instrument as well as the offsetting loss or gain on the hedged item attributable to the hedged risk are recognized in current earnings. The Entity includes the gain or loss on the hedged items (that is, fixed-rate receivables) in the same line item—interest income—as the offsetting loss or gain on the related interest rate swaps.

As of December 31, 20X2 and 20X1, the following amounts were recorded on the balance sheet related to cumulative basis adjustments for fair value hedges.

| Line Item in the Balance Sheet in Which the Hedged Item Is Included | Carrying Amount of the Hedged Assets/(Liabilities) | | Cumulative Amount of Fair Value Hedging Adjustment Included in the Carrying Amount of the Hedged Assets/(Liabilities) | |
|---|---|---|---|---|
| | 20X2 | 20X1 | 20X2 | 20X1 |
| Loans receivable[a] | $115 | $124 | $10[b] | $20 |

(a) These amounts include the amortized costs basis of closed portfolios of loans receivable used to designate hedging relationships in which the hedged time is the stated amount of assets in the closed portfolios anticipated to be outstanding for the designated hedge period. At December 31, 20X2 and 20X1, the amortized cost basis of the closed portfolios used in these hedging relationships was $52 and $60, respectively, the cumulative basis adjustments associated with these hedging relationships was $5 and $7, respectively, and the amounts of the designated hedged items were $16 and $18, respectively.

(b) The balance includes $2 of hedging adjustment on a discontinued hedging relationship.

As of December 31, 20X2 and 20X1, the total notational amount of the Entity's pay-fixed/receive-variable interest rate swaps was $79 and $82, respectively.

In accordance with ASC 815-10-50-4EEE, for each line item disclosed in accordance with ASC 815-10-55-4EE(c) that includes hedging relationships designated under the portfolio layer method, an entity should separately disclose:

- The amortized cost basis of the closed portfolios of financial assets or the beneficial interests
- The amount that represents the hedged items (i.e., the hedged layer or layers)
- The basis adjustment associated with the hedged items (i.e., the hedged layer or layers).

Example 20 in ASC 815-10-55-181 illustrates these disclosures.

### Trading derivative instruments

The comprehensive derivative disclosure example in Section 11.2.1.2 above included a disclosure for the effect of derivative instruments not designated as hedging instruments on the income statement. ASC 815-10-50-4F and ASC 815-10-55-183 explain that if an entity's policy is to include derivative instruments that are not designated as hedging instruments in its trading activities, it can elect to not separately disclose gains and losses in this tabular format but rather disclose the gains and losses on derivative instruments with its other trading activities provided that certain details are disclosed.

**ASC 815-10-50-4F**

For derivative instruments that are not designated or qualifying as hedging instruments under Subtopic 815-20, if an entity's policy is to include those derivative instruments in its trading activities (for example, as part of its trading portfolio that includes both derivative instruments and nonderivative or cash instruments), the entity can elect to not separately disclose gains and losses as required by paragraph 815-10-50-4CC provided that the entity discloses all of the following:

a. The gains and losses on its trading activities (including both derivative instruments and nonderivative instruments) recognized in the statement of financial performance, separately by major types of items, for example:
    1. Fixed income/interest rates
    2. Foreign exchange
    3. Equity
    4. Commodity
    5. Credit.
b. The line items in the statement of financial performance in which trading activities gains and losses are included
c. A description of the nature of its trading activities and related risks, and how the entity manages those risks.

If an entity elects to include this information about its derivative instrument trading activities outside the derivative footnote, it should cross-reference the derivative footnote to the footnote in which it is included. An example of a disclosure that includes gains on losses on derivative instruments with other trading activities follows.

**Example 11-6: Sample portion of footnote illustrating only the tabular disclosure of trading derivatives – adapted from ASC 815-10-55-184**

**Note X. Derivatives (in part)**

| The Effect of Trading Activities on the Statement of Financial Performance for the Years Ended December 31, 2010, and 2009 | | |
|---|---|---|
| **Type of Instrument** | **Trading Revenue** | |
| | **2010** | **2009** |
| Fixed income/interest rate | $ XX,XXX | $ XX,XXX |
| Foreign exchange | XX,XXX | XX,XXX |
| Equity | XX,XXX | XX,XXX |
| Commodity | XX,XXX | XX,XXX |
| Credit | XX,XXX | XX,XXX |
| Other | XX,XXX | XX,XXX |
| Total | $ XX,XXX | $ XX,XXX |
| **Line Item in Income Statement** | **Trading Revenue** | |
| | **2010** | **2009** |
| Principal/Proprietary transactions | $ XX,XXX | $ XX,XXX |
| Asset management income | XX,XXX | XX,XXX |
| Other income | XX,XXX | XX,XXX |
| Total | $ XX,XXX | $ XX,XXX |

The revenue related to each category includes realized and unrealized gains and losses on both derivative instruments and nonderivative instruments.

### 11.2.1.3 Basis adjustment considerations under the portfolio layer method

ASC 815-10-50-5B provides that for portfolio layer method hedges, an entity does not need to disclose

> …the basis adjustment on a more disaggregated basis than the portfolio layer method closed portfolio to meet the objectives of disclosure requirements in other Topics unless that disaggregation is required in accordance with paragraph 815-20-45-4. After an entity allocates a basis adjustment in accordance with paragraph 815-20-45-4 (if applicable), if other Topics require the disclosure of the amortized cost basis of assets included in the closed portfolio on a basis that requires disaggregating the assets included in the closed portfolio, the entity shall exclude the portfolio layer method basis adjustment from the amortized cost basis of those assets. In that case, the entity shall disclose the total amount of the portfolio layer method basis adjustment excluded from the amortized cost basis of the assets included in the closed portfolio

Additionally, ASC 815-10-50-5C requires certain disclosures if the outstanding amount of the closed portfolio that is designated as the hedged item is less than the hedged layer or layers (i.e., a breach has occurred). Namely, the amount of the hedge basis adjustment that is recognized in current-period interest income because of the breach, as well as the circumstances that led to the breach, should be disclosed.

### 11.2.1.4 Credit-risk-related contingent features

To alert the financial statement users to potential cash flow issues that may result from using derivative instruments, an entity is required to disclose certain information regarding counterparty credit risk and the existence of credit-risk-related contingent features. A common example of such a feature is a requirement to post additional collateral if certain events, such as a downgrade in credit rating, occur. Pursuant to ASC 815-10-50-4H, an entity that holds or issues derivative instruments (or nonderivative hedging instruments) should, for every annual and interim reporting period for which a balance sheet is presented, disclose:

- The existence and nature of credit-risk-related contingent features and the circumstances in which these features could be triggered in derivative instruments (or nonderivative hedging instruments) that are in a net liability position at the end of the reporting period
- The aggregate fair value amounts of derivative instruments (or nonderivative hedging instruments) that contain credit-risk-related contingent features that are in a net liability position at the end of the reporting period
- The aggregate fair value of assets that are already posted as collateral at the end of the reporting period and the aggregate fair value of additional assets that would be required to be posted as collateral or needed to settle the instrument immediately, if the credit-risk-related contingent features were triggered at the end of the reporting period

Amounts required to be reported for nonderivative hedging instruments should be the carrying value of the nonderivative hedging instrument, which includes the adjustment for the foreign currency transaction gain or loss on that instrument.

**Example 11-7: Sample portion of footnote illustrating only the disclosure of contingent features in derivative instruments (ASC 815-10-55-185)**

**Note X. Derivatives (in part)**

**Contingent features:** Certain of the Entity's derivative instruments contain provisions that require the Entity's debt to maintain an investment grade credit rating from each of the major credit-rating agencies. If the Entity's debt were to fall below investment grade, it would be in violation of these provisions, and the counterparties to the derivative instruments could request immediate payment or demand immediate and ongoing full overnight collateralization on derivative instruments in net liability positions. The aggregate fair value of all derivative instruments with credit-risk-related contingent features that are in a liability position on December 31, 20X9, is $XX million, for which the Entity has posted collateral of $X million in the normal course of business. If the credit-risk-related contingent features underlying these agreements were triggered on December 31, 20X9, the Entity would be required to post an additional $XX million of collateral to its counterparties.

### 11.2.1.5 Credit derivative instruments

A credit derivative instrument is a derivative instrument:

- In which one or more of its underlyings are related to the credit risk of a specified entity (or a group of entities) or an index based on the credit risk of a group of entities
- That exposes the seller to potential loss from credit-risk-related events specified in the contract

Examples of credit derivative instruments include, but are not limited to, credit default swaps, credit spread options and credit index products.

A seller of credit derivative instruments (sometimes referred to as the writer of the contract) is the party that assumes credit risk, which could be a guarantor in a guarantee-type contract, or any party that provides the credit protection in a credit derivative contract.

As noted in ASC 815-10-50-4K, a seller of credit derivative instruments should disclose information about its credit derivative instruments and hybrid instruments (e.g., credit-linked notes) that have embedded credit derivatives to allow financial statement users to assess the potential effect of these derivative instruments and hybrid instruments on the entity's financial statements. With respect to hybrid instruments that have embedded credit derivatives, the seller of the embedded credit derivative instrument should disclose the required information for the entire hybrid instrument, not just the embedded credit derivatives. However, these disclosures do not apply to an embedded derivative related to the transfer of credit risk that is only in the form of subordination of one financial instrument to another.

Even if there only is a remote chance that the seller of a credit derivative instrument would be required to make any payments under that derivative instrument, ASC 815-10-50-4K requires that for each balance sheet presented, the seller should disclose information for each credit derivative instrument (or each group of similar credit derivative instruments).

**ASC 815-10-50-4K**

a. The nature of the credit derivative, including all of the following:
    1. The approximate term of the credit derivative
    2. The reason(s) for entering into the credit derivative
    3. The events or circumstances that would require the seller to perform under the credit derivative
    4. The current status (that is, as of the date of the statement of financial position) of the payment/performance risk of the credit derivative, which could be based on either recently issued external credit ratings or current internal groupings used by the seller to manage its risk
    5. If the entity uses internal groupings for purposes of item (a)(4), how those groupings are determined and used for managing risk.

b. All of the following information about the maximum potential amount of future payments under the credit derivative:
    1. The maximum potential amount of future payments (undiscounted) that the seller could be required to make under the credit derivative, which shall not be reduced by the effect of any amounts that may possibly be recovered under recourse or collateralization provisions in the credit derivative (which are addressed in items (c) through (f))
    2. The fact that the terms of the credit derivative provide for no limitation to the maximum potential future payments under the contract, if applicable
    3. If the seller is unable to develop an estimate of the maximum potential amount of future payments under the credit derivative, the reasons why it cannot estimate the maximum potential amount.

c. The fair value of the credit derivative as of the date of the statement of financial position

d. The nature of any recourse provisions that would enable the seller to recover from third parties any of the amounts paid under the credit derivative

e. The nature of any assets held either as collateral or by third parties that, upon the occurrence of any specified triggering event or condition under the credit derivative, the seller can obtain and liquidate to recover all or a portion of the amounts paid under the credit derivative

f. If estimable, the approximate extent to which the proceeds from liquidation of assets held either as collateral or by third parties would be expected to cover the maximum

> potential amount of future payments under the credit derivative. In its estimate of potential recoveries, the seller of credit protection shall consider the effect of any purchased credit protection with identical underlying(s).

One way to present the above information for groups of similar credit derivative instruments is provided in ASC 815-10-50-4L. In this method, an entity would first segregate the disclosures by major types of contracts. Examples of major types of contracts include, but are not limited to:

- Single-name credit default swaps
- Traded indexes
- Other portfolio products
- Swaptions

Then, for each major type, an entity may provide additional subgroups for major types of referenced or underlying asset classes (e.g., corporate debt, sovereign debt, structured finance).

#### 11.2.1.6 Additional disclosures for cash flow hedges

In addition to the disclosures above, in annual and interim financial statements for cash flow hedging instruments and the transactions they hedge, ASC 815-30-50-1 requires:

- A description of the transactions or other events that will result in the reclassification into earnings of gains and losses that are reported in AOCI
- The estimated net amount of the existing gains or losses at the reporting date that is expected to be reclassified into earnings within the next 12 months (which, according to ASC 815-30-50-4, could be different than the net amount reported in AOCI)
- The maximum length of time over which the entity is hedging its exposure to the variability in future cash flows for forecasted transactions, excluding those forecasted transactions related to the payment of variable interest on existing financial instruments

As noted in ASC 815-30-50-4 through 50-6, the amount of OCI to be reclassified into earnings in the coming 12 months could be greater or less than the net amount reported in AOCI. If there are multiple cash flows associated with the hedged transaction, the amount in AOCI needs to be allocated to each of the forecasted transactions. Consideration generally needs to be given to the underlying fair value and expected cash flow computations for the derivative instrument amounts to which the AOCI balance relates.

**Example 11-8: Reclassification of AOCI to earnings over the next 12 months**

Using the swap example in Section 11.1.1.1, the swap is in an asset position and has a fair value of $10 million reported in OCI that is comprised of gross expected cash outflows with a net present value of approximately $3 million in the next 12 months, and gross expected cash inflows with a net present value of approximately $13 million for the remaining term of the interest rate swap.

The gain or loss on our interest rate swap is reported as a component of OCI and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. As of December 31, 20X0, $3 million of the amount deferred in AOCI is expected to be reclassified to earnings as an increase to interest expense during the next twelve months.

ASC 220-10-45-14A requires changes in AOCI to be presented either on the face of the financial statements or as a separate disclosure in the notes. Various illustrative examples are included in ASC 220-10-55. The following details are required to be disclosed, according to ASC 815-30-50-2.

**ASC 815-30-50-2**

a. The beginning and ending accumulated derivative instrument gain or loss

b. The related net change associated with current period hedging transactions

c. The net amount of any reclassification into earnings

d. The difference between the change in fair value of an excluded component and the initial value of that excluded component recognized in earnings under a systematic and rational method in accordance with paragraph 815-20-25-83A.

### 11.2.1.7 Additional disclosures for embedded derivatives that are not separated

In addition to the required disclosures discussed above, ASC 815-15-50-1 explains that if an entity accounts for hybrid financial instruments at fair value, it should also disclose the information required by ASC 825-10-50-28 through 50-32 for the fair value option.

Further, ASC 815-15-50-2 requires an entity to provide information that will allow financial statement users to understand the effect of changes in the fair value of hybrid financial instruments measured at fair value on earnings (or other performance indicators for an entity that does not report earnings).

As it relates to a convertible instrument, such as debt, for which an embedded conversion option previously accounted for as a derivative instrument no longer meets the separation criteria, the entity is required to disclose both of the following, pursuant to ASC 815-15-50-3.

**ASC 815-15-50-3**

An issuer shall disclose both of the following for the period in which an embedded conversion option previously accounted for as a derivative instrument under this Subtopic no longer meets the separation criteria under this Subtopic:

a. A description of the principal changes causing the embedded conversion option to no longer require bifurcation under this subtopic

b. The amount of the liability for the conversion option reclassified to stockholders' equity.

### 11.2.1.8 Disclosures regarding balance sheet offsetting

ASC 815-10-50-7 requires an entity to disclose its accounting policy as to whether it does or does not offset assets and liabilities with the same counterparty. ASC 815-10-50-7A reinforces the fact that ASC 210-20-50 requires disclosures about derivative instruments that are either offset or subject to an enforceable master netting arrangement or similar agreement as discussed in Section 11.1.1.2. These requirements are outlined in ASC 210-20-50-1 through 50-6.

For such derivative instruments, an entity is required to disclose information that enables financial statement users to evaluate the effect or potential effect of netting arrangements on its financial position for recognized assets and liabilities. These disclosures are important in building comparability between entities that elect to offset qualifying amounts and those that do not. These requirements are illustrated through the use of various examples included in ASC 210-20-55.

ASC 815-10-50-8 requires an entity to disclose the amounts recognized at the end of each reporting period for the right to reclaim cash collateral or the obligation to return it.

**ASC 815-10-50-8**

a. A reporting entity that has made an accounting policy decision to offset fair value amounts shall separately disclose amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral that have been offset against net derivative positions in accordance with paragraph 815-10-45-5.

b. A reporting entity shall separately disclose amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral under master netting arrangements that have not been offset against net derivative instrument positions.

c. A reporting entity that has made an accounting policy decision to not offset fair value amounts shall separately disclose the amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral under master netting arrangements.

### 11.2.1.9 Additional disclosures for contracts in an entity's own equity

ASC 815-40 applies to not only certain derivative instruments that are indexed to, and potentially settled in, an entity's own stock, but also to certain derivative-like instruments. Its disclosure requirements should be considered by entities that have contracts on their own equity outstanding. Refer to Chapter 5 of Accounting for debt and equity instruments in financing transactions for additional information on ASC 815-40.

### 11.2.1.10 Disclosures by not-for-profit organizations

As indicated in ASC 815-10-50-4G, not-for profits (NFPs) within the scope of ASC 954, should present quantitative disclosure tables that are similarly formatted to those discussed herein. NFPs should refer to amounts within their performance indicator, instead of in earnings, and amounts outside their performance indicator, instead of in OCI. Other NFPs should disclose the gain or loss recognized in changes in net assets using a similar format. All NFPs also should indicate which class or classes of net assets (unrestricted, temporarily restricted or permanently restricted) are affected.

# Appendix A: Accounting standards updates mentioned in this guide

## A.1 ASU 2025-07 – High level overview

In September 2025, the FASB issued Accounting Standards Update 2025-07, *Derivatives and Hedging (Topic 815) and Revenue from Contracts with Customers (Topic 606): Derivatives Scope Refinements and Scope Clarification for Share-Based Noncash Consideration from a Customer in a Revenue Contract* (ASU 2025-07).

Stakeholders raised concerns that the definition of a derivative in ASC 815 is applied too broadly to contracts whose variables are tied to the operations or activities of one of the parties to the contract. Examples include ESG-linked bond provisions, research and development funding arrangements, and litigation funding arrangements. Stakeholders noted that accounting for these contracts as derivative instruments measured at fair value often does not provide decision-useful information and creates unnecessary cost and complexity.

Separately, diversity in practice has arisen regarding how to account for share-based noncash consideration received from a customer—such as shares or warrants—in exchange for goods or services. Questions centered on whether such instruments should be accounted for immediately under derivative or equity securities guidance, or only when the related performance obligations under ASC 606 are satisfied.

ASU 2025-07 responds to this feedback by refining scope and clarifying existing guidance.

### A.1.1 Main provisions

#### A.1.1.1 Derivatives scope refinements

ASU 2025-07 expands an existing scope exception under ASC 815 to exclude non-exchange-traded contracts with underlyings based on the operations or activities of one of the parties to the contract.

The scope exception does not apply to:

- Variables based on market rates, market prices or market indexes
- Variables based on the price or performance of a financial asset or liability of a party to the contract
- Contracts or features involving the issuer's own equity evaluated under ASC 815-40
- Call or put options on debt instruments

ASU 2025-07 is expected to result in more contracts and embedded features being excluded from the scope of ASC 815.

#### A.1.1.2 Share-based noncash consideration

ASU 2025-07 states that ASC 606 governs the accounting for share-based noncash consideration received from a customer in exchange for goods or services. Accordingly:

- The noncash consideration should be accounted for under ASC 606, including the specific noncash consideration guidance in ASC 606-10-32-21 through 32-24.
- Other GAAP guidance (e.g., ASC 815 on derivatives or ASC 321 on equity securities) is not applied unless and until the entity's right to receive or retain the consideration becomes unconditional under the guidance in ASC 606.

### A.1.2 Effective date

ASU 2025-07 is effective for all entities for annual reporting periods beginning after December 15, 2026, including interim periods within those annual periods. Early adoption is permitted.

### A.1.3 Transition

For the derivative scope refinements, ASU 2025-07 states that an entity is permitted to apply the guidance in ASU 2025-07 either:

- Prospectively to new contracts entered into on or after the date of adoption
- On a modified retrospective basis through a cumulative-effect adjustment to the opening balance of retained earnings as of the beginning of the annual reporting period of adoption for contracts existing as of the beginning of the annual reporting period of adoption

For transactions involving the receipt of share-based non-cash consideration, ASU 2025-07 states that an entity is permitted to apply the guidance in ASU 2025-07 either:

- Prospectively to new contracts entered into on or after the date of adoption, including modified contracts accounted for as separate contracts in accordance with ASC 606-10-25-12
- On a modified retrospective basis through a cumulative-effect adjustment to the opening balance of retained earnings as of the beginning of the annual reporting period of adoption for contracts existing as of the beginning of the annual reporting period of adoption

## A.2 ASU 2025-09 – High level overview

### A.2.1 Overview

In November 2025, the FASB issued ASU 2025-09, *Derivatives and Hedging (Topic 815): Hedge Accounting Improvements* (ASU 2025-09), to align hedge accounting more closely with the economics of an entity's risk management activities.

Stakeholders noted to the FASB that, in certain instances, it is challenging to apply hedge accounting for otherwise highly effective hedging relationships. This has resulted in less decision-useful information for investors. Stakeholders also identified areas of hedge accounting guidance that required updating to address the impact of reference rate reform.

ASU 2025-09 addresses five issues intended to enable financial statements to better reflect certain hedging strategies by allowing entities to achieve and maintain hedge accounting for a greater number of highly effective economic hedges. The objective of ASU 2025-09 is to more closely align hedge accounting with the economics of an entity's risk management activities. The FASB believes that the changes set forth in ASU 2025-09 to the hedge accounting guidance will improve the decision usefulness of the information provided to investors.

ASU 2025-09 affects the types of hedges discussed in the following sections.

#### A.2.1.1 Similar risk assessment for cash flow hedges

ASU 2025-09 expands the hedged risks that may be combined within a group of individual forecasted transactions in a cash flow hedge. Specifically, the ASU changes the requirement to designate a group of individual forecasted transactions from having a shared risk exposure to having a similar risk exposure. An entity must evaluate whether the risks are similar both when the hedge is initiated and throughout the life of the hedging relationship. The ASU further explains that individual forecasted transactions may be viewed as having a similar risk exposure when the designated hedging derivative is highly effective in offsetting each of the risks included in the group. Additionally, in certain circumstances, entities may use a qualitative approach on an ongoing basis to assess whether the group continues to meet the similar-risk criterion.

#### A.2.1.2 Hedging forecasted interest payments on choose-your-rate debt instruments

ASU 2025-09 enables an entity to apply cash flow hedge accounting to forecasted interest payments on variable-rate borrowings whose contractual provisions permit the borrower to switch both the reference interest rate index and the interest rate tenor (i.e., the reset interval) on which interest is calculated. These arrangements are commonly described as "choose-your-rate" debt. Under this model, the debt agreement specifies the permissible alternative rate indexes and tenors that may be designated as the hedged risk throughout the hedge term without discontinuing hedge accounting. The ASU also allows entities to employ certain simplifying assumptions when evaluating the likelihood of the forecasted interest payments occurring and when performing hedge-effectiveness assessments. This guidance may be applied to existing, forecasted issuances of, and subsequent replacements of choose-your-rate debt. The ASU explicitly prohibits extending this approach by analogy to other fact patterns.

#### A.2.1.3 Cash flow hedges of nonfinancial forecasted transactions

ASU 2025-09 broadens the applicability of hedge accounting to forecasted purchases and sales of nonfinancial assets. Rather than requiring that a price component be contractually specified, an entity may, when certain conditions are met, designate hedge relationships for eligible components of forecasted spot transactions, forward transactions and subcomponents of explicitly referenced components in a contract's pricing formula. For a forecasted purchase or sale of a nonfinancial asset to qualify for hedge designation, the variable pricing element must be clearly and closely related to the underlying nonfinancial asset being purchased or sold, consistent with the requirements of the existing normal purchases and normal sales scope exception.

#### A.2.1.4 Net written options as hedging instruments

ASU 2025-09 revises the hedge accounting requirements applicable to net written options so that the guidance better reflects structural differences that emerged between the loan and swap markets following the discontinuation of LIBOR. In particular, ASU 2025-09 removes the requirement to perform the net written option assessment for a compound derivative consisting of a swap combined with a written option when that compound instrument is designated as the hedging instrument in either a cash flow hedge or a fair value hedge of interest rate risk.

#### A.2.1.5 Foreign-currency-denominated debt instrument as hedging instrument and hedged item (dual hedge)

ASU 2025-09 removes the recognition and presentation mismatch that arises in a dual-hedge structure (i.e., when the same foreign-currency-denominated debt instrument is designated both as the hedging instrument in a net investment hedge and as the hedged item in a fair value hedge of interest rate risk). Under the new guidance, an entity must exclude the fair value hedge basis adjustment associated with that debt instrument from the net investment hedge effectiveness analysis. Consequently, any gains or losses resulting from remeasuring the fair value hedge basis adjustment at the spot exchange rate are recorded immediately in earnings. ASU 2025-09 also prohibits applying this guidance by analogy to other situations.

### A.2.2 Effective date

For PBEs, ASU 2025-09 is effective for annual reporting periods beginning after December 15, 2026, and interim periods within those annual reporting periods. For entities other than PBEs, ASU 2025-09 is effective for annual reporting periods beginning after December 15, 2027, and interim periods within those annual reporting periods. Early adoption is permitted on any date on or after the issuance date of ASU 2025-09.

### A.2.3 Transition

The guidance in ASU 2025-09 should be applied prospectively for all hedging relationships. An entity may elect to adopt ASU 2025-09 for hedging relationships that exist as of the date of adoption.

# Appendix B: Acronyms, definitions and literature references

Several acronyms are used throughout this guide and references are made to specific topics and subtopics in the ASC. This appendix includes an acronym legend, which lists the acronyms and their corresponding definitions, definitions of certain key terms and a literature listing of ASUs and ASC topics and subtopics referred to throughout this guide with their corresponding titles.

### Acronym legend

| Acronym | Definition |
|---|---|
| AOCI | Accumulated other comprehensive income |
| ASC | FASB's Accounting Standards Codification |
| ASU | Accounting Standards Update |
| CDO | Collateralized debt obligation |
| CPI | Consumer Price Index |
| ESG | Environmental, social and governance |
| FASB | Financial Accounting Standards Board |
| FVO | Fair value option |
| GAAP | Generally accepted accounting principles |
| IPO | Initial public offering |
| IRR | Initial rate of return |
| ISO | Independent system operator |
| LIBOR | London Interbank Offered Rate |
| NFP | Not-for-profit organization |
| OCI | Other comprehensive income |
| OIS | Overnight Index Swap |
| S&P 500 | Standard and Poor's 500 index |
| SEC | Securities and Exchange Commission |
| SIFMA | Securities Industry and Financial Markets Association |
| SOFR | Secured Overnight Financing Rate |
| U.S. GAAP | U.S. generally accepted accounting principles |

## Definitions

Several terms with specific meaning are used throughout this guide. Those terms and the corresponding definition, based primarily on the ASC Master Glossary, are provided in the following table. If a definition is not from the ASC Master Glossary, that fact is noted along with sources, if applicable.

| Term | Definition |
|---|---|
| Active Market | A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis. |
| All-in-One Hedge | In an all-in-one hedge, a derivative instrument that will involve gross settlement is designated as the hedging instrument in a cash flow hedge of the variability of the consideration to be paid or received in the forecasted transaction that will occur upon gross settlement of the derivative instrument itself. |
| 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.<br>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. |
| Beneficial Interest | Rights to receive all or portions of specified cash inflows received by a trust or other entity, including, but not limited to, all of the following:<br>• Senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through<br>• Premiums due to guarantors<br>• Commercial paper obligations<br>• 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 so that it can satisfy its obligations. For example, in the electric industry, capacity (sometimes referred to as installed capacity) is the capability to deliver electric power to the electric transmission system of an operating control area. |
| Carrying Amount | For a receivable, the face amount increased or decreased by applicable accrued interest and applicable unamortized premium, discount, finance charges, or issue costs and also an allowance for uncollectible amounts and other valuation accounts.<br>For a payable, the face amount increased or decreased by applicable accrued interest and applicable unamortized premium, discount, finance charges, or issue costs.<br>The amount of an item as displayed in the financial statements. |

| Term | Definition |
|---|---|
| Cash Flow Hedge | A hedge of the exposure to variability in the cash flows of a recognized asset or liability, or of a forecasted transaction, that is attributable to a particular risk. |
| Contractual Net Settlement<br>[non-Master Glossary definition] | According to ASC 815-10-15-100, “in this form of net settlement, neither party is required to deliver an asset that is associated with the underlying and that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (or the notional amount plus a premium or minus a discount). (For example, most interest rate swaps do not require that either party deliver interest bearing assets with a principal amount equal to the notional amount of the contract.) Net settlement may be made in cash or by delivery of any other asset (such as the right to receive future payments—see the discussion beginning in paragraph 815-10-15-104), whether or not that asset is readily convertible to cash.” |
| Contractually Specified Component | An index or price explicitly referenced in an agreement to purchase or sell a nonfinancial asset other than an index or price calculated or measured solely by reference to an entity’s own operations.<br>Following the adoption of ASU 2025-09, this term will be superseded and removed from the ASC Master Glossary. |
| Credit Risk | For purposes of a hedged item in a fair value hedge, credit risk is the risk of changes in the hedged item's fair value attributable to both of the following:<br>a. Changes in the obligor’s creditworthiness<br>b. Changes in the spread over the benchmark interest rate with respect to the hedged item’s credit sector at inception of the hedge.<br>For purposes of a hedged transaction in a cash flow hedge, credit risk is the risk of changes in the hedged transaction's cash flows attributable to all of the following:<br>a. Default<br>b. Changes in the obligor’s creditworthiness<br>c. Changes in the spread over the contractually specified interest rate or the benchmark interest rate with respect to the related financial asset’s or liability’s credit sector at inception of the hedge. |
| Debt Security | Any security representing a creditor relationship with an entity. The term debt security also includes all of the following:<br>• Preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor<br>• A collateralized mortgage obligation (or other instrument) that is issued in equity form but is required to be accounted for as a nonequity instrument regardless of how that instrument is classified (that is, whether equity or debt) in the issuer's balance sheet<br>• U.S. Treasury securities<br>• U.S. government agency securities<br>• Municipal securities |

| Term | Definition |
|---|---|
| | • Corporate bonds<br>• Convertible debt<br>• Commercial paper<br>• All securitized debt instruments, such as collateralized mortgage obligations and real estate mortgage investment conduits<br>• Interest-only and principal-only strips.<br>The term debt security excludes all of the following:<br>• Option contracts<br>• Financial futures contracts<br>• Forward contracts<br>• Lease contracts<br>• Receivables that do not meet the definition of *security* and, so, are not debt securities, for example:<br>– Trade accounts receivable arising from sales on credit by industrial or commercial entities<br>– Loans receivable arising from consumer, commercial, and real estate lending activities of financial institutions |
| Derivative Instrument<br>[non-Master Glossary definition] | Per ASC 815-10-15-83, "a derivative instrument is a financial instrument or other contract with all of the following characteristics:<br>a) Underlying, notional amount, payment provision. The contract has both of the following terms, which determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required:<br>1) One or more underlyings<br>2) One or more notional amounts or payment provisions or both.<br>b) Initial net investment. The contract requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.<br>c) Net settlement. The contract can be settled net by any of the following means:<br>1) Its terms implicitly or explicitly require or permit net settlement.<br>2) It can readily be settled net by a means outside the contract.<br>3) It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement." |
| Discount | The difference between the net proceeds, after expense, received upon issuance of debt and the amount repayable at its maturity. See premium. |
| Embedded Derivative | Implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by a contract in a manner similar to a derivative instrument. |
| Equity Security | Any security representing an ownership interest in an entity (for example, common, preferred, or other capital stock) or the right to acquire (for example, warrants, rights, forward purchase contracts, and call options) or dispose of (for example, put options and forward sale contracts) an |

| Term | Definition |
|---|---|
| | ownership interest in an entity at fixed or determinable prices. The term equity security does not include any of the following:<br>• Written equity options (because they represent obligations of the writer, not investments)<br>• Cash-settled options on equity securities or options on equity-based indexes (because those instruments do not represent ownership interests in an entity)<br>• Convertible debt or preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor. |
| Expected Cash Flow | The probability-weighted average (that is, mean of the distribution) of possible future cash flows. |
| Fair Value Hedge | A hedge of the exposure to changes in the fair value of a recognized asset or liability, or of an unrecognized firm commitment, that are attributable to a particular risk. |
| Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) | The fixed rate on a U.S. dollar, constant-notional interest rate swap that has its variable-rate leg referenced to the Fed Funds Effective Rate (an overnight rate) with no additional spread over the Fed Funds effective rate on that variable-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, equates to the present value of the variable cash flows. |
| Financial Asset | Cash, evidence of an ownership interest in an entity, or a contract that conveys to one entity a right to do either of the following:<br>• Receive cash or another financial instrument from a second entity<br>• Exchange other financial instruments on potentially favorable terms with the second entity. |
| Financial Instrument | Cash, evidence of an ownership interest in an entity, or a contract that both:<br>a. Imposes on one entity a contractual obligation either:<br>1. To deliver cash or another financial instrument to a second entity<br>2. To exchange other financial instruments on potentially unfavorable terms with the second entity.<br>b. Conveys to that second entity a contractual right either:<br>1. To receive cash or another financial instrument from the first entity<br>2. To exchange other financial instruments on potentially favorable terms with the first entity.<br>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. |

| Term | Definition |
|---|---|
| | Contractual rights and contractual obligations encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights (contractual obligations) that are financial instruments meet the definition of asset (liability) set forth in FASB Concepts Statement No. 6, Elements of Financial Statements, although some may not be recognized as assets (liabilities) in financial statements—that is, they may be off-balance sheet—because they fail to meet some other criterion for recognition. [Upon adoption of ASU 2024-02, Some contractual rights (contractual obligations) that are financial instruments may not be recognized in financial statements—that is, they may be off-balance sheet—because they fail to meet some other criterion for recognition.]<br><br>For some financial instruments, the right is held by or the obligation is due from (or the obligation is owed to or by) a group of entities rather than a single entity. |
| Financial Statements Are Available to Be Issued | Financial statements are considered available to be issued when they are complete in a form and format that complies with GAAP and all approvals necessary for issuance have been obtained, for example, from management, the board of directors, and/or significant shareholders. The process involved in creating and distributing the financial statements will vary depending on an entity's management and corporate governance structure as well as statutory and regulatory requirements. |
| Firm Commitment | An agreement with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics:<br><br>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. The binding provisions of an agreement are regarded to include those legal rights and obligations codified in the laws to which such an agreement is subject. A price that varies with the market price of the item that is the subject of the firm commitment cannot qualify as a fixed price. For example, a price that is specified in terms of ounces of gold would not be a fixed price if the market price of the item to be purchased or sold under the firm commitment varied with the price of gold.<br><br>b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable. In the legal jurisdiction that governs the agreement, the existence of statutory rights to pursue remedies for default equivalent to the damages suffered by the nondefaulting party, in and of itself, represents a sufficiently large disincentive for nonperformance to make performance probable for purposes of applying the definition of a firm commitment. |
| 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 |

| Term | Definition |
|---|---|
| | forecasted transaction does not give an entity any present rights to future benefits or a present obligation for future sacrifices. |
| Foreign Exchange Risk | The risk of changes in a hedged item's fair value or functional-currency-equivalent cash flows attributable to changes in the related foreign currency exchange rates. |
| Hedged Layer | The hedged item designated in a portfolio layer method hedging relationship, representing a stated amount or stated amounts of a closed portfolio of financial assets or one or more beneficial interests secured by a portfolio of financial instruments that is not expected to be affected by prepayments, defaults, or other factors affecting the timing and amount of cash flows for the designated hedge period. |
| Host Contract | A hybrid instrument exclusive of the embedded derivative. |
| Hybrid Instrument | A contract that embodies both an embedded derivative and a host contract. |
| Interest Rate Risk | For recognized variable-rate financial instruments and forecasted issuances or purchases of variable-rate financial instruments, interest rate risk is the risk of changes in the hedged item's cash flows attributable to changes in the contractually specified interest rate in the agreement.<br>For recognized fixed-rate financial instruments, interest rate risk is the risk of changes in the hedged item's fair value attributable to changes in the designated benchmark interest rate. For forecasted issuances or purchases of fixed-rate financial instruments, interest rate risk is the risk of changes in the hedged item's cash flows attributable to changes in the designated benchmark interest rate. |
| Internal Derivative | A foreign currency derivative instrument that has been entered into with another member of a consolidated group (such as a treasury center). |
| Intrinsic Value | The amount by which the fair value of the underlying stock exceeds the exercise price of an option. For example, an option with an exercise price of $20 on a stock whose current market price is $25 has an intrinsic value of $5. (A nonvested share may be described as an option on that share with an exercise price of zero. Thus, the fair value of a share is the same as the intrinsic value of such an option on that share.) |
| Lease Term | The noncancellable period for which a lessee has the right to use an underlying asset, together with all of the following:<br>• Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option<br>• Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option<br>• Periods covered by an option to extend (or not to terminate) the lease in which exercise of the option is controlled by the lessor. |
| Loan | A contractual right to receive money on demand or on fixed or determinable dates that is recognized as an asset in the creditor's balance sheet. Examples include but are not limited to accounts receivable (with |

| Term | Definition |
|---|---|
| | terms exceeding one year) and notes receivable. This definition encompasses loans accounted for as debt securities. |
| Loan Commitment | Legally binding commitments to extend credit to a counterparty under certain prespecified terms and conditions. They have fixed expiration dates and may either be fixed-rate or variable-rate. Loan commitments can be either of the following:<br>• Revolving (in which the amount of the overall commitment is reestablished upon repayment of previously drawn amounts)<br>• Nonrevolving (in which the amount of the overall commitment is not reestablished upon repayment of previously drawn amounts).<br>Loan commitments can be distributed through syndication arrangements, in which one entity acts as a lead and an agent on behalf of other entities that will each extend credit to a single borrower. Loan commitments generally permit the lender to terminate the arrangement under the terms of covenants negotiated under the agreement. |
| London Interbank Offered Rate (LIBOR) Swap Rate | The fixed rate on a single-currency, constant-notional interest rate swap that has its variable-rate leg referenced to the London Interbank Offered Rate (LIBOR) with no additional spread over LIBOR on that variable-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 variable cash flows.<br>As a result of reference rate reform, LIBOR was discontinued after June 30, 2023. |
| Market Risk | The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risk comprises the following:<br>• Interest rate risk<br>• Currency risk<br>• Other price risk. |
| Market Risk Benefit | A contract or contract feature in a long-duration contract issued by an insurance entity that both protects the contract holder from other-than-nominal capital market risk and exposes the insurance entity to other-than-nominal capital market risk. |
| Mortgage-Backed Securities | Securities issued by a governmental agency or corporation (for example, Government National Mortgage Association [GNMA] or Federal Home Loan Mortgage Corporation [FHLMC]) or by private issuers (for example, Federal National Mortgage Association [FNMA], banks, and mortgage banking entities). Mortgage-backed securities generally are referred to as mortgage participation certificates or pass-through certificates. A participation certificate represents an undivided interest in a pool of specific mortgage loans. Periodic payments on GNMA participation certificates are backed by the U.S. government. Periodic payments on FHLMC and FNMA certificates are guaranteed by those corporations, but are not backed by the U.S. government. |

| Term | Definition |
|---|---|
| Nonperformance Risk | The risk that an entity will not fulfill an obligation. Nonperformance risk includes, but may not be limited to, the reporting entity's own credit risk. |
| Normal Purchases and Normal Sales [non-Master Glossary definition] | Per ASC 815-10-15-22, "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." |
| Notional amount | A number of currency units, shares, bushels, pounds, or other units specified in a derivative instrument. Sometimes other names are used. For example, the notional amount is called a face amount in some contracts. |
| Payment Provision | A payment provision specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner. |
| Premium | The excess of the net proceeds, after expense, received upon issuance of debt over the amount repayable at its maturity. See discount. |
| Private Company | An entity other than a public business entity, a not-for-profit entity, or an employee benefit plan within the scope of Topics 960 through 965 on plan accounting. |
| Public Business Entity | A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity.<br>a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).<br>b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.<br>c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.<br>d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.<br>e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.<br>An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business |

| Term | Definition |
|---|---|
| | entity for purposes of financial statements that are filed or furnished with the SEC. |
| Readily Convertible to Cash | Assets that are readily convertible to cash have both of the following:<br>• Interchangeable (fungible) units<br>• Quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price |
| Regular-Way Security Trades | Regular-way security trades are contracts that provide for delivery of a security within the period of time (after the trade date) generally established by regulations or conventions in the marketplace or exchange in which the transaction is being executed. |
| Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate | The fixed rate on a U.S. dollar, constant-notional interest rate swap that has its variable-rate leg referenced to the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index with no additional spread over the SIFMA Municipal Swap Index on that variable-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, equates to the present value of the variable cash flows. |
| Spot Rate | The exchange rate for immediate delivery of currencies exchanged. |
| Time Value of an Option | The time value of an option is equal to the fair value of an option less its intrinsic value. |
| Transaction | An external event involving transfer of something of value (future economic benefit) between two (or more) entities. |
| Underlying | A specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under a contract). An underlying may be a price or rate of an asset or liability but is not the asset or liability itself. An underlying is a variable that, along with either a notional amount or a payment provision, determines the settlement of a derivative instrument. |
| Zero-Coupon Method | A swap valuation method that involves computing and summing the present value of each future net settlement that would be required by the contract terms if future spot interest rates match the forward rates implied by the current yield curve. The discount rates used are the spot interest rates implied by the current yield curve for hypothetical zero coupon bonds due on the date of each future net settlement on the swap. |

## Literature listing

| ASC topic or subtopic | Title |
|---|---|
| 210-10 | Balance Sheet – Overall |
| 210-20 | Balance Sheet – Offsetting |
| 220-10 | Income Statement – Reporting Comprehensive Income – Overall |
| 230 | Statement of Cash Flows |
| 230-10 | Statement of Cash Flows – Overall |
| 235 | Notes to Financial Statements |
| 235-10 | Notes to Financial Statements – Overall |
| 310-20 | Receivables – Nonrefundable Fees and Other Costs |
| 320 | Investments—Debt Securities |
| 321 | Investments—Equity Securities |
| 330-10 | Inventory – Overall |
| 450 | Contingencies |
| 460 | Guarantees |
| 460-10 | Guarantees – Overall |
| 480 | Distinguishing Liabilities from Equity |
| 480-10 | Distinguishing Liabilities from Equity – Overall |
| 606 | Revenue from Contracts with Customers |
| 606-10 | Revenue from Contracts with Customers – Overall |
| 718 | Compensation—Stock Compensation |
| 718-10 | Compensation – Stock Compensation – Overall |
| 815 | Derivatives and Hedging |
| 815-10 | Derivatives and Hedging – Overall |
| 815-15 | Derivatives and Hedging – Embedded Derivatives |
| 815-20 | Derivatives and Hedging – Hedging – General |
| 815-25 | Derivatives and Hedging – Fair Value Hedges |
| 815-30 | Derivatives and Hedging – Cash Flow Hedges |
| 815-35 | Derivatives and Hedging – Net Investment Hedges |
| 815-40 | Derivatives and Hedging – Contracts in Entity's Own Equity |
| 815-45 | Derivatives and Hedging – Weather Derivatives |
| 820 | Fair Value Measurement |
| 820-10 | Fair Value Measurement – Overall |

| ASC topic or subtopic | Title |
|---|---|
| 825-10 | Financial Instruments – Overall |
| 825-20 | Financial Instruments – Registration Payment Arrangements |
| 830 | Foreign Currency Matters |
| 830-10 | Foreign Currency Matters – Overall |
| 830-20 | Foreign Currency Matters – Foreign Currency Transactions |
| 830-30 | Foreign Currency Matters – Translation of Financial Statements |
| 835-20 | Interest – Capitalization of Interest |
| 835-30 | Interest – Imputation of Interest |
| 842 | Leases |
| 845 | Nonmonetary Transactions |
| 860 | Transfers and Servicing |
| 860-10 | Transfers and Servicing – Overall |
| 942-320 | Financial Services—Depository and Lending – Investments—Debt and Equity Securities |
| 944 | Financial Services—Insurance |
| 944-20 | Financial Services—Insurance – Insurance Activities |
| 954 | Health Care Entities |
| 960 | Plan Accounting—Defined Benefit Pension Plans |
| 960-325 | Plan Accounting—Defined Benefit Pension Plans – Investments – Other |

| Other literature | Title |
|---|---|
| ASU 2017-12 | Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Heding Activities |
| ASU 2023-06 | Disclosure Improvements: Codification Amendments in Response to the SEC's Disclosure Update and Simplification Initiative |
| ASU 2024-02 | Codification Improvements – Amendments to Remove References to the Concepts Statements |
| ASU 2025-07 | Derivatives and Hedging (Topic 815) and Revenue from Contracts with Customers (Topic 606): Derivatives Scope Refinements and Scope Clarification for Share-Based Noncash Consideration from a Customer in a Revenue Contract |
| ASU 2025-09 | Derivatives and Hedging (Topic 815): Hedge Accounting Improvements |

# Appendix C: Summary of significant changes since last edition

The following list summarizes the significant changes to this guide since our last edition (December 2024):

## Chapter 1 – Overview

- Updated Looking forward: FASB research projects in Section 1.6 for the current status of each project on the FASB's research agenda

## Chapter 3 – Scope of ASC 815 and determining what constitutes a derivative instrument

- Updated Section 3.1, Section 3.3, Section 3.3.5, Example 3-14, Section 3.3.11, and Section 3.3.11.3 for the issuance of ASU 2025-07
- Updated Section 3.3, Section 3.3.11 and Section 3.3.11.3 for the effectiveness of ASU 2023-05
- Added Section 3.3.5.4, including Example 3-17, to address the issuance of ASU 2025-07

## Chapter 5 – Overview of hedge accounting and the requirements to apply it

- Updated Section 5.1, Section 5.2.1, Section 5.2.2, Section 5.2.2.2, Section 5.2.4.1 and Section 5.2.4.3 for the issuance of ASU 2025-09
- Removed discussion of the last of layer method from Section 5.2.1 and Section 5.2.2.1 due to the guidance being superseded by the portfolio layer method, which is currently effective
- Added Example 5-4A due to the issuance of ASU 2025-09

## Chapter 6 – Commodities hedging

- Updated Section 6.2, Section 6.3, Example 6-2 and Example 6-6 for the issuance of ASU 2025-09
- Added Section 6.2.4 to address the issuance of ASU 2025-09 regarding the criteria for hedging a nonfinancial asset
- Added Example 6-1 and renumbered the subsequent examples accordingly
- Added Example 6-1A, Example 6-4A, Example 6-5A, Example 6-8A, Example 6-9A, Example 6-10, Example 6-11, Example 6-12 and Example 6-13 due to the issuance of ASU 2025-09 and renumbered the subsequent examples accordingly

## Chapter 7 – Hedges related to interest rate risk

- Removed discussion of the last of layer method from Section 7.2.2, Section 7.2.2.1, Example 7-9 and Example 7-15 due to the guidance being superseded by the portfolio layer method, which is currently effective
- Deleted Example 7-2, which illustrated the last-of-layer method due to the guidance being superseded by the portfolio layer method, which is currently effective; renumbered the subsequent examples accordingly
- Added Example 7-3A due to the issuance of ASU 2025-09

## Chapter 8 – Foreign currency hedges

- Added Example 8-1A due to the issuance of ASU 2025-09

## Chapter 9 – Fair value hedge accounting

- Removed discussion of the last of layer method from Section 9.2.1.1 due to the guidance being superseded by the portfolio layer method, which is currently effective
- Updated Section 9.3 for the issuance of ASU 2025-09

## Chapter 10 – Cash flow hedge accounting

- Updated Section 10.4 for the issuance of ASU 2025-09

## Chapter 11 – Presentation and disclosure

- Updated Section 11.1.2.3 for the effectiveness of ASU 2022-01
- Removed discussion of the last-of-layer method from Example 11-5 and Section 11.2.1.3 due to the guidance being superseded by the portfolio layer method, which is currently effective

## Appendices

- Updated Appendix A for the issuance of ASU 2025-07 and ASU 2025-09; removed discussion of ASU 2022-01 due to the current effectiveness of the guidance
- Updated Appendix B for the issuance of ASU 2025-07 and ASU 2025-09; removed references to literature that were no longer referenced in the guide
- Added Appendix C

# A Guide to Derivatives and Hedge Accounting

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**+1 800 274 3978**
**rsmus.com**

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