

Review of U.S. derivative guidance and the application to SAP is complex with many facets. This initial document considers consistency in the determination of hedge effectiveness between U.S. GAAP and SAP. The second element pertaining to the accounting and reporting of hedging instruments, including excluded components, will be considered separately, as that guidance has been historically different.

1) Assessment of Hedge Effectiveness – Consistency with U.S. GAAP

NAIC staff agrees that the assessment of hedge effectiveness for derivatives should be consistent between U.S. GAAP and SAP. This would ensure that transactions identified to be highly effective hedges under U.S. GAAP would also be identified as highly effective hedges under statutory accounting. If a hedging instrument results with offsetting changes (or other permitted aspects) to a hedged item pursuant to the guidelines under U.S. GAAP to qualify as a highly effective hedge, the same assessment as a highly effective hedge should occur under SAP.

NAIC staff highlights that the current guidance in SSAP No. 86 in Exhibit A – Discussion of Hedge Effectiveness and Exhibit B – Assessment of Hedging Effectiveness have not been significantly updated since the original issuance of FAS 133, *Accounting for Derivative Instruments and Hedging Activities* and SSAP No. 86. Exhibit A continues to reference guidance issued by the Derivatives Implementation Group (DIG) in E7 and E8, which were not considered official FASB positions, although these DIG provisions (and other clarifications) been incorporated into the FASB Codification as authoritative. NAIC staff highlights that the list of components permitted to be excluded from the assessment of hedge effectiveness captured in the FASB Codification (815-20-25-82) differs from the statutory accounting guidance in SSAP No. 86, Exhibit B. The statutory accounting guidance in Exhibit B reflects original guidance from FAS 133, paragraph 63, but the statutory accounting guidance has not been updated to reflect provisions from the DIG E19 incorporated into the FASB Codification or the revisions from ASU 2017-12 that pertain to cross-currency basis spread.

To ensure consistency with U.S. GAAP in the assessment of hedge effectiveness, **NAIC staff recommends that the Working Group consider adoption, with modification, of U.S. GAAP guidance pertaining to the criteria for initial and subsequent hedge effectiveness detailed in the FASB Accounting Standards Codification (ASC) paragraphs 815-20-25-72 through 815-20-35-20, as modified through the issuance of ASU 2017-12. Although the U.S. GAAP guidance for the assessment and determination of hedge effectiveness is proposed to be adopted, this action recommends statutory modifications to specify that the accounting and reporting of hedging instruments, including excluded components of the instruments, shall follow statutory specific guidance detailed in SSAP No. 86. The intent of this guidance is to clarify that the determination of whether a hedging instrument qualifies as an effective hedge shall converge with U.S. GAAP, but that the measurement method shall continue to follow statutory specific provisions. The proposed adoption only extends to revisions incorporated through ASU 2017-12, as such, any subsequent U.S. GAAP edits would continue to require statutory accounting consideration before they were considered adopted.**

Exposure and request for comments - Excerpts of the U.S. GAAP guidance proposed to be adopted are recommended to replace the existing guidance in Exhibit A and Exhibit B of SSAP No. 86. However, these excerpts do not reflect the full U.S. GAAP guidance referenced. This reduction of quoted guidance is simply to manage the extent of detail captured in SSAP No. 86. With exposure of the proposed excerpts and adoption language, the Working Group requests comments on whether certain paragraphs should be removed as unnecessary in the Exhibit and whether other guidance from the referenced U.S. GAAP would be beneficial to be incorporated. (NAIC staff notes that the U.S. GAAP themes previously captured within Exhibit A and B have been retained – with updated ASC language.) Unless noted with tracked changes, the cited paragraphs are proposed to be incorporated directly from U.S. GAAP. (The tracked changes most commonly update GAAP references or paraphrase topics captured in GAAP references.)

Proposed New Exhibit A Which Would Replace The Existing Exhibit A and Exhibit B

EXHIBIT A – DISCUSSION OF HEDGE EFFECTIVENESS

The guidance within this exhibit reflects the adoption, with modification, of *FASB Accounting Standards Codification (ASC) 815-20-25-72 through 815-20-35-20*, as revised through the issuance of *ASU 2017-12: Derivatives and Hedging: Targeted Improvements to Accounting for Hedging Activities* (ASU 2017-12) (issued on August 28, 2017). This adoption captures the U.S. GAAP guidance for the assessment and determination of hedge effectiveness, with modification to require the accounting and reporting of hedging instruments, including excluded components of hedging instruments to follow specific statutory accounting guidance in SSAP No. 86. The intent of this guidance is to clarify that the determination of whether a hedging instrument and derivative transaction qualifies as an effective hedge shall converge with U.S. GAAP, but that the measurement and reporting of effective hedge transactions shall follow statutory specific provisions. The adoption only extends to revisions incorporated to the FASB ASC through ASU 2017-12, therefore any subsequent U.S. GAAP edits to the ASC would require statutory accounting adoption before application. The guidance within this Exhibit reflects excerpts from the U.S. GAAP ASC, but do not reflect the full U.S. GAAP guidance referenced in the adopted language. The exclusion of cited guidance is to manage the extent of detail included within SSAP No. 86. Excerpts not duplicated within from the cited U.S. GAAP guidance are considered adopted unless subject to the specific accounting and reporting statutory exclusion. This Exhibit intends to supplement the guidance in SSAP No. 86 on hedge effectiveness. In any event in which this Exhibit could be interpreted as conflicting with the SSAP No. 86 guidance, the guidance in the body of SSAP No. 86 shall be followed.

(Staff Note: Tracked changes show proposed revisions to the U.S. GAAP guidance.)

Hedge Effectiveness Criteria Applicable to Both Fair Value Hedges and Cash Flow Hedges

1. This guidance addresses hedge effectiveness criteria applicable to both fair value hedges and cash flow hedges. *(815-20-25-74)*
2. To qualify for hedge accounting, the hedging relationship, both at inception of the hedge and on an ongoing basis, shall be expected to be highly effective in achieving either of the following: *(815-20-25-75)*
 - a. Offsetting changes in fair value attributable to the hedged risk during the period that the hedge is designated (if a fair value hedge)
 - b. Offsetting cash flows attributable to the hedged risk during the term of the hedge (if a cash flow hedge), unless the hedging instrument is used to modify the contractually specified interest receipts or payments associated with a recognized financial asset liability from one variable rate to another variable rate. ~~except as indicated in paragraph 815-20-25-50~~
3. If the hedging instrument (such as an at-the-money option contract) provides only one-sided offset of the hedged risk, either of the following conditions shall be met: *(815-20-25-76)*
 - a. The increases (or decreases) in the fair value of the hedging instrument are expected to be highly effective in offsetting the decreases (or increases) in the fair value of the hedged item (if a fair value hedge).
 - b. The cash inflows (outflows) from the hedging instrument are expected to be highly effective in offsetting the corresponding change in the cash outflows or inflows of the hedged transaction (if a cash flow hedge).

4. 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: (815-20-25-77)

- 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:
 - i. Notional amounts
 - ii. Maturities
 - iii. Quantity
 - iv. 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)
 - v. Delivery Dates

5. An entity shall consider hedge effectiveness in two different ways—in prospective considerations and in retrospective evaluations: (815-20-25-79)

- a. Prospective considerations. The entity's expectation that the relationship will be highly effective over future periods in achieving offsetting changes in fair value or cash flows, which is forward looking, must be assessed on a quantitative basis at hedge inception unless one of the exceptions [detailed in ASU 2017-12, paragraph 815-20-25-3\(b\)\(2\)\(iv\)\(01\)](#)¹ is met. Prospective assessments shall be subsequently performed whenever financial statements or earnings are reported and at least every three months. The entity shall elect at hedge inception ~~in accordance with paragraph 815-20-25-3(b)(2)(iv)(03)~~ whether to perform subsequent [retrospective and prospective hedge effectiveness](#) assessments on a quantitative or qualitative basis. ~~See paragraphs 815-20-35-2A through 35-2F for additional guidance on qualitative assessments of hedge effectiveness.~~ A quantitative assessment can be based on regression or other statistical analysis of past changes in fair values or cash flows as well as on other relevant information. The quantitative prospective assessment of hedge effectiveness shall 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 for the period used to assess whether the requirement for expectation of highly effective offset is satisfied. The quantitative prospective assessment may not be limited only to the likely or expected 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 or the hedged items. Generally, the process of formulating an expectation regarding the effectiveness of a proposed hedging relationship involves a probability-weighted analysis of the possible changes in fair value (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 for the hedge period. Therefore, a probable future change in fair value will be more heavily weighted than a reasonably possible future change. ~~That calculation technique is consistent with the definition of the term expected cash flow in FASB~~

¹ Reference to this ASU 2017-12 guidance is consistent with the guidance in SSAP No. 86, paragraph 42, footnote 5.

~~Concepts Statement No. 7, Using Cash Flow Information and Present Value in Accounting Measurements.~~

- b. Retrospective evaluations. An assessment of effectiveness may be performed on a quantitative or qualitative basis on the basis of the entity's election at hedge inception ~~in accordance with paragraph 815-20-25-3(b)(2)(iv)(03)~~. That assessment shall be performed whenever financial statements or earnings are reported, and at least every three months. ~~See paragraphs 815-20-35-2 through 35-4 for further guidance.~~ At inception of the hedge, an entity electing a dollar-offset approach to perform retrospective evaluations on a quantitative basis may choose either a period-by-period approach or a cumulative approach in designating how effectiveness of a fair value hedge or of a cash flow hedge will be assessed retrospectively under that approach, depending on the nature of the hedge initially documented in accordance with paragraph 815-20-25-3. ~~For example, an entity may decide that the cumulative approach is generally preferred, yet may wish to use the period-by-period approach in certain circumstances. See paragraphs 815-20-35-5 through 35-6 for further guidance.~~

Skipping 815-20-25-79A

6. All assessments of effectiveness shall be consistent with the originally documented risk management strategy for that particular hedging relationship. An entity shall use the quantitative effectiveness assessment method defined at hedge inception consistently for the periods that the entity either elects or is required to assess hedge effectiveness on a quantitative basis. (815-20-25-80)

7. This Subtopic guidance does not specify a single method for assessing whether a hedge is expected to be highly effective. The method of assessing effectiveness shall be reasonable. The appropriateness of a given method of assessing hedge effectiveness depends on the nature of the risk being hedged and the type of hedging instrument used. Ordinarily, an entity shall assess effectiveness for similar hedges in a similar manner, including whether a component of the gain or loss on a derivative instrument is excluded in assessing effectiveness for similar hedges. Use of different methods for similar hedges shall be justified. The mechanics of isolating the change in time value of an option discussed beginning in paragraph 13 815-20-25-98 also shall be applied consistently. (815-20-25-81)

8. In defining how hedge effectiveness will be assessed, an entity shall specify whether it will include in that assessment all of the gain or loss on a hedging instrument. An entity may exclude all or a part of the hedging instrument's time value from the assessment of hedge effectiveness, as follows: (815-20-25-82)

- a. If the effectiveness of a hedge with an option is assessed based on changes in the option's intrinsic value, the change in the time value of the option would be excluded from the assessment of hedge effectiveness.
- b. If the effectiveness of a hedge with an option is assessed based on changes in the option's minimum value, that is, its intrinsic value plus the effect of discounting, the change in the volatility value of the contract shall be excluded from the assessment of hedge effectiveness.
- c. An entity may exclude any of the following components of the change in an option's time value from the assessment of hedge effectiveness:
 - i. The portion of the change in time value attributable to the passage of time (theta)

- ii. The portion of the change in time value attributable to changes due to volatility (vega)
 - iii. The portion of the change in time value attributable to changes due to interest rates (rho).
- d. If the effectiveness of a hedge with a forward contract or futures contract is assessed based on changes in fair value attributable to changes in spot prices, 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 shall be excluded from the assessment of hedge effectiveness.
- e. An entity may exclude the portion of the change in fair value of a currency swap attributable to a cross-currency basis spread.

9. No other components of a gain or loss on the designated hedging instrument shall be excluded from the assessment of hedge effectiveness nor shall an entity exclude any aspect of a change in an option's value from the assessment of hedge effectiveness that is not one of the permissible components of the change in an option's time value. For example, an entity shall not exclude from the assessment of hedge effectiveness the portion of the change in time value attributable to changes in other market variables (that is, other than rho and vega). (815-20-25-83)

Note – The following ASC Paragraphs 815-20-25-83A and 83B would not be considered adopted under the proposed language as they address measurement and recognition. SAP measurement and recognition guidance will be captured in the body of the SSAP or Appendix C.

For fair value and cash flow hedges, the initial value of the component excluded from the assessment of effectiveness shall be recognized in earnings using a systematic and rational method over the life of the hedging instrument. Any difference between the change in fair value of the excluded component and amounts recognized in earnings under that systematic and rational method shall be recognized in other comprehensive income. Example 31 beginning in paragraph 815-20-55-235 illustrates this approach for a cash flow hedge in which the hedging instrument is an option and the entire time value is excluded from the assessment of effectiveness. (815-20-25-83A)

For fair value and cash flow hedges, an entity alternatively may elect to record changes in the fair value of the excluded component currently in earnings. This election shall be applied consistently to similar hedges in accordance with paragraph 815-20-25-81 and shall be disclosed in accordance with paragraph 815-10-50-4EEEE. (815-20-25-83B)

10. If the critical terms of the hedging instrument and of 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. 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 of the FASB Codification are met. (815-20-25-84)
- b. The fair value of the forward contract at inception is zero.

- c. Either of the following criteria is met:
- i. The change in the discount or premium on the forward contract is excluded from the assessment of effectiveness pursuant to paragraphs ~~7-9~~815-20-25-81 through ~~25-83~~.
 - ii. The change in expected cash flows on the forecasted transaction is based on the forward price for the commodity.

11. In a cash flow hedge of a group of forecasted transactions in accordance with paragraph 28a of the SSAP guidance ~~815-20-25-15(a)(2)~~, an entity may assume that the timing in which the hedged transactions are expected to occur and the maturity date of the hedging instrument match in accordance with paragraph 10a ~~815-20-25-84(a)~~ if those forecasted transactions occur and the derivative matures within the same 31-day period or fiscal month. (815-20-25-84A)

12. If all of the criteria in paragraphs ~~10-11~~ 815-20-25-84 through 25-84A are met, an entity shall still perform and document an assessment of hedge effectiveness at the inception of the hedging relationship and, ~~as discussed beginning in paragraph 815-20-35-9~~, on an ongoing basis throughout the hedge period. No quantitative effectiveness assessment is required at hedge inception if the criteria in paragraphs ~~10-11~~ 815-20-25-84 through 25-84A are met ~~(see paragraph 815-20-25-3(b)(2)(iv)(01))~~. (815-20-25-85)

Skipped paragraphs 815-20-25-86 to 815-20-25-97

Computing Changes in an Option's Time Value

13. In computing the changes in an option's time value that would be excluded from the assessment of hedge effectiveness, an entity shall use a technique that appropriately isolates those aspects of the change in time value. Generally, to allocate the total change in an option's time value to its different aspects—the passage of time and the market variables—the change in time value attributable to the first aspect to be isolated is determined by holding all other aspects constant as of the beginning of the period. Each remaining aspect of the change in time value is then determined in turn in a specified order based on the ending values of the previously isolated aspects. (815-20-25-98)

14. Based on that general methodology, if only one aspect of the change in time value is excluded from the assessment of hedge effectiveness (for example, theta), that aspect shall be the first aspect for which the change in time value is computed and would be determined by holding all other parameters constant for the period used for assessing hedge effectiveness. However, if more than one aspect of the change in time value is excluded from the assessment of hedge effectiveness (for example, theta and vega), an entity shall determine the amount of that change in time value by isolating each of those two aspects in turn in a prespecified order (one first, the other second). The second aspect to be isolated would be based on the ending value of the first isolated aspect and the beginning values of the remaining aspects. The portion of the change in time value that is included in the assessment of effectiveness shall be determined by deducting from the total change in time value the portion of the change in time value attributable to excluded components. (815-20-25-99)

Skipped paragraphs 815-20-25-100 and 815-20-25-101

Assuming Perfect Hedge Effectiveness in a Hedge with an Interest Rate Swap

15. The conditions for the shortcut method do not determine which hedging relationships qualify for hedge accounting; rather, those conditions determine which hedging relationships qualify for a shortcut version of hedge accounting that assumes perfect hedge effectiveness. If all of the applicable conditions in

the list in paragraph ~~17 815-20-25-104~~ are met, an entity may assume perfect effectiveness in a hedging relationship of interest rate risk involving a recognized interest-bearing asset or liability (or a firm commitment arising on the trade [pricing] date to purchase or issue an interest-bearing asset or liability) and an interest rate swap (or a compound hedging instrument composed of an interest rate swap and a mirror-image call or put option as discussed in paragraph ~~17e 815-20-25-104(e)~~) provided that, in the case of a firm commitment, the trade date of the asset or liability differs from its settlement date due to generally established conventions in the marketplace in which the transaction is executed. The shortcut method's application shall be limited to hedging relationships that meet each and every applicable condition. That is, all the conditions applicable to fair value hedges shall be met to apply the shortcut method to a fair value hedge, and all the conditions applicable to cash flow hedges shall be met to apply the shortcut method to a cash flow hedge. A hedging relationship cannot qualify for application of the shortcut method based on an assumption of perfect effectiveness justified by applying other criteria. The verb *match* is used in the specified conditions in the list to mean *be exactly the same or correspond exactly*. (815-20-25-102)

16. Implicit in the conditions for the shortcut method is the requirement that a basis exist for concluding on an ongoing basis that the hedging relationship is expected to be highly effective in achieving offsetting changes in fair values or cash flows. In applying the shortcut method, an entity shall consider the likelihood of the counterparty's compliance with the contractual terms of the hedging derivative that require the counterparty to make payments to the entity. (815-20-25-103)

17. All of the following conditions apply to both fair value hedges and cash flow hedges: (815-20-25-104)

- 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:
 - i. 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).

- ii. 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:
 - i. The fixed rate is the same throughout the term.
 - ii. 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 [as a partial-term hedge of interest rate risk in which the assumed maturity of the hedged items occur on the date in which the last hedged cash flow is due and payable](#), ~~in accordance with paragraph 815-25-35-13B~~, with the following qualifications:
 - i. 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).
 - ii. 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:
 - (a.) The terms of the two call options match exactly, including all of the following:
 - (1.) Maturities
 - (2.) 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
 - (3.) Related notional amounts
 - (4.) Timing and frequency of payments
 - (5.) Dates on which the instruments may be called.
 - (b.) The entity is the writer of one call option and the holder (purchaser) of the other call option.
- f. Any other terms in the interest-bearing financial instruments or interest rate swaps meet both of the following conditions:

- i. The terms are typical of those instruments.
 - ii. The terms do not invalidate the assumption of perfect effectiveness.
18. All of the following incremental conditions apply to fair value hedges only: (815-20-25-105)
 - 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 as a partial-term hedge of interest rate risk in which the assumed maturity of the hedged items occur on the date in which the last hedged cash flow is due and payable~~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 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:
 - i. 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).
 - ii. 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.
19. All of the following incremental conditions apply to cash flow hedges only: (815-20-25-106)
 - 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:
 - i. There is no floor or cap on the variable interest rate of the interest rate swap.
 - ii. 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 28a of the SSAP guidance](#) ~~paragraph 815-20-25-15(a)~~), if both of the following criteria are met:
 - i. The notional amount of the interest rate swap designated as the hedging instrument (~~see paragraph (a)~~) matches the notional amount of the aggregate group of hedged transactions.
 - ii. 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.

20. The shortcut method may be applied to a hedging relationship that involves the use of an interest rate swap-in-arrears provided all of the applicable conditions are met. (815-20-25-107)

21. Any discount or premium in the hedged debt's carrying amount (including any related deferred issuance costs) is irrelevant to and has no direct impact on the determination of whether an interest rate swap contains a mirror-image call option under paragraph [17e.i.\(e\)](#). Typically, the call price is greater than the par or face amount of the debt instrument. The carrying amount of the debt is economically unrelated to the amount the issuer would be required to pay to exercise the call embedded in the debt. (815-20-25-108)

22. The fixed interest rate on a hedged item need not exactly match the fixed interest rate on an interest rate swap designated as a fair value hedge. Nor does the variable interest rate on an interest-bearing asset or liability need to be the same as the variable interest rate on an interest rate swap designated as a cash flow hedge. An interest rate swap's fair value comes from its net settlements. The fixed and variable interest rates on an interest rate swap can be changed without affecting the net settlement if both are changed by the same amount. That is, an interest rate swap with a payment based on LIBOR and a receipt based on a

fixed rate of 5 percent has the same net settlements and fair value as an interest rate swap with a payment based on LIBOR plus 1 percent and a receipt based on a fixed rate of 6 percent. (815-20-25-109)

23. Comparable credit risk at inception is not a condition for assuming perfect effectiveness even though actually achieving perfect offset would require that the same discount rate be used to determine the fair value of the swap and of the hedged item or hedged transaction. To justify using the same discount rate, the credit risk related to both parties to the swap as well as to the debtor on the hedged interest-bearing asset (in a fair value hedge) or the variable-rate asset on which the interest payments are hedged (in a cash flow hedge) would have to be the same. However, because that complication is caused by the interaction of interest rate risk and credit risk, which are not easily separable, comparable creditworthiness is not considered a necessary condition for assuming perfect effectiveness in a hedge of interest rate risk. (815-20-25-111)

Skipped paragraphs 815-20-25-112 through 815-20-25-143

Hedge Effectiveness – After Designation

24. If a fair value hedge or cash flow hedge initially qualifies for hedge accounting, the entity would continue to assess whether the hedge meets the effectiveness test on either a quantitative basis (using either a dollar-offset test or a statistical method such as regression analysis) or a qualitative basis. ~~See paragraphs 815-20-35-2A through 35-2F for additional guidance on qualitative assessments of effectiveness.~~ If the hedge fails the effectiveness test at any time (that is, if the entity does not expect the hedge to be highly effective at achieving offsetting changes in fair values or cash flows), the hedge ceases to qualify for hedge accounting. At least quarterly, the hedging entity shall determine whether the hedging relationship has been highly effective in having achieved offsetting changes in fair value or cash flows through the date of the periodic assessment.) (815-20-35-2)

Effectiveness Assessment on a Qualitative Basis

25. An entity may qualitatively assess hedge effectiveness if both of the following criteria are met: (815-20-35-2A)

- a. An entity performs an initial quantitative test of hedge effectiveness on a prospective basis (that is, it is not assuming that the hedging relationship is perfectly effective at hedge inception ~~as described in paragraph 815-20-25-3(b)(2)(iv)(01)(A) through (H)~~), and the results of that quantitative test demonstrate highly effective offset.
- b. At hedge inception, an entity can reasonably support an expectation of high effectiveness on a qualitative basis in subsequent periods.

26. An entity may elect to qualitatively assess hedge effectiveness in accordance with [paragraph 25 815-20-35-2A](#) on a hedge-by-hedge basis. If an entity makes this qualitative assessment election, only the quantitative method specified in an entity's initial hedge documentation must comply with [paragraph 7815-20-25-81](#). (815-20-35-2B)

27. When an entity performs qualitative assessments of hedge effectiveness, it shall verify and document whenever financial statements or earnings are reported and at least every three months that the facts and circumstances related to the hedging relationship have not changed such that it can assert qualitatively that the hedging relationship was and continues to be highly effective. While not all-inclusive, the following is a list of indicators that may, individually or in the aggregate, allow an entity to continue to assert qualitatively that the hedging relationship is highly effective: (815-20-35-2C)

- a. An assessment of the factors that enabled the entity to reasonably support an expectation of high effectiveness on a qualitative basis has not changed such that the entity can continue to assert qualitatively that the hedging relationship was and continues to be highly effective. ~~This shall include an assessment of the guidance in paragraph 815-20-25-100 when applicable.~~
- b. There have been no adverse developments regarding the risk of counterparty default.

28. If an entity elects to assess hedge effectiveness on a qualitative basis and then facts and circumstances change such that the entity no longer can assert qualitatively that the hedging relationship was and continues to be highly effective in achieving offsetting changes in fair values or cash flows, the entity shall assess effectiveness of that hedging relationship on a quantitative basis in subsequent periods. In addition, an entity may perform a quantitative assessment of hedge effectiveness in any reporting period to validate whether qualitative assessments of hedge effectiveness remain appropriate. In both cases, the entity shall apply the quantitative method that it identified in its initial hedge documentation ~~in accordance with paragraph (b)(2)(iv)(03).~~ (815-20-35-2D)

29. When an entity determines that facts and circumstances have changed and it no longer can assert qualitatively that the hedging relationship was and continues to be highly effective, the entity shall begin performing subsequent quantitative assessments of hedge effectiveness as of the period that the facts and circumstances changed. If there is no identifiable event that led to the change in the facts and circumstances of the hedging relationship, the entity may begin performing quantitative assessments of effectiveness in the current period. (815-20-35-2E)

30. After performing a quantitative assessment of hedge effectiveness for one or more reporting periods as discussed in paragraphs ~~28-29~~ ~~815-20-35-2D through 35-2E~~, an entity may revert to qualitative assessments of hedge effectiveness if it can reasonably support an expectation of high effectiveness on a qualitative basis for subsequent periods. ~~See paragraphs 815-20-55-79G through 55-79N for implementation guidance on factors to consider when determining whether qualitative assessments of effectiveness can be performed after hedge inception.~~ (815-20-35-2F)

Quantitative Hedge Effectiveness Assessments After Hedge Designation

31. Quantitative assessments can be based on regression or other statistical analysis of past changes in fair values or cash flows as well as on other relevant information. (815-20-35-2G)

32. If an entity elects at the inception of a hedging relationship to use the same regression analysis approach for both prospective considerations and retrospective evaluations of assessing effectiveness, then during the term of that hedging relationship both of the following conditions shall be met: (815-20-35-3)

- a. Those regression analysis calculations shall generally incorporate the same number of data points.
- b. That entity must periodically update its regression analysis (or other statistical analysis).

33. Electing to use a regression or other statistical analysis approach instead of a dollar-offset approach to perform retrospective evaluations of assessing hedge effectiveness may affect whether an entity can apply hedge accounting for the current assessment period. (815-20-35-4)

34. In periodically (that is, at least quarterly) assessing retrospectively the effectiveness of a fair value hedge (or a cash flow hedge) in having achieved offsetting changes in fair values (or cash flows) under a

dollar-offset approach, an entity shall use either a period-by-period approach or a cumulative approach on individual fair value hedges (or cash flow hedges): (815-20-35-5)

- a. Period-by-period approach. The period-by-period approach involves comparing the changes in the hedging instrument's fair values (or cash flows) that have occurred during the period being assessed to the changes in the hedged item's fair value (or hedged transaction's cash flows) attributable to the risk hedged that have occurred during the same period. If an entity elects to base its comparison of changes in fair value (or cash flows) on a period-by-period approach, the period cannot exceed three months. Fair value (or cash flow) patterns of the hedging instrument or the hedged item (or hedged transaction) in periods before the period being assessed are not relevant.
- b. Cumulative approach. The cumulative approach involves comparing the cumulative changes (to date from inception of the hedge) in the hedging instrument's fair values (or cash flows) to the cumulative changes in the hedged item's fair value (or hedged transaction's cash flows) attributable to the risk hedged.

35. If an entity elects at inception of a hedging relationship to base its comparison of changes in fair value (or cash flows) on a cumulative approach, then that entity must abide by the results of that methodology as long as that hedging relationship remains designated. Electing to utilize a period-by-period approach instead of a cumulative approach (or vice versa) to perform retrospective evaluations of assessing hedge effectiveness under the dollar-offset method may affect whether an entity can apply hedge accounting for the current assessment period. (815-20-35-6)

Assessing Effectiveness Based on Whether the Critical Terms of the Hedging Instrument and the Hedged Items Match

36. If, at inception, the critical terms of the hedging instrument and the hedged forecasted transaction are the same (see paragraphs ~~10-11815-20-25-84 through 25-84A~~), the entity can conclude that changes in cash flows attributable to the risk being hedged are expected to be completely offset by the hedging derivative. Therefore, subsequent assessments can be performed by verifying and documenting whether the critical terms of the hedging instrument and the forecasted transaction have changed during the period in review. (815-20-35-9)

37. Because the assessment of hedge effectiveness in a cash flow hedge involves assessing the likelihood of the counterparty's compliance with the contractual terms of the derivative instrument designated as the hedging instrument, the entity must also assess whether there have been adverse developments regarding the risk of counterparty default, particularly if the entity planned to obtain its cash flows by liquidating the derivative instrument at its fair value. (815-20-35-10)

38. If there are no such changes in the critical terms or adverse developments regarding counterparty default, the entity may conclude that the hedging relationship is perfectly effective. In that case, the change in fair value of the derivative instrument can be viewed as a proxy for the present value of the change in cash flows attributable to the risk being hedged. (815-20-35-11)

39. However, the entity must assess whether the hedging relationship is expected to continue to be highly effective using a quantitative assessment method (either a dollar-offset test or a statistical method such as regression analysis) if any of the following conditions exist: (815-20-35-12)

- a. The critical terms of the hedging instrument or the hedged forecasted transaction have changed.

- b. There have been adverse developments regarding the risk of counterparty default.

Possibility of Default by the Counterparty to Hedging Derivative

40. For an entity to conclude on an ongoing basis that the hedging relationship is expected to be highly effective in achieving offsetting changes in cash flows, the entity shall not ignore whether it will collect the payments it would be owed under the contractual provisions of the derivative instrument. In complying with the requirements of paragraph ~~2b815-20-25-75(b)~~, the entity shall assess the possibility of whether the counterparty to the derivative instrument will default by failing to make any contractually required payments to the entity as scheduled in the derivative instrument. In making that assessment, the entity shall also consider the effect of any related collateralization or financial guarantees. The entity shall be aware of the counterparty's creditworthiness (and changes therein) in determining the fair value of the derivative instrument. Although a change in the counterparty's creditworthiness would not necessarily indicate that the counterparty would default on its obligations, such a change shall warrant further evaluation. (815-20-35-14)

41. If the likelihood that the counterparty will not default ceases to be probable, an entity would be unable to conclude that the hedging relationship in a cash flow hedge is expected to be highly effective in achieving offsetting cash flows. (815-20-35-15)

42. In contrast, a change in the creditworthiness of the derivative instrument's counterparty in a fair value hedge would have an immediate effect because that change in creditworthiness would affect the change in the derivative instrument's fair value, which would immediately affect both of the following: (815-20-35-16)

- a. The assessment of whether the relationship qualifies for hedge accounting
- b. The amount of mismatch between the change in the fair value of the hedging instrument and the hedged item attributable to the hedged risk recognized in earnings under fair value hedge accounting.

43. Paragraph ~~16815-20-25-103~~ states that, in applying the shortcut method, an entity shall consider the likelihood of the counterparty's compliance with the contractual terms of the hedging derivative that require the counterparty to make payments to the entity. That paragraph explains that implicit in the criteria for the shortcut method is the requirement that a basis exist for concluding on an ongoing basis that the hedging relationship is expected to be highly effective in achieving offsetting changes in fair values or cash flows. (815-20-35-18)

Change in Hedge Effectiveness Method When Hedge Effectiveness is Assessed on a Quantitative Basis

44. If the entity identifies an improved method of assessing hedge effectiveness in accordance with the guidance in paragraph ~~6815-20-25-80~~ and wants to apply that method prospectively, it shall do both of the following: (815-20-35-19)

- a. Discontinue the existing hedging relationship
- b. Designate the relationship anew using the improved method.

45. The new method of assessing hedge effectiveness shall be applied prospectively and shall also 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 by an entity shall not be considered a change in accounting

principle as defined in ~~Topic 250~~ SSAP No. 3—Accounting Changes and Corrections of Errors. (815-20-35-20)

U.S. GAAP ASC Excerpts Proposed to be Excluded from Exhibit A

This information is included to illustrate the guidance within the adopted ASC references that are not proposed to be captured in Exhibit A. The guidance within these paragraphs would be considered part of the statutory adoption unless they include specific accounting and reporting guidance. Comments are requested on whether any of the following paragraphs should be explicitly captured in Exhibit A.

Skipping 815-20-25-79A

815-20-25-79A See paragraphs 815-20-25-139 through 25-142 about the timing of hedge effectiveness assessments required by paragraph 815-20-25-79 for a private company that is not a financial institution or a not-for-profit entity (except for a not-for-profit entity that 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).

Skipped paragraphs 815-20-25-86 through 815-20-25-97

815-20-25-86 The remainder of this guidance on hedge effectiveness criteria applicable to both fair value hedges and cash flow hedges is organized as follows:

- a. Hedge effectiveness when the hedging instrument is an option or combination of options
- b. Hedge effectiveness when hedged exposure is more limited than hedging instrument
- c. Hedge effectiveness during designated hedge period
- d. Assuming perfect effectiveness in a hedge with an interest rate swap (the shortcut method).

Hedge Effectiveness When the Hedging Instrument Is an Option or Combination of Options

815-20-25-87 The hedge effectiveness criteria applicable to options and combinations of options are organized as follows:

- a. Determining whether a combination of options is net written
- b. Hedge effectiveness of written options
- c. Hedge effectiveness of options in general.

Determining Whether a Combination of Options Is Net Written

815-20-25-88 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.

Strike Prices and Notional Amounts Remain Constant

815-20-25-89 For a combination of options in which the strike price and the notional amount in both the written option component and the purchased option component remain constant over the life of the respective component, that combination of options would be considered a net purchased option or a zero cost collar (that is, the combination shall not be considered a net written option subject to the requirements of paragraph 815-20-25-94) provided all of the following conditions are met:

- a. No net premium is received.
- b. The components of the combination of options are based on the same underlying.
- c. The components of the combination of options have the same maturity date.
- d. The notional amount of the written option component is not greater than the notional amount of the purchased option component.

815-20-25-90 If the combination of options does not meet all of those conditions, it shall be subject to the test in paragraph 815-20-25-94. For example, a combination of options having different underlying indexes, such as a collar containing a written floor based on three-month U.S. Treasury rates and a purchased cap based on three-month London Interbank Offered Rate (LIBOR), shall not be considered a net purchased option or a zero cost collar even though those rates may be highly correlated.

Strike Prices and Notional Amounts Do Not Remain Constant

815-20-25-91 If either the written option component or the purchased option component for a combination of options has either strike prices or notional amounts that do not remain constant over the life of the respective component, the assessment to determine whether that combination of options can be considered not to be a written option under paragraph 815-20-25-88 shall be evaluated with respect to each date that either the strike prices or the notional amounts change within the contractual term from inception to maturity.

815-20-25-92 Even though that assessment is made on the date that a combination of options is designated as a hedging instrument (to determine the applicability of paragraph 815-20-25-94), it shall consider the receipt of a net premium (in cash or as a favorable rate or other term) from that combination of options at each point in time that either the strike prices or the notional amounts change, such as either of the following circumstances:

- a. If strike prices fluctuate over the life of a combination of options and no net premium is received at inception, a net premium will typically be received as a favorable term in one or more reporting periods within the contractual term from inception to maturity.
- b. If notional amounts fluctuate over the life of a combination of options and no net premium is received at inception, a net premium or a favorable term will typically be received in one or more periods within the contractual term from inception to maturity.

815-20-25-93 In addition, a combination of options in which either the written option component or the purchased option component has either strike prices or notional amounts that do not remain constant over the life of the respective component shall satisfy all of the conditions in paragraph 815-20-25-89 to be considered not to be a written option (that is, to be considered to be a net purchased option or zero cost collar) under paragraph 815-20-25-88. For example, if the notional amount of the written option component is greater than the notional amount of the purchased option component at any date that the notional amount changes within the contractual term from inception to maturity, the combination of options shall be

considered to be a written option under paragraph 815-20-25-88 and, thus, subject to the criteria in the following paragraph.

Hedge Effectiveness of Written Options

815-20-25-94 If a written option is designated as hedging a recognized asset or liability or an unrecognized firm commitment (if a fair value hedge) or the variability in cash flows for a recognized asset or liability or an unrecognized firm commitment (if a cash flow hedge), the combination of the hedged item and the written option provides either of the following:

- a. At least as much potential for gains as a result of a favorable change in the fair value of the combined instruments (that is, the written option and the hedged item, such as an embedded purchased option) as exposure to losses from an unfavorable change in their combined fair value (if a fair value hedge)
- b. At least as much potential for favorable cash flows as exposure to unfavorable cash flows (if a cash flow hedge).

815-20-25-95 The written-option test in the preceding paragraph shall be applied only at inception of the hedging relationship and is met if all possible percentage favorable changes in the underlying (from zero percent to 100 percent) would provide either of the following:

- a. At least as much gain as the loss that would be incurred from an unfavorable change in the underlying of the same percentage (if a fair value hedge)
- b. At least as much favorable cash flows as the unfavorable cash flows that would be incurred from an unfavorable change in the underlying of the same percentage (if a cash flow hedge).

815-20-25-96 The time value of a written option (or net written option) may be excluded from the written-option test if, in defining how hedge effectiveness will be assessed, the entity specifies that it will base that assessment on only changes in the option's intrinsic value. In that circumstance, the change in the time value of the options would be excluded from the assessment of hedge effectiveness in accordance with paragraph 815-20-25-82(a).

815-20-25-97 When applying the written-option test to determine whether there is symmetry of the gain and loss potential of the combined hedged position for all possible percentage changes in the underlying, an entity is permitted to measure the change in the intrinsic value of the written option (or net written option) combined with the change in fair value of the hedged item.

Skipped paragraphs 815-20-25-100 and 815-20-25-101

Hedge Effectiveness When Hedged Exposure Is More Limited Than Hedging Instrument

815-20-25-100 An entity may designate as the hedging instrument in a fair value hedge or cash flow hedge a derivative instrument that does not have a limited exposure comparable to the limited exposure of the hedged item to the risk being hedged. However, to make that designation, in accordance with paragraph 815-20-25-75, the entity shall establish that the hedging relationship is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period that the hedge is designated. See paragraph 815-20-25-79(a) for additional guidance on prospective considerations of hedge effectiveness in this circumstance.

Hedge Effectiveness during Designated Hedge Period

815-20-25-101 It is inappropriate under this Subtopic for an entity to designate a derivative instrument as the hedging instrument if the entity expects that the derivative instrument will not be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period that the hedge is designated, unless the entity has documented undertaking a dynamic hedging strategy in which it has committed itself to an ongoing repositioning strategy for its hedging relationship.

Skipped paragraphs 815-20-25-112 through 815-20-25-143

>>>> Application of Prepayable Criterion

815-20-25-112 An interest-bearing asset or liability shall be considered prepayable under the provisions of paragraph 815-20-25-104(e) 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:

a. 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.

b. 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.

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.

815-20-25-114 Furthermore, a right to cause a contract to be prepaid at its then fair value would not cause the interest-bearing asset or liability to be considered prepayable because that right would have a fair value of zero at all times and essentially would provide only liquidity to the holder.

815-20-25-115 Application of this guidance to specific debt instruments is illustrated in paragraph 815-20-55-75.

Application of the Shortcut Method to a Portfolio of Hedged Items

815-20-25-116 Portfolio hedging cannot be used to circumvent the application of the shortcut method criteria beginning in paragraph 815-20-25-102 to a fair value hedge of an individual interest-bearing asset or liability. A portfolio of interest-bearing assets or interest-bearing liabilities cannot qualify for the shortcut method if it contains an interest-bearing asset or liability that individually cannot qualify for the shortcut method.

815-20-25-117 The fair value hedge requirements of paragraph 815-20-25-12(b)(1) ensure that the individual items in a portfolio share the same risk exposure and have fair value changes attributable to the hedged risk that are expected to respond in a generally proportionate manner to the overall fair value changes of the entire portfolio. That requirement restricts the types of portfolios that can qualify for portfolio hedging; however, it also permits the existence of a mismatch between the change in the fair value of the individual hedged items and the change in the fair value of the hedged portfolio attributable to the hedged risk in portfolios that do qualify. As a result, the assumption of perfect effectiveness required for the shortcut method generally is inappropriate for portfolio hedges of similar assets or liabilities that are not also nearly identical (except for their notional amounts). Application of the shortcut method to portfolios that meet the requirements of paragraph 815-20-25-12(b)(1) is appropriate only if the assets or liabilities in the portfolio meet the same stringent criteria in paragraphs 815-20-25-104(e), 815-20-25-104(g), and 815-20-25-105(a) as required for hedges of individual assets and liabilities.

Application of Whether the Shortcut Method Was Not or No Longer Is Appropriate

815-20-25-117A In the period in which an entity determines that use of the shortcut method was not or no longer is appropriate, the entity may use a quantitative method to assess hedge effectiveness and measure hedge results without dedesignating the hedging relationship if both of the following criteria are met:

- a. The entity documented at hedge inception in accordance with paragraph 815-20-25-3(b)(2)(iv)(04) which quantitative method it would use to assess hedge effectiveness and measure hedge results if the shortcut method was not or no longer is appropriate during the life of the hedging relationship.

b. The hedging relationship was highly effective on a prospective and retrospective basis in achieving offsetting changes in fair value or cash flows attributable to the hedged risk for the periods in which the shortcut method criteria were not met.

815-20-25-117B If the criterion in paragraph 815-20-25-117A(a) is not met, the hedging relationship shall be considered invalid in the period in which the criteria for the shortcut method were not met and in all subsequent periods. If the criterion in paragraph 815-20-25-117A(a) is met, the hedging relationship shall be considered invalid in all periods in which the criterion in paragraph 815-20-25-117A(b) is not met.

815-20-25-117C If an entity cannot identify the date on which the shortcut criteria ceased to be met, the entity shall perform the quantitative assessment of effectiveness documented at hedge inception for all periods since hedge inception.

815-20-25-117D The terms of the hedged item and hedging instrument used to assess effectiveness, in accordance with paragraph 815-20-25-117A(b), shall be those existing as of the date that the shortcut criteria ceased to be met. For cash flow hedges, if the hypothetical derivative method is used as a proxy for the hedged item, the value of the hypothetical derivative shall be set to zero as of hedge inception.

Hedge Effectiveness Criterion Applicable to Fair Value Hedges Only—Effectiveness Horizon

815-20-25-118 In documenting its risk management strategy for a fair value hedge, an entity may specify an intent to consider the possible changes (that is, not limited to the likely or expected changes) in value of the hedging derivative instrument and the hedged item only over a shorter period than the derivative instrument's remaining life in formulating its expectation that the hedging relationship will be highly effective in achieving offsetting changes in fair value for the risk being hedged. The entity does not need to contemplate the offsetting effect for the entire term of the hedging instrument.

Consideration of Prepayment Risk Using the Last-of-Layer Method

815-20-25-118A In a fair value hedge of interest rate risk designated under the last-of-layer method in accordance with paragraph 815-20-25-12A, an entity may exclude prepayment risk when measuring the change in fair value of the hedged item attributable to interest rate risk.

Hedge Effectiveness Criteria Applicable to Cash Flow Hedges Only

815-20-25-119 The hedge effectiveness criteria applicable to cash flow hedges only are organized as follows:

- a. Consideration of the time value of money
- b. Consideration of counterparty credit risk
- c. Additional considerations for options in cash flow hedges
- d. Assuming perfect hedge effectiveness in a cash flow hedge of a variable-rate borrowing with a receive-variable, pay-fixed interest rate swap recorded under the simplified hedge accounting approach.

Consideration of the Time Value of Money

815-20-25-120 In assessing the effectiveness of a cash flow hedge, an entity generally shall consider the time value of money, especially if the hedging instrument involves periodic cash settlements.

815-20-25-121 An example of a situation in which an entity likely would reflect the time value of money is a tailing strategy with futures contracts. When using a tailing strategy, an entity adjusts the size or contract amount of futures contracts used in a hedge so that earnings (or expense) from reinvestment (or funding) of daily settlement gains (or losses) on the futures do not distort the results of the hedge. To assess offset of expected cash flows when a tailing strategy has been used, an entity could reflect the time value of money, perhaps by comparing the present value of the hedged forecasted cash flow with the results of the hedging instrument.

Consideration of Counterparty Credit Risk

815-20-25-122 For a cash flow hedge, an entity shall consider the likelihood of the counterparty's compliance with the contractual terms of the hedging derivative instrument that require the counterparty to make payments to the entity. Paragraph 815-20-35-14 states that, for an entity to conclude on an ongoing basis that a cash flow hedging relationship is expected to be highly effective in achieving offsetting changes in cash flows, the entity shall not ignore whether it will collect the payments it would be owed under the contractual provisions of the derivative instrument. See paragraphs 815-20-35-14 through 35-18 for further guidance.

Additional Considerations for Options in Cash Flow Hedges

815-20-25-123 When an entity has documented that the effectiveness of a cash flow hedge will be assessed based on changes in the hedging option's intrinsic value pursuant to paragraph 815-20-25-82(a), that assessment (and the related cash flow hedge accounting) shall be performed for all changes in intrinsic value—that is, for all periods of time when the option has an intrinsic value, such as when the underlying is above the strike price of the call option.

815-20-25-124 When a purchased option is designated as a hedging instrument in a cash flow hedge, an entity shall not define only limited parameters for the risk exposure designated as being hedged that would include the time value component of that option. An entity cannot arbitrarily exclude some portion of an option's intrinsic value from the hedge effectiveness assessment simply through an articulation of the risk exposure definition. It is inappropriate to assert that only limited risk exposures are being hedged (for example, exposures related only to currency-exchange-rate changes above \$1.65 per pound sterling as illustrated in Example 26 [see paragraph 815-20-55-205]).

815-20-25-125 If an option is designated as the hedging instrument in a cash flow hedge, an entity may assess hedge effectiveness based on a measure of the difference, as of the end of the period used for assessing hedge effectiveness, between the strike price and forward price of the underlying, undiscounted. Although assessment of cash flow hedge effectiveness with respect to an option designated as the hedging instrument in a cash flow hedge shall be performed by comparing the changes in present value of the expected future cash flows of the forecasted transaction to the change in fair value of the derivative instrument (aside from any excluded component under paragraph 815-20-25-82), that measure of changes in the expected future cash flows of the forecasted transaction based on forward rates, undiscounted, is not prohibited. With respect to an option designated as the hedging instrument in a cash flow hedge, assessing hedge effectiveness based on a similar measure with respect to the hedging instrument eliminates any difference that the effect of discounting may have on the hedging instrument and the hedged transaction. Pursuant to paragraph 815-20-25-3(b)(2)(iv), entities shall document the measure of intrinsic value that will be used in the assessment of hedge effectiveness. As discussed in paragraph 815-20-25-80, that measure must be used consistently for each period following designation of the hedging relationship.

Assessing Hedge Effectiveness Based on an Option's Terminal Value

815-20-25-126 The guidance in paragraph 815-20-25-129 addresses a cash flow hedge that meets all of the following conditions:

- 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).

815-20-25-127 This guidance has no effect on the accounting for fair value hedging relationships. In addition, in determining the accounting for seemingly similar cash flow hedging relationships, it would be inappropriate to analogize to this guidance.

815-20-25-128 For a hedging relationship that meets all of the conditions in paragraph 815-20-25-126, an entity may focus on the hedging instrument's terminal value (that is, its expected future pay-off amount at its maturity date) in determining whether the hedging relationship is expected to be highly effective in achieving offsetting cash flows attributable to the hedged risk during the term of the hedge. An entity's focus on the hedging instrument's terminal value is not an impediment to the entity's subsequently deciding to dedesignate that cash flow hedge before the occurrence of the hedged transaction. If the hedging instrument is a purchased cap consisting of a series of purchased caplets that are each hedging an individual hedged transaction in a series of hedged transactions (such as caplets hedging a series of hedged interest payments at different monthly or quarterly dates), the entity may focus on the terminal value of each caplet (that is, the expected future pay-off amount at the maturity date of each caplet) in determining whether each of those hedging relationships is expected to be highly effective in achieving offsetting cash flows. The guidance in this paragraph applies to a purchased option regardless of whether at the inception of the cash flow hedging relationship it is at the money, in the money, or out of the money.

815-20-25-129 A hedging relationship that meets all of the conditions in paragraph 815-20-25-126 may be considered to be perfectly effective if all of the following conditions are met:

- 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.

The condition in (d) is consistent with the entity's focus on the hedging instrument's terminal value. If the holder of the option chooses to pay for the ability to exercise the option at dates before the maturity date (for example, by acquiring an American-style option), the hedging relationship would not be perfectly effective.

815-20-25-129A In a hedge of a group of forecasted transactions in accordance with paragraph 815-20-25-15(a)(2), an entity may assume that the timing in which the hedged transactions are expected to occur and the maturity date of the hedging instrument match in accordance with paragraph 815-20-25-129(a) if those forecasted transactions occur and the derivative matures within the same 31-day period or fiscal month.

Hedge Effectiveness of a Net-Purchased Combination of Options

815-20-25-130 The guidance in the following paragraph addresses a cash flow hedging relationship that meets both of the following conditions:

- a. A combination of options (deemed to be a net purchased option) is designated as the hedging instrument.
- b. The effectiveness of the hedge is assessed based only on changes in intrinsic value of the hedging instrument (the combination of options).

815-20-25-131 The assessment of effectiveness of a cash flow hedging relationship meeting the conditions in the preceding paragraph may be based only on changes in the underlying that cause a change in the intrinsic value of the hedging instrument (the combination of options). Thus, the assessment can exclude ranges of changes in the underlying for which there is no change in the hedging instrument's intrinsic value.

Hedge Accounting Provisions Applicable to Certain Private Companies

Assuming Perfect Hedge Effectiveness in a Cash Flow Hedge of a Variable-Rate Borrowing with a Receive-Variable, Pay-Fixed Interest Rate Swap Recorded under the Simplified Hedge Accounting Approach

815-20-25-133 Paragraphs 815-10-35-1A through 35-1C, 815-10-50-3, 815-20-25-3A, 815-20-25-119, 815-20-25-134 through 25-138, 815-20-55-79A through 55-79B, 825-10-50-3, and 825-10-50-8 provide guidance for an entity electing the simplified hedge accounting approach. See paragraph 815-10-65-6 for transition guidance on applying the simplified hedge accounting approach.

815-20-25-134 The conditions for the simplified hedge accounting approach determine which cash flow hedging relationships qualify for a simplified version of hedge accounting. If all of the conditions in paragraphs 815-20-25-135 and 815-20-25-137 are met, an entity may assume perfect effectiveness in a cash flow hedging relationship involving a variable-rate borrowing and a receive-variable, pay-fixed interest rate swap.

815-20-25-135 Provided all of the conditions in paragraph 815-20-25-137 are met, the simplified hedge accounting approach may be applied by a **private company** except for a financial institution as described in paragraph 942-320-50-1. An entity may elect the simplified hedge accounting approach for any receive-variable, pay-fixed interest rate swap, provided that all of the conditions for applying the simplified hedge accounting approach specified in paragraph 815-20-25-137 are met. Implementation guidance on the conditions set forth in paragraph 815-20-25-137 is provided in paragraphs 815-20-55-79A through 55-79B.

815-20-25-136 In applying the simplified hedge accounting approach, the documentation required by paragraph 815-20-25-3 to qualify for hedge accounting must be completed by the date on which the first annual **financial statements are available to be issued** after hedge inception rather than concurrently at hedge inception.

815-20-25-137 An eligible entity under paragraph 815-20-25-135 must meet all of the following conditions to apply the simplified hedge accounting approach to a cash flow hedge of a variable-rate borrowing with a receive-variable, pay-fixed interest rate swap:

- a. Both the variable rate on the swap and the borrowing are based on the same index and reset period (for example, both the swap and borrowing are based on one-month London Interbank Offered Rate [LIBOR] or both the swap and borrowing are based on three-month LIBOR).
- b. The terms of the swap are typical (in other words, the swap is what is generally considered to be 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.
- c. The repricing and settlement dates for the swap and the borrowing match or differ by no more than a few days.
- d. The swap’s fair value at inception (that is, at the time the derivative was executed to hedge the interest rate risk of the borrowing) is at or near zero.
- e. The notional amount of the swap matches the principal amount of the borrowing being hedged. In complying with this condition, the amount of the borrowing being hedged may be less than the total principal amount of the borrowing.
- f. 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.

815-20-25-138 A cash flow hedge established through the use of a forward starting receive-variable, pay-fixed interest rate swap may be permitted in applying the simplified hedge accounting approach only if the occurrence of forecasted interest payments to be swapped is probable. When forecasted interest payments are no longer probable of occurring, a cash flow hedging relationship will no longer qualify for the simplified hedge accounting approach and the General Subsections of this Topic shall apply at the date of change and on a prospective basis.

Timing of Hedge Documentation for Certain Private Companies If Simplified Hedge Accounting Approach Is Not Applied

Concurrent Hedge Documentation

815-20-25-139 Concurrent with hedge inception, a **private company** that is not a financial institution as described in paragraph 942-320-50-1 shall document the following:

- a. The hedging relationship in accordance with paragraph 815-20-25-3(b)(1)
- b. The hedging instrument in accordance with paragraph 815-20-25-3(b)(2)(i)
- c. The hedged item in accordance with paragraph 815-20-25-3(b)(2)(ii), including (if applicable) firm commitments or the analysis supporting a last-of-layer designation in paragraph 815-20-25-3(c), or forecasted transactions in paragraph 815-20-25-3(d)
- d. The nature of the risk being hedged in accordance with paragraph 815-20-25-3(b)(2)(iii).

815-20-25-140 A private company that is not a financial institution is not required to perform or document the following items concurrent with hedge inception but rather is required to perform or document them within the time periods discussed in paragraph 815-20-25-142:

- a. The method of assessing hedge effectiveness at inception and on an ongoing basis in accordance with paragraph 815-20-25-3(b)(2)(iv) and (vi)
- b. Initial hedge effectiveness assessments in accordance with paragraph 815-20-25-3(b)(2)(iv)(01) through (04).

815-20-25-141 Example 1A beginning in paragraph 815-20-55-80A illustrates hedge documentation when the critical terms of the hedging instrument and hedged forecasted transaction match. Although that Example illustrates the documentation of the method of assessing hedge effectiveness, private companies that are not financial institutions may complete hedge documentation requirements in accordance with paragraphs 815-20-25-139 through 25-140.

Hedge Effectiveness Assessments

815-20-25-142 For a private company that is not a financial institution, the performance and documentation of the items listed in paragraph 815-20-25-140, as well as required subsequent quarterly hedge effectiveness assessments, may be completed before the date on which the next interim (if applicable) or annual financial statements are available to be issued. Even though the completion of the initial and ongoing assessments of effectiveness may be deferred to the date on which financial statements are available to be issued the assessments shall be completed using information applicable as of hedge inception and each subsequent quarterly assessment date when completing this documentation on a deferred basis. Therefore, the assessment should be performed to determine whether the hedge was highly effective at achieving offsetting changes in fair values or cash flows at inception and in each subsequent quarterly assessment period up to the reporting date.

Hedge Accounting Provisions Applicable to Certain Not-for-Profit Entities

815-20-25-143 Not-for-profit entities (except for 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) may apply the guidance on the timing of hedge documentation and hedge effectiveness assessments in paragraphs 815-20-25-139 through 25-142. Specifically, those entities shall document the items listed in paragraph 815-20-25-139 concurrent with hedge inception, but they may perform and document the items listed in paragraph 815-20-25-140 and perform the required subsequent quarterly hedge effectiveness assessments in accordance with paragraph 815-20-25-142 within the time periods discussed in paragraph 815-20-25-142.

<https://naiconline.sharepoint.com/teams/FRSStatutoryAccounting/NationalMeetings/A.NationalMeetingMaterials/2022/4-SpringNM/Exposures/21-20SSAPNo.86-ExhibitA3-2-22.docx>