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A guide to accounting for derivatives

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1. Introduction to derivatives and how they are accounted for

1.1 Overview

This guide is intended to provide a high-level overview of derivatives, including the accounting for them as well as financial statement presentation and disclosure. ASC 815 provides the authoritative guidance for derivatives and hedging. This guide is based primarily on the content within ASC 815-10 and ASC 815-15 and is composed of the following chapters:

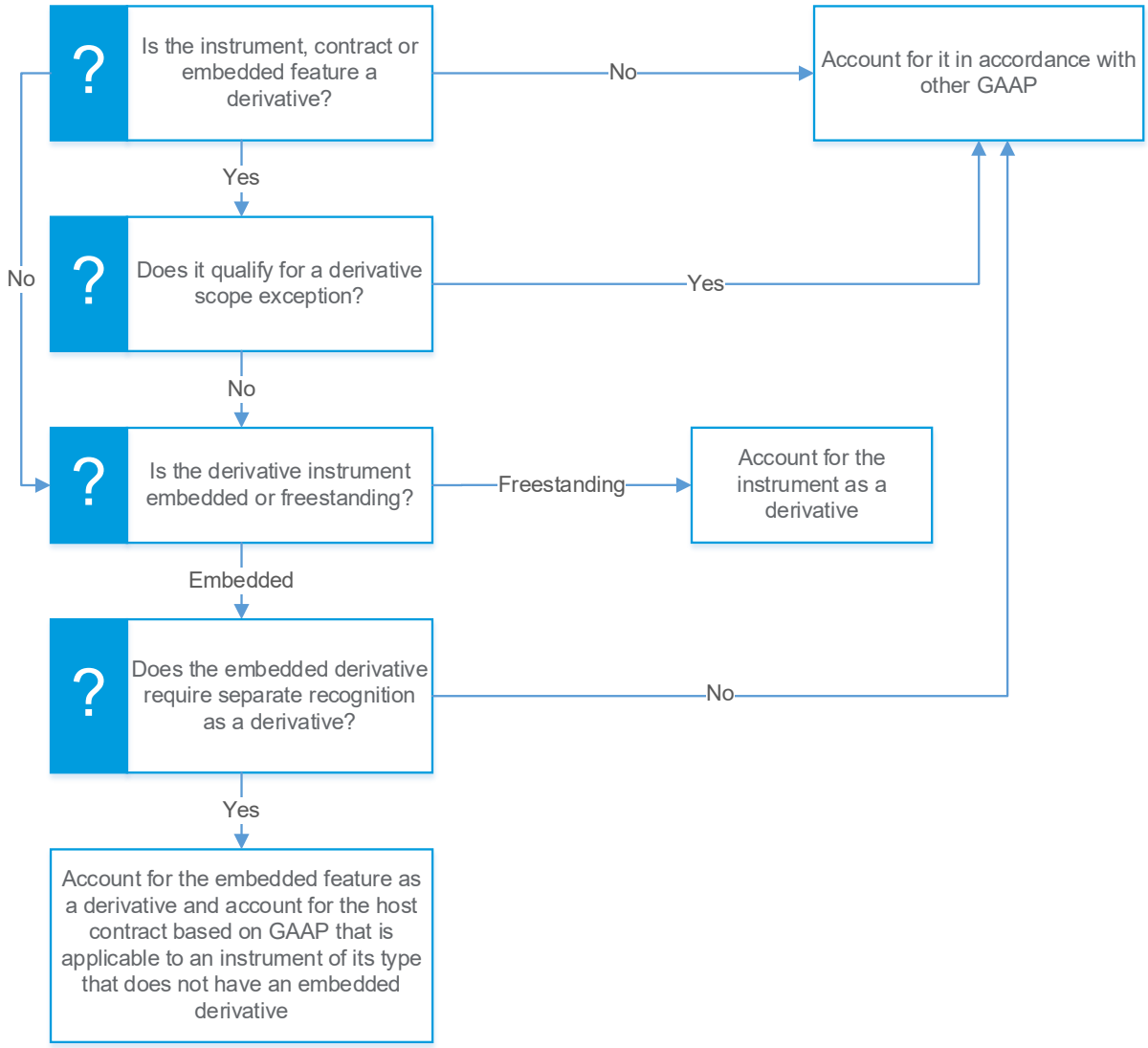
- Chapter 1: Introduction to derivatives and how they are accounted for
- Chapter 2: Definition of a derivative and scope exceptions to derivative accounting
- Chapter 3: Embedded derivatives
- Chapter 4: Presentation and disclosure of derivatives and hedging activity
- Appendix A: Accounting Standards Updates mentioned in this guide
- Appendix B: Acronyms and literature references

Refer also to our companion guides:

- A guide to hedge accounting upon the adoption of ASU 2017-12, which is based on the content within ASC 815-20, ASC 815-25, ASC 815-30 and ASC 815-35
- A guide to accounting for debt and equity instruments in financing transactions. Amongst other provisions,
  - Chapter 2 and 3 address the accounting for debt with conversion options and other embedded features
  - 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, which amongst other provisions, addresses the accounting for contracts that are not derivatives and are within the scope of the Certain Contract on Debt and Equity Securities subsection of ASC 815-10.

Derivatives and their related financial reporting considerations are complex. Reference should be made to the appropriate subtopics within ASC 815 for a comprehensive understanding of the relevant guidance. The following flow chart provides an overview of the accounting considerations that come into play when determining if an instrument, contract or embedded feature requires recognition as a derivative, along with references to sections within this guide where you can learn more about each consideration. As the flow chart demonstrates, the application of the guidance in some respects differs depending on whether the instrument is freestanding or embedded. Section 2.1.2 of Chapter 2 aids in making this determination. Note that it is not necessary to adhere to the order in which the accounting considerations are outlined in this flowchart. For example, rather than determining if an instrument, contract or feature is a derivative, it may be more efficient to determine if it qualifies for a derivative scope exception, in which case whether it is a derivative is a moot point. Similarly, when analyzing an embedded feature to determine if separate recognition as a derivative is necessary, it may be more efficient to determine if the embedded feature qualifies for a derivative scope exception or does not meet another criterion discussed in Chapter 3 to require separate recognition as a derivative. (For example, an embedded feature that has economic

characteristics and risks that are clearly and closely related to the host contract does not require separate recognition as a derivative).



1.2 How are derivatives accounted for?

ASC 815-10-35 requires derivatives within its scope to be recognized at fair value on the statement of financial position. The meaning of the term “derivative” herein refers to a financial instrument or contract that meets the definition of a derivative pursuant to ASC 815 and not necessarily the colloquial definition of a derivative. See Chapter 2 for the ASC 815 definition of a derivative. An exception to this exists under the simplified approach that is discussed beginning at ASC 815-20-25-133, whereby certain private companies can elect to recognize certain interest rate swaps at settlement value rather than fair value. Derivatives are recognized as assets or liabilities, depending on their contractual rights or obligations. Absent an election to apply hedge accounting, changes in the fair value of derivatives are recognized through the statement of performance and can therefore cause significant earnings volatility from one period to the next. Refer to A guide to hedge accounting upon the adoption of ASU 2017-12 for more information on hedge accounting and the requirements that must be met to apply it. Refer also to

Chapter 3 for additional considerations related to the accounting for an embedded derivative that has been separately recognized and the host contract that remains after separation.

As noted in ASC 815-10-25-2 and 25-3, a contract (or a feature embedded in a contract) can move in and out of derivative status. If a contract that was not by definition a derivative at the time it was acquired or entered into later becomes a derivative that is within the scope of ASC 815, it would be immediately recognized as a derivative asset or liability, at its fair value, with the initial offsetting entry and entries to continuously adjust the carrying amount to fair value recognized through the statement of financial performance. Conversely, if a contract that was accounted for as a derivative, ceases to be a derivative, 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.

Select reasons why a contract or feature may move in and out of derivative status

- Conclusions reached on whether the net settlement characteristic of a derivative exists may change. Specifically, as noted at Section 2.2.1.4.2 of Chapter 2, the evaluation of whether a market mechanism exists and whether items to be delivered under a contract are readily convertible to cash must be reassessed on an ongoing basis.
- The entity may newly qualify or no longer qualify for a scope exception. For example:
  - To qualify for the nonfinancial asset or liability scope exception discussed at Section 2.3.5.2 of Chapter 2 the underlying asset cannot be considered readily convertible to cash. Conclusions reached in this regard can change from time to time as market activity changes.
  - As discussed in Section 3.4.3 of Chapter 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 didn't qualify for the scope exception to newly qualify.
  - As discussed in Section 2.3.2.3 of Chapter 2, 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.
- Modifications are made to the terms of the instrument or contract. As noted in Section 3.4.3 of Chapter 3, a modification to a hybrid instrument could trigger the need to reassess conclusions reached as to whether an embedded derivative is clearly and closely related to the host contract. Additionally, changes to the terms may impact conclusions reached on whether a contract or embedded feature is a derivative, and if so, whether it qualifies for a scope exception.

1.3 What is a derivative?

A derivative is a contract whose value is based on an underlying variable. That is, a derivative derives its value from the fluctuation of a particular price (e.g., commodity price) or index (e.g., interest rate index) or the occurrence or nonoccurrence of an event (e.g., hurricane). Derivative instruments come in various forms and are designed to do various things. Certain derivatives may be designed to lock in the future price of a commodity, such as steel. Other derivatives 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.

Entities may intentionally enter into derivatives for trading or investment purposes, or they may enter into them to hedge a specific risk. It is important to understand that common contracts entities enter into may be a derivative or contain an embedded derivative. As such, one has to be proactive in considering if a contract or feature within a contract may be a derivative.

A derivative instrument is defined as a financial instrument or other contract that has all of the following characteristics:

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 related indices

-The occurrence of a specified event (e.g., IPO, change in control)

Either notional amount

E.g., 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., a payment of $50,000 will be made if a commodity index reaches a specified level).

Initial net investment

The contract or instrument 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., exchange traded commodity or security).

Each of these characteristics are explored more fully in Chapter 2.

1.3.1 Why do entities use derivatives?

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 they purchased the underlying asset at its market price. Consider the following example that 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 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 derivatives popular trading instruments. Interestingly, it is also what makes derivatives valuable risk management tools. That is, an entity can take a trading position or mitigate certain risks by entering into a derivative with little or no upfront money.

1.3.1.1 Using derivatives for 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 derivatives can change in fair value relatively quickly, these instruments lend themselves to being used for trading purposes 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.

Derivatives 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. That is, when an entity enters into a derivative, it is doing so in contemplation that slight fluctuations in the derivative’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. The following comparison demonstrates how Investor A would have made out upon the expiration of the option under 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
Extended gain if share price increases to $15	$50 ($5 x 10 shares)	$125 ($5 x 25)
Extended loss if share price decreases to $5	($50) (-$5 x 10 shares)	($100) ($4 purchase price x 25)

1.3.1.2 Using derivatives for risk management purposes

An entity may enter into a derivative 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 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 now decides that it no longer wants to be subject to the potential variability attributable to fluctuations in the prime rate.	Entity A enters 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 aggregate economic perspective, the swap converts the floating 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 that are attributable to changes in the prime rate.
Entity B invested in a fixed-rate debt security	Entity B enters into an interest rate swap with a	Under the swap agreement, Entity B receives interest based on a Treasury rate and pays

Risk management situation	Derivative used to manage risk	Risk management result
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.	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.	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. Now, as interest rates (specifically Treasury) rise and fall, the interest rate Entity B receives on the Treasury "leg" of the swap adjusts accordingly. By implementing this risk management strategy and thereby effectively converting the debt security from a fixed rate to a variable rate, Entity B has protected itself against the change in fair value of its debt security that 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 enters 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 purchase 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.

1.4 Hidden derivatives

In many cases, reporting entities don't 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. 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 at future dates. A common example of an ordinary embedded feature 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. Chapters 2 and 3 of this guide aid in understanding what a derivative is and when they require derivative accounting treatment.

1.5 How are derivatives transacted?

Broadly speaking, derivatives are transacted in one of the two following ways.

Exchange-traded	Over the counter (OTC)
These derivatives are traded through mechanisms referred to as exchanges and clearinghouses. Exchange-traded derivatives are standardized, which makes them more liquid and makes trading them more efficient. When a derivative is traded on an exchange, a clearinghouse stands between the two derivative counterparties. Essentially, 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. An example of an exchange-traded derivative is a futures contract that is described in the following table.	OTC derivative trades are negotiated and executed between counterparties according to their individual risk preferences. These private trades go through derivative 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 derivatives markets), each counterparty is directly exposed to the credit risk of the other counterparty. OTC derivative 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. OTC derivatives make up a greater portion of the derivatives market. An example of an OTC derivative is a forward contract that is described in the following table.

1.6 Common types of derivative contracts

The following table discusses some common types of contracts that are derivatives if all the characteristics of a derivative as discussed in Chapter 2 are met.

Type of contract	Description	Example
Forward contract	A forward contract is a contract where one party agrees to sell a financial instrument, commodity, or some other asset to another party at a future date, with the selling price established at the inception of the contract.	A forward contract to sell 1,000 bushels of corn at $5 per bushel 90 days after inception of the contract.
Futures contract	A futures contract is 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 interest rate swap agreement is an arrangement between two counterparties whereby each party agrees to be obligated to make a series of interest-based payments to the other	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 per annum of one-month

Type of contract	Description	Example
	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 and vice versa, which are commonly referred to as a fixed-to-floating interest rate swap 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., LIBOR, Prime), which is commonly referred to as a basis swap. The payments are made on a net basis on contractual settlement dates.	LIBOR also applied to a notional amount of $1 million. Payments on the swap are due on the last business day of the month, every month during its term. On the payment date, if one-month LIBOR is less than 1%, Party A will pay Party B the difference between 1% and one-month LIBOR multiplied by $1 million multiplied by 30/360. If, however, one-month LIBOR is greater than 1%, Party B will pay Party A the difference between one-month LIBOR and 1% multiplied by $1 million multiplied by 30/360.
Currency swap	Typically, under a 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 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	Under a 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 floating price. However, some commodity swaps involve the exchange of floating payments that are based on one index for floating payments based on another index. On pre-defined	Party A agrees to pay Party B $2.70 per mm BTU for natural gas and Party B agrees to pay Party A the current Henry Hub rate for natural gas per mm BTU. The swap settles upon the last business day of the month, 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 mm BTU multiplied by 10,000. If however, the Henry Hub rate for natural gas per mm BTU is greater than $2.70,

Type of contract	Description	Example
	settlement dates, a payment exchanges hands on a net basis.	Party B will pay Party A the difference between the Henry Hub rate for natural gas and $2.70 per mm BTU multiplied by 10,000.
Call option	A call option is 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 either at any time during the term of the option or upon a specified date or dates. 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. 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. In this example, Entity XYZ is considered the call purchaser or holder and Entity ABC is considered the call writer or seller. From Entity XYZ's perspective, the call option is considered a purchased call; and from Entity ABC's perspective, the call option is considered a written call.
Put option	A put option is 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 exercise its put option either at any time during the term of the option or upon a specified date or dates. 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. 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.	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 share upon the inception of the put option. In this example, Entity XYZ is considered the put purchaser or holder and Entity ABC is considered the put writer or seller. From Entity XYZ's perspective, the put option is considered a purchased put; and from Entity ABC's perspective, the put option is considered a written put.

Type of contract	Description	Example
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. 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. 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. 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. 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. The scope of ASC 815 and the determination of what is a derivative

2.1 Scope of ASC 815

ASC 815 applies to all entities and to all financial instruments and other contracts that meet the definition of a derivative in ASC 815-10-15-83 and do not qualify for one of the many scope exceptions discussed in Section 2.3 of this chapter.

2.1.1 Unit of account for scope purposes

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

- A contract should be viewed as freestanding or embedded because if embedded, there are additional conditions in ASC 815-15-25-1 that must be met to recognize an embedded feature as a derivative (Refer to Chapter 3 for a summary of this analysis).
- Two or more contracts should be viewed as a unit when applying the guidance in ASC 815-10.

2.1.2 Freestanding or embedded

A freestanding financial instrument is defined in the master glossary as:

> 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.

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

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 the issuance of that debt instrument, it is viewed as a separate freestanding instrument from the debt 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, and not an embedded derivative, by the option writer and the holder.

2.1.3 Viewing multiple contracts as a unit

As indicated in ASC 815-10-15-8, an entity may enter into two or more transactions that together would create an economic result that is similar to that of a single transaction that would be required to be accounted for as a derivative. 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 the following indicators are present:

- The transactions were entered into contemporaneously and in contemplation of each other.
- 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 2.1.1: Recognition—Viewing Separate Transactions as a Unit for Purposes of Evaluating Net Settlement

Case A: Two Forward Contracts Viewed as a Unit (from ASC 815-10-55-177 to 55-178)

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.

Examples from ASC 815-10-55 follow to demonstrate the application of this guidance in the context of interest rate swaps and lending transactions.

Example 2.1.2: Recognition—Viewing Separate Transactions as a Unit (from ASC 815-10-55-171 to 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.

Example 2.1.3: Borrowing and Lending Transactions Viewed as a Unit (from ASC 815-10-55-179 to 55-180)

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.

Whereas ASC 815-10-15-9 sets forth the indicators that an entity should consider to determine whether individual nonderivative contracts or transactions should be viewed as one unit of account for purposes of concluding if that unit of account is a derivative within the scope of ASC 815. ASC 815-10-25-6 addresses whether an entity should consider two derivative 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 feature 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 features within the contract. Refer to Chapter 3 for more information about the accounting analysis for embedded derivatives.

As it relates to put and call options, ASC 815-10-25-7 to 25-13 provide 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 of the 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, they are viewed as a separate unit of account from the bond or other instrument to which they relate.

2.2 The determination of what is a derivative within the scope of ASC 815

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 FASB recognized that over time, such a list would likely become outdated. As a result, the FASB created a definition of a derivative supplemented with a list of scope exceptions. In other words, an instrument that by definition is a derivative is within the scope of ASC 815 unless it qualifies for a scope exception discussed in Section 2.3 of this chapter.

2.2.1 Definition of derivative instrument

The following definition of a derivative is provided in 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 upon its initial recognition may subsequently meet the definition of a derivative, 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. See Chapter 1 for an introduction on how to account for derivatives.

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

2.2.1.1 Underlying

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

> 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 that can be 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.

An underlying is a key characteristic of a derivative. Generally, when the underlying fluctuates, the fair value of the derivative 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 derivatives 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 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, 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.

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

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 to 55-83.

2.2.1.2 Notional amount or payment provision

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

> **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.
>
> **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, an underlying is a variable associated with a derivative. The notional amount is the quantity specified in the derivative contract. The interaction of the underlying and notional amount of a derivative, 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	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 LIBOR on $10,000,000	One-month LIBOR	$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

Derivative	Underlying	Notional amount	Payment provision
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.

2.2.1.2.1 Determining the notional amount in requirements contracts

Unlike a typical commodity contract that specifies a fixed number of units to be bought (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 (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.

> 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 requirements 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.

Minimum quantity specified	Maximum quantity specified	Otherwise determinable quantity (see Note)	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
Yes	Yes	More than the maximum	Maximum quantity
Yes	Yes	Not determinable	Minimum quantity

Note: The otherwise determinable quantity refers to the quantity that is reliably determinable from the requirements contract and (or) 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, which could happen for example if 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 2.2.1: Identifying a commodity contract's notional amount (from ASC 815-10-55-5 to 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.

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.

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.

2.2.1.3 Initial net investment

For a financial instrument or contract to meet the definition of a derivative, 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 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 derivatives often require no, or little initial net investment is because a derivative 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 as well as examples of an initial net investment of a derivative are provided in 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 derivatives that require an initial net investment as compensation is provided in 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 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 derivatives require a mutual exchange of currencies or other assets, potentially at the inception and maturity of the derivative. 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 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 to 15-97.

> 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) exists. 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.
>
> 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 to 55-168 that provide insight into the concept.

The following table summarizes the three cases.

	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 bps	3-month LIBOR minus 100 bps
Fixed-rate	6.65%	9.65%	5.65%

	Case A	Case B	Case C
Initial net investment (Note 1)	$1,228,179	$1,782,245	$1,043,490
Commensurate initial net investment (Note 2)	$1,228,179	$1,228,179	$1,228,179
The initial net investment characteristic of a derivative is met	No	No	Yes

Note 1: 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). The initial net investment is different in each case because the fixed interest rate is different in each case.

Note 2: 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 of 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 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 derivatives 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 to be more than a nominal amount for purposes of assessing the initial net investment characteristic of a derivative.

Although the prepaid interest rate swaps in Case A and Case B are not derivatives in their entirety, they each contain an embedded interest rate swap that needs to be separately recognized as a derivative unless the entire instrument is accounted for at fair value through earnings as elaborated on at 815-10-55-158 to 163. Embedded derivatives are discussed more fully in Chapter 3 of this guide.

Determining the initial net investment when a derivative (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 is modified, that is generally viewed as a termination of the original derivative and the issuance of a new derivative. As such, 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 or not the new interest rate swap is a derivative in its entirety or a hybrid instrument in the form of a debt host contract and an "at-market" interest rate swap. Oftentimes when these modifications occur, the new swap is 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 such that the new swap is determined to be a derivative 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 2.2.2: Initial Net Investment—Forward Contract Embedded with Equity Derivative (from ASC 815-10-55-74 to 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.

Note: Refer to Chapter 3 for further information on embedded derivatives.

A financial instrument or other contract that does not met the initial net investment characteristic of a derivative is not a derivative.

2.2.1.4 Net settlement

Whether a financial instrument or other contract meets the definition of a derivative is often determined by whether the net settlement characteristic exists. To meet the net settlement characteristic of a derivative, 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 following 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. Each of the three forms of net settlement are discussed further in the following subsections.

2.2.1.4.1 Contractual net settlement

The following explanation of contractual net settlement is provided in 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.

Whereas gross settlement refers to a two-way form of settlement where one party transfers cash and the other party transfers a physical asset, contractual net settlement essentially refers to a one-way transfer to settle a contract whereby only 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 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.

A financial instrument that requires or permits net share settlement has the net settlement characteristic of a derivative.

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, 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 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 item(s) that is subject to the contract (common in commodity contracts that require physical delivery)	The net settlement characteristic exists because the amount of the penalty is based on changes in the price of the item(s) subject to the contract. See ASC 815-10-15-103(a).

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 item(s) subject to the contract. See ASC 815-10-15-103(b).
A fixed-penalty amount per unit ($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 item(s) subject to the contract. See ASC 815-10-15-103(b).
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 being assessed in relation to the overall penalty.

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 favorable price changes only 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. 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 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. Under those circumstances, those kinds of contracts would meet the characteristic described as net settlement in ASC 815-10-15-100.

As this guidance implies, if an asymmetrical default provision exists, an entity should consider how the parties have historically settled similar contracts between them. A pattern of electing to exercise the default provision and net settling contracts indicates that the two parties have tacitly agreed to settle the contracts net such that the net settlement characteristic of a derivative would be deemed to exist.

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

Example 2.2.3: Asymmetrical Default Provision Does Not Constitute Net Settlement (from ASC 815-10-55-10 to 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 time rather than in one payment at settlement. Such a structured payout meets the net settlement characteristic of a derivative if the fair value of the cash flows that will be received (paid) approximates the amount that would be received (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 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 may be met. ASC 815-10-55-21 provides the following example:

> …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. 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 to 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 if it can be settled net by either of the following:

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

2.2.1.4.2 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 to 15-116 provides indicators for each of those primary characteristics. Not all of the indicators need to be present to satisfy a particular 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. • 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 a contract to relinquish all of its future rights or 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 because no party is relieved of both their rights and obligations under the original contract. 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	• There are multiple market participants who are willing and able to assume the rights and obligations of the seller under a contract. • 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
	implementation guidance in ASC 815-10-55-92 to 55-98.	
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. 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. • The transfer of the instrument involves standardized documentation and standardized settlement procedures. • Sales of individual contracts do not require significant negotiation. • Sales of individual contracts do not require unique structuring. • 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 or not net settlement through a market mechanism exists for a contract. See example 2.2.5 in Section 2.2.1.4.3 of this chapter about net settlement at inception and throughout the life of a contract.

A futures exchange generally satisfies all of the characteristics of a market mechanism as elaborated on 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: Does a market that lacks an exchange for settling certain contracts, but which possesses many brokers for effectuating such transactions qualify as a market mechanism under ASC 815?

Answer: 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 the following relevant guidance:

> 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.

2.2.1.4.3 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 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
- Is itself a derivative instrument (e.g., net settlement would exist in a swaption contract because the asset to be delivered, a swap, is a derivative)

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, the party would be indifferent about whether it receives that 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.

When determining if the asset to be delivered can be readily converted to cash, as mentioned in ASC 815-10-15-123, an entity should not combine individual instruments. ASC 815-10-55-111 illustrates this in the context of a long-term commodity supply contract whereby 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 whereby 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 if there are no regulatory restrictions governing 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 definition of readily convertible to cash that is provided in the master glossary is as follows.

> 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.

The following four conditions must exist for an asset to be deemed to be readily convertible to cash.

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

The conditions that must exist for an asset to be considered to be readily convertible to cash such that the net settlement characteristic of a derivative exists are discussed further beginning in the following paragraph.

Assets that are interchangeable (fungible) units

For assets to be delivered pursuant to a contract to be considered readily convertible to cash such that the net settlement characteristic of a derivative is met, the assets must be interchangeable. The individual assets that comprise a group of assets are interchangeable if each of the individual assets within the group are indistinguishable from one another. This means that any one of the individual assets within the group could replace any one of the other individual 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 under a contract to be considered readily convertible to cash such that the net settlement characteristic of a derivative is met, the assets must have prices quoted in an active market.

The master glossary provides the following definition of an 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 such that the net settlement characteristic of a derivative is met, 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 that will 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 over a period of time that is 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, 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 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 2.2.6—Net Settlement—Effect of Multiple Deliveries.

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 features rather than a freestanding instrument. More specifically, the example discusses a single bond with multiple embedded conversion options and multiple bonds each having a single embedded conversion option. Although the example involves embedded features, the concepts regarding net settlement are the same for an embedded feature and a freestanding instrument. Refer to Chapter 3 for further information on embedded derivatives.

Example 2.2.4: Net Settlement—Readily Convertible to Cash - Effect of Daily Transaction Volumes (from ASC 815-10-55-99 to 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 3, 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 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 under a contract to be considered readily convertible to cash such that the net settlement characteristic of a derivative is met, 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, which could include, but not be limited to transportation, maintenance, and storage.

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

> 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.
>
> 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.
>
> 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, 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 to 15-138, if the issuer restricts the sale or transfer of the underlying stock for greater 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 on 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 2.2.5: Net Settlement at Inception and Throughout a Contract's Life (from ASC 815-10-55-84 to 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.

Example 2.2.6: Net Settlement—Effect of Multiple Deliveries (from ASC 815-10-55-111 to 55-118)

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 five 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 five-year contract—the forward market exists only for the next 12 months while the contract period is for the next five 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 five-year contract into five 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 or not the contract would qualify for the normal purchases and normal sales scope exception as discussed beginning in paragraph 815-10-15-22.

2.3 Scope exceptions

The scope of ASC 815 is comprised of a broadly crafted definition of a derivative along with an extensive list of scope exceptions. The FASB intentionally created a broad definition of a derivative 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. 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 to 15-21)	Both parties to the contract	A contract that provides “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.”

Scope Exception	Can apply to:	Description of contracts scoped out
Normal purchases and normal sales (ASC 815-10-15-22 to 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 upon the adoption of ASU 2018-12, market risk benefits (ASC 815-10-15-52 to 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 to 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. • A climatic or geological variable or other physical variable. • The price or value of a nonfinancial asset or nonfinancial liability of one of the parties to the contract that meets certain conditions. • Specified volumes of sales or service revenues of one of the parties to the contract.
Derivative instruments that impede sales accounting (ASC 815-10-15-63 to 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-owned life insurance and bank-owned life insurance) that is accounted for in accordance with ASC 325-30.
Certain investment contracts (ASC 815-10-15-68 to 15-68A)	The investor	The following type of investments of a defined benefit plan: • Investments accounted for under ASC 960-325-35-1. • Insurance contracts accounted for under ASC 960-325-35-3.

Scope Exception	Can apply to:	Description of contracts scoped out
Certain loan commitments (ASC 815-10-15-69 to 15-71)	The lender	All commitments that a lender makes to originate a loan other than a commitment for a mortgage loan that will be held for sale.
	The borrower	Any loan commitment held by a borrower.
Certain interest-only strips and principal-only strips (ASC 815-10-15-72 to 15-73)	The issuer and investor	Interest-only strips and principal-only strips that result from separating a debt instrument into (a) an instrument that entitles its holder to receive payments associated with the repayment of the principal of the debt instrument and (b) 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 to 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 • Contracts subject to ASC 718 • Certain contracts to enter into a business combination, or acquisition by, or merger of, a not-for-profit entity • Certain forward contracts that require the reporting entity to deliver cash in exchange for the acquisition of a fixed number of its equity shares
Leases (ASC 815-10-15-79)	The lessor and lessee	A lease that is within the scope of ASC 840 or ASC 842.
Residual value guarantees (ASC 815-10-15-80 to 15-81)	The party who accounts for the residual value guarantee under ASC 840 or ASC 842	A residual value guarantee that is within the scope of ASC 840 or ASC 842.
Registration payment arrangements (ASC 815-10-15-82)	Both parties to the arrangement	A registration payment arrangement 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 within the scope of ASC 606 for an entity operating as a casino and for the casino operations of other entities.

2.3.1 Regular-way security trades

The following definition and example of regular-way security trades are provided in 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.

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

An entity must understand the customary settlement period as well as the regulations and marketplace conventions of the relevant market as this understanding is crucial to determine whether contracts to purchase or sell securities qualify for this exception. In the U.S., the standard settlement cycle for most broker-dealer security trades at the time of this publication is within two business days (practice had been three days prior to amended Rule 15c6-1(a) of the Securities Exchange Act of 1934 which became effective in September of 2017.) In February 2022, the SEC issued a proposed rule which would shorten the standard settlement cycle for most broker-dealer transactions from two business days after trade to one. The guidance in ASC 815-10-15-15 was not amended for the 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 and 15-17.

> 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).
>
> This 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 this 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.

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 and depository and lending institutions, as well as 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.

2.3.1.1 "When-issued" or "to-be announced" (TBA) 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 at a later date when it is issued. 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 paragraphs 815-10-15-100 through 15-109)
- A market mechanism exists to facilitate net settlement of that contract (as discussed in paragraphs 815-10-15-110 through 15-118)

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

Example 2.3.1: Regular-Way Security Trades-Shortest-Period Criterion (from ASC 815-10-55-118 to 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%) 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.

2.3.1.2 Repurchase agreements, wash sales and short sales

ASC 815-10-55-56 addresses repurchase agreements and wash sales whereby 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 treatment if the net settlement characteristic of a derivative 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), generally documented in three separate contracts:

a. Selling a security (by the short seller to the purchaser)

b. Borrowing a security (by the short seller from the lender)

c. Delivering the borrowed security (by the short seller to the purchaser)

d. Purchasing a security (by the short seller from the market)

e. Delivering the purchased security (by the short seller to the lender).

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

2.3.2 Normal purchases and normal sales

It is not uncommon for a contract to buy or sell a fungible asset like a commodity to meet the definition of a derivative. 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 derivatives. 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 to15-51 is not required to be accounted for as a derivative under ASC 815. This is the only scope exception in ASC 815 that is optional and 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 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 is accounted for as a derivative until the designation is made.

The following explanation of what constitutes normal purchases and normal sales is provided in 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 considering 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 at the date the entity decides to elect to account for that contract as a normal purchase or normal sale, if later. 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. An example follows:

A-1 Manufacturer enters into long-term purchase contracts with its oil supplier that have all the characteristics of a derivative to lock in a fixed oil price for quantities that are reflective of its expected future needs. A-1 Manufacturer does not want the income statement 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 derivatives 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 derivatives at fair value through earnings.

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 derivatives under ASC 815 even if the contract otherwise meets the definition of a derivative. 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 the following:

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

- Documentation

2.3.2.1 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 to 15-29 provide the following guidance for determining whether a contract includes normal terms in relation to an entity's business requirements.

> 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
>
> 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 quantities 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 judgement and consider the factors and evidence as described in the guidance in ASC 815-10-15-28 to 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 as previously described does not qualify for the normal purchases and normal sales scope exception. A contract that contains normal terms must also meet all of the other conditions in ASC 815-10-15-30 to 15-51 that are applicable to qualify for this scope exception.

2.3.2.2 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 3 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 the following guidance on analyzing the phrase "clearly and closely related."

> 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. As a result, a contract that contains any of these price adjustments would not qualify for the normal purchases and normal sales scope exception.

a. The underlying is extraneous (that is, 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.

b. If the underlying is not extraneous as discussed in (a), the magnitude and direction of the impact of the price adjustment are not consistent with the relevancy of the underlying. That is, 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).

c. The underlying is a currency exchange rate involving a foreign currency that meets none of the criteria in paragraph 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 (sold) is provided in 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 to 15-29 and 15-35 to 15-51 that are applicable to qualify for this scope exception).

2.3.2.3 Probable physical settlement

For contracts that have contractual net settlement provisions or a market mechanism for net settlement, 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 to qualify for the normal purchases and normal sales scope exception. This condition is provided in 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 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).

If it is not probable at inception and throughout its term that a contract with a contractual net settlement provision or a market mechanism for net settlement will not settle net and will result in physical delivery, it does not qualify for the normal purchases and normal sales scope exception. 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 to 15-34 and 15-37 to 15-51 to qualify for this scope exception).

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 reason(s) 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.

2.3.2.4 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 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 2.3.2.3 of this chapter, 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 to 15-51.

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

2.3.2.4.1 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.

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 to 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 to 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.

2.3.2.5 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, which make a futures contract ineligible for the normal purchases and normal sales scope exception pursuant to ASC 815-10-15-36.

2.3.2.6 Contracts with optionality features

Rather than entering forward contracts that commit the parties to purchase or sell a stated quantity of a certain item, entities may enter 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, ASC 815-10-55-24 and 55-28 to 55-29 whereby 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 to 15-51 (Refer to Section 2.3.2.7.1 of this chapter)
- The option component permits the holder only to purchase (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 2.3.2: Normal Purchases and Normal Sales—Application to Forward Contracts that Contain Optionality Features (from ASC 815-10-55-121 to 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.

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 derivatives— one that 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 into two or more derivatives.
- 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 to 55-30 provide further guidance on accounting for forward contracts with optionality.

2.3.2.7 Electricity contracts

ASC 815-10-15-36A addresses the purchase (sale) of electricity on a forward basis and whether such purchase (sale) with transmission services constitutes 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.

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.

2.3.2.7.1 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 quality 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 provides guidance in ASC 815-10-15-45 to 15-51 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 815-10-15-45 and 15-37 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 in 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 below.
	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.

Conditions apply to	Condition to be met
	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 a 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 being booked 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. Said another way, 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 is not considered to be net settled as a consequence of it:

1. requiring 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,
2. transferring the legal title of the electricity to the ISO during transmission, or
3. involving 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.

> 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, 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.

	Option Contract That Is a Capacity Contract	Financial Option Contract on Electricity
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 to 15-44 That is, the guidance summarized in Section 2.3.2 of this chapter 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 (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.

2.3.2.8 Take-or-pay contracts

A take-or-pay contract is a contract whereby 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 and would qualify for the normal purchases and normal sales scope exception if all of the relevant conditions are met.

2.3.2.8.1 Contracts that meet the definition of a derivative after inception

If a contract meets the definition of a derivative in ASC 815 after its initial recognition, an entity may apply the normal purchases and normal sales scope exception as soon as it realizes the contract meets the definition of a derivative. However, the entity will still have to meet the documentation and other conditions of the normal purchases and normal sales scope exception.

2.3.3 Certain insurance contracts and upon the adoption of ASU 2018-12, 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 derivatives.

Specifically, neither the holder nor issuer of a contract that meets all of the following conditions provided in ASC 815-10-15-52 should account for the contract as a derivative under ASC 815.

- 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.

We have observed that 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 traditional life insurance contracts and traditional casualty insurance contracts from the guidance in ASC 815 is provided in ASC 815-10-15-53, which is 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 (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 (for example, 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. An indexed annuity, a variable life insurance contract, a property and casualty contract with foreign currency options and a nontraditional life insurance contract that is primarily an investment that incidentally provides a death benefit are examples of insurance products that may have a derivative component. An entity should evaluate such a contract to determine if it contains an embedded derivative that is required to 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 3 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 2.3.3: Certain Insurance Contracts—Essentially Assured Amounts (from 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 determined to be highly probable of occurring does not qualify for the insurance contract scope exception if both of the following conditions are met:

- Those minimum payment cash flows are indexed to or altered by changes in a variable.
- Those minimum payment amounts are 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 3 for further information on embedded derivatives.

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 policy holder 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 as a consequence 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 to 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 that is discussed later in this chapter.

2.3.4 Certain financial guarantee contracts

A financial guarantee is an agreement whereby 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. However, the FASB created a scope exception so that certain financial guarantee contracts are not

accounted for as derivatives. Specifically, neither the guaranteed party nor the guarantor account for a contract that meets all of the following conditions in ASC 815-10-15-58 as a derivative under ASC 815.

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.

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

> …..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 as a consequence of the specified party filing for bankruptcy.
A guarantee that requires the guarantor to make a payment if the	Does not apply. For a contract to qualify for the financial guarantee scope exception, it must provide for payments to be

Description of the contract	Financial guarantee scope exception
specified party violates a debt covenant	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 was automatically accelerated due to the occurrence of a "nonpayment-based" default (e.g., bankruptcy, debt covenant violation, change in control)	It depends. 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, the payments under the guarantee 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 make its payment 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.
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	It would apply if all the conditions in ASC 815-10-15-58 are met. The aforementioned 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 derivatives that transfer credit risk from one party to another party	It depends. Some credit derivatives 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

Description of the contract	Financial guarantee scope exception
	circumstances whereby all the conditions in ASC 815-10-15-58 are not met, the scope exception does not apply.

Financial guarantees and ASC 460

If a financial guarantee is excluded from ASC 815, the entity would consider the guidance in ASC 460 if applicable to determine the appropriate recognition, measurement and disclosure requirements related to the contract. Also, as elaborated on in ASC 460-10-50-1, certain disclosures required by ASC 460 are applicable to guarantees that are outside the scope of ASC 460 (e.g., guarantees accounted for as derivatives in accordance with ASC 815, except for credit derivatives). In addition, ASC 944-20 provides accounting guidance for financial guarantees that are insurance contracts and reinsurance contracts that do not meet the definition of a derivative that are issued by insurance entities.

2.3.5 Certain nonexchange traded contracts

ASC 815 provides the following four 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

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 in ASC 815 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 to 15-61, determining whether a contract qualifies for one of the nonexchange-traded scope exceptions depends on the contract's predominant characteristics. This means that an entity should account for a contract as a derivative 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.

2.3.5.1 Climatic, geological or other physical variable

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

The following are examples of underlyings contained in certain contracts that may qualify for this scope exception:

- 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 in a contract (e.g., to hedge against property casualty)
- Temperature or average temperatures 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. 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 2.3.7 of this chapter.

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 2.3.4: Certain Contracts that Are Not Traded on an Exchange—Distinguishing Between Physical and Financial Variables (from ASC 815-10-55-135 to 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, 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 two underlyings—a physical variable (that is, the occurrence of at least one 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 derivatives that qualify for this scope exception may be within the scope of ASC 815-45.

2.3.5.2 Nonfinancial asset or liability

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

Under ASC 815-10-15-59(b), the underlying on which settlement is based is:

> 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:
>
> 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.)

Under ASC 815-10-15-59(c), the underlying on which settlement is based is:

> 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.

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, we expect that more assets will be readily convertible to cash.

If any of the relevant 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.

The following are some examples of nonfinancial assets that we believe may be considered unique:

- 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, or watercraft, etc.

The preceding list is not meant to be all inclusive.

2.3.5.2.1 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.

> 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. 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 to 55-9.

Example 2.3.5: Participating mortgage (from ASC 815-15-55-8 to 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 how 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 2.3.6: Certain Contracts that Are Not Traded on an Exchange—Nonfinancial Asset of One of the Parties to a Contract (from ASC 815-10-55-142 to 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).

2.3.5.3 Specified volumes of sales or service revenues

A contract that is not traded on an exchange for which the underlying on which settlement is based is specified volumes of sales or service revenues of one of the parties to the contract is not accounted for as a derivative under ASC 815-10-15-59(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 a contract that provides for settlements that are based on sales volume or service revenues of one of the parties to the contract was not intended to be accounted for as a derivative. A lease contract may contain a clause whereby 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 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.

Sales and revenues underlying

ASC 815-10-15-59(d) notes that the specified volumes of sales or service revenues scope exception does not apply to "contracts based on changes in sales or revenues due to changes in market prices". However, we believe the FASB did not intend to prohibit the application of this exception to royalty arrangements that require payments based on changes in revenues that are due to changes in market prices when such changes are applied to the volume of items sold or services rendered. As a result, we believe that the conditions for the specified volumes of sales or service revenues scope exception can be satisfied by royalty arrangements that require payments based on changes in either sales or revenues that are due to both changes in per unit market prices and in the number of units.

2.3.6 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 potential derivative impedes the recognition of a related contract as a sale. An example would be an entity that sells loans and has an option to purchase them back. 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 statement of financial position. 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 in a transfer that is subject to ASC 860.

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

The following table describes certain potential derivatives and whether they qualify for the sales accounting impediment scope exception.

Description of the potential derivative	Applicability of the sales accounting impediment scope exception
Cleanup call—an option held by the servicer or its affiliate, which may be the transferor, to purchase the remaining 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 in relationship to the benefits of servicing.	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 and the transferred asset would be double counting the assets on the statement of financial position.
A call option (other than a cleanup call) 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 problem of double counting that would occur if the transferred financial asset was not derecognized and a derivative instrument was recognized.
A derivative that a transferor holds 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 under ASC 815 if recognizing both the derivative 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.

2.3.7 Investments in life Insurance

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

2.3.8 Certain investment contracts

There is guidance within ASC 960 that 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 derivatives. As explained in ASC 815-10-15-68, this scope exception applies only to the following investment contracts:

- Plan investments accounted for under ASC 960-325-35-1
- 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.

2.3.8.1 Synthetic guaranteed investment contracts

As the name implies, a synthetic guaranteed investment contract is a financial instrument that simulates the performance of a guaranteed investment contract. An in-depth discussion of these contracts is included in ASC 815-10-05-8 through 05-15 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. 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.

2.3.9 Certain loan commitments

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

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

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

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. Such a commitment often is a derivative that would be subject to ASC 815 if net settlement exists (e.g., because the loans that are subject to the commitment can be readily converted to cash).

2.3.10 Certain interest-only strips and principal-only strips

Interest-only strips (I/Os) and principal-only strips (P/Os) result from separating a debt instrument into (a) an instrument that is entitled to receive payments associated with the repayment of the principal of the debt instrument (the P/O) and (b) an instrument that is entitled to receive payments associated with the

payments of interest on the principal balance of the debt instrument (the I/O). ASC 815 provides a narrow scope exception for simple I/Os and P/Os. The parties to an I/O or P/O strip that meets both of the following conditions, which are listed in ASC 815-10-15-72, do not account for it as a derivative under ASC 815:

a. 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.

b. It does not incorporate any terms not present in the original debt instrument.

I/O strips and P/O strips can be a form 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 strip to not qualify for this scope exception. This as well as the guidance in ASC 815-10-15-73 are reinforced in the following table.

Description of I/O strip or P/O strip	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 AS 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 to provide for servicing in excess of adequate compensation.	Does not apply
A portion of the interest or principal cash flows of a specific debt instrument for any other purpose.	Does not apply

2.3.11 Certain contracts involving an entity's own equity

One of the basic principles of ASC 815 is that a derivative instrument represents rights or obligations that meet the definitions of assets or liabilities. As an extension of that notion, items classified as equity are not accounted for as derivatives. The primary scope exception guidance is in ASC 815-10-15-74 to 15-78. The following guidance in ASC 815-10-15-74 outlines the types of contracts that qualify for the scope exception for certain contracts involving an entity's own equity:

> 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:
>
> 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

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.

As explained in ASC 815-10-15-75, the scope exceptions in the preceding paragraph 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 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, 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 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

2.3.11.1 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 Guide to Accounting for Debt and Equity Instruments in Financing Transactions Sections 5.2.2.1 and 5.2.2.2 for determining whether a contract is both:

- Indexed to the issuer's own stock
- Classified in stockholders' equity in the issuer's statement of financial position

2.3.11.2 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 under ASC 815. 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 and (or) nonemployees (including customers) in exchange for goods or services does not account for those awards as derivatives. However, such an award would be

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

As noted in ASC 815-10-55-46 to 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. As such, in circumstances like this, an entity should consider whether the modified instrument is a derivative 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.

2.3.11.3 Contracts to facilitate a business combination

In accordance with ASC 815-10-15-74(c), the parties to the following contracts do not account for them as derivatives:

- A contract between an acquirer and a seller to enter into a business combination
- A contract to enter into an acquisition by a not-for-profit entity
- A contract between one or more NFPs to enter into a merger of not-for-profit entities

Although the preceding types of contracts typically do not meet the definition of a derivative, they are nonetheless explicitly scoped out of ASC 815.

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 derivatives in their entirety or contain embedded derivatives that it should account for as derivatives in accordance with ASC 815. This evaluation includes considering whether the contracts or instruments meet the definition of a derivative 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 in ASC 815. 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 Section 12.4.

2.3.11.4 Fixed-for-fixed forward contracts

In accordance with ASC 815-10-15-74(d), a forward contract that requires settlement whereby 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 to 30-5 is not accounted for as a derivative under ASC 815. For further information on accounting for such forward contracts refer to RSM's Guide to Accounting for Debt and Equity Instruments in Financing Transactions.

2.3.12 Leases

In accordance with ASC 815-10-15-79, the lessor and lessee of a lease that is within the scope of ASC 840 or ASC 842 for the reporting entity do not account for the lease as a derivative under ASC 815. 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 3 of this guide for further information on embedded derivatives.

2.3.13 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 840 or ASC 842 is not accounted for as a derivative under ASC 815.

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, 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 under ASC 815, the guarantor should consider whether the guarantee falls within the scope of ASC 460.

2.3.14 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 under ASC 815.

2.3.15 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.

3. Embedded derivatives

3.1 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 in its entirety may contain a feature(s) that have the same or similar economic effect(s) as a derivative instrument. 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 other 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 identifying 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 potential embedded derivatives, it must also determine whether any embedded derivatives that it identified require separate accounting. Making these determinations requires careful analysis and management judgment. The process to determine if an embedded feature requires separate accounting is multi-faceted. To illustrate, an embedded feature is not accounted for separately as a derivative unless it meets the definition of a derivative under ASC 815 *and* does not meet any of the 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 recorded in earnings, the embedded derivative is not separated because essentially it is already receiving the accounting treatment that it would receive if it would be 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 the economic characteristics and risks of the host contract requires not only identifying and understanding the nature of the embedded derivative, but also requires understanding the nature of the host contract. Determining the nature of the host contract is oftentimes a subjective assessment. Consider an instrument that has been determined to contain an equity-like embedded derivative. If the host contract is more akin to equity, then 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, then the economic characteristics and risks of an embedded equity-like derivative would not be considered clearly and closely related to that of the host contract and if the other required conditions are met, the embedded feature would be accounted for separately as a derivative. This chapter explores all of these concepts in more depth.

Accounting for embedded derivatives

If it is determined that an embedded derivative requires separate accounting, it is accounted for as if it is a freestanding derivative. That is, the embedded derivative is initially and subsequently reported and measured on the statement of financial position 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 is designated as a hedging instrument in a cash flow or net investment hedge. (Refer to Chapter 3 for additional guidance on the accounting for embedded derivatives and to RSM's A Guide to Hedge Accounting Upon the Adoption of ASU 2017-12 for further guidance on hedge accounting).

3.1.1 Embedded derivative terminology

When determining whether an embedded feature must be accounted for as a derivative, 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
Host contract	The component of the hybrid instrument other than 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 that are discussed later in this chapter.

The following example demonstrates 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 included in this example, a different conclusion may be reached.

Stock purchase warrants	Warrants are generally considered to be freestanding even if issued with another financial instrument, such as debt or stock. That 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).

3.1.2 Scope exceptions

In addition to the general scope exceptions summarized in ASC 815-10-15-13 and discussed in Chapter 2 of this guide 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 to 15-21 and are summarized in the table that follows.

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 2.3.2 of Chapter 2 is not considered to contain an embedded derivative.
Unsettled foreign currency transactions (ASC 815-15-15-5 to 15-6)	Unsettled foreign currency transactions, including financial instruments, contain embedded foreign currency derivatives if the transactions meet all the following: a. They are monetary items. b. They have their principal payments, interest payments, or both denominated in a foreign currency. c. They are subject to the requirement in Subtopic 830-20 to recognize any foreign currency transaction gain or loss in earnings. 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 applies to financial instruments that are not securities as well.
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 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 tranches of securitized financial instruments for subordination purposes. Consequently, the following circumstances (among others) would not qualify for this scope exception and would potentially be subject to separate derivative accounting: a. An embedded derivative feature relating to another type of risk (including another type of credit risk) is present in the securitized financial instruments. b. The holder of an interest in a tranche of that securitized financial instrument is exposed to the possibility (however remote) of being required to make potential future payments (not merely receive reduced cash inflows) because the possibility of those future payments is not created by subordination. (Note, however, that the securitized financial instrument may involve other tranches that are not exposed to potential future payments and, thus, those other tranches might qualify for the scope exception.)

Contract, transaction or feature	Conditions that must be met to be exempt from the guidance on embedded derivatives
	c. The holder owns an interest in a single-tranche securitization vehicle; therefore, the subordination of one tranche to another is not relevant.
Features involving certain currencies (ASC 815-15-15-10 to 15-21)	An embedded foreign currency derivative is not separated from its host contract and accounted for separately as a derivative if the following conditions in ASC 815-15-15-10 are met: a. The host contract is not a financial instrument. b. The host contract requires payment(s) denominated in any of the following currencies: 1. The functional currency of any substantial party to that contract 2. The currency in which the price of the related good or service that is acquired or delivered is routinely denominated in international commerce (for example, the U.S. dollar for crude oil transactions) 3. The local currency of any substantial party to the contract 4. The currency used by a substantial party to the contract as if it were the functional currency because the primary economic environment which the party operates is highly inflationary (as discussed in paragraph 830-10-45-11) c. Other aspects of the embedded foreign currency derivative are clearly and closely related to the host contract. The evaluation of whether a contract qualifies for the exception in this paragraph should be performed only at inception of the contract. While this scope exception does not apply to financial instruments, it applies 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. Refer to ASC 815-15-55-1 to 55-4 for implementation guidance on the application of this scope exception to insurance contracts 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 counterparty). An illustration regarding this determination is provided in ASC 815-15-55-213 to 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. The following expands on two of the key concepts in this embedded foreign currency derivative scope exception. **Substantial party to a contract (ASC 815-15-15-12)** When determining who is a substantial party to the contract:

Contract, transaction or feature	Conditions that must be met to be exempt from the guidance on embedded derivatives
	• 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) • Look through the legal form of the contract to analyze the substance of the underlying relationships The implementation guidance in ASC 815-15-55-84 to 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. **Routinely denominated in international commerce (ASC 815-15-15-14)** 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 in 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. **Foreign currency caps and floors** ASC 815-15-15-15 to 15-19 should be considered when determining if the scope exception applies to foreign currency caps and floors within a nonfinancial contract.

3.1.3 Identifying potential 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 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 use similar, but not identical terms to describe the same features that may potentially represent embedded derivatives.

Potential embedded derivative	Key terminology to watch for
Conversion options (commonly found in debt instruments and preferred stock)	• Convert, convertible, upon conversion • Exchange, exchangeable

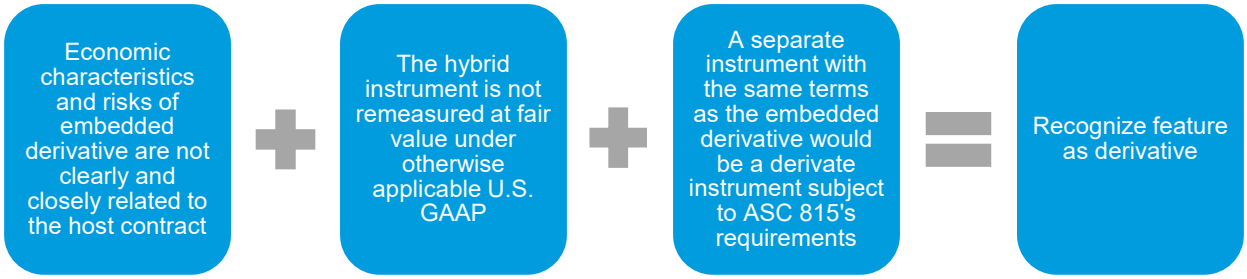
Potential embedded derivative	Key terminology to watch for
Redemption features (commonly found in debt instruments and preferred stock)	• Accelerate(d) repayment, prepay, repay • Call, callable, put, puttable • Upon the occurrence of certain contingent events (e.g., deemed liquidation, liquidation, change in control), the instrument will be paid off, redeemed • Redeem, redeemable, upon redemption • Repurchase • Return
Interest rate features/indexation	• The rate will be adjusted, increased, decreased • Ceiling(s), cap(s), floor(s), formula • The rate will be determined by • Index, indexed to, reference(d)
Credit indexation	• Amount or timing of cash flows will be adjusted upon - Bankruptcy - Default - Credit rating change
Foreign exchange indexation	• Exchange rate • The mention of a specific currency that is not the currency of the parties to the transaction • Index, indexed to, reference(d)
Equity or earnings indexation	• Amount or timing of cash flows will be adjusted based on - Equity index - Earnings metrics (EBITDA, EPS, gain(s), loss(es), net income, profit, revenue) - Formula
Commodity price indexation	• Index, indexed to, reference(d) to a particular commodity price • Ceiling(s), cap(s), floor(s), formula refencing a commodity index • Price, pricing
Other	• Cancel • Choice, choose among, choose between

Potential embedded derivative	Key terminology to watch for
	• Condition, conditional, contingency, contingent • Elect • Entitle • Exercise • Extend, extension • Option • Right(s)

3.2 Derivative analysis of embedded features

The determination of which, if any, embedded derivative must be separately recognized as a derivative is complex. Specifically, ASC 815-15-25-1 requires derivative recognition for embedded derivatives if all the following 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 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 feature separately as a derivative "if and only if" all the preceding conditions are met. As such, if the determination is made that one condition is not met for a particular embedded feature, the feature would not be accounted for as a derivative 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.

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 arise as to whether each embedded feature should be analyzed separately or combined with similar features that may exist within the same instrument or contract. Entities may

arrive at different conclusions on what features require separate accounting as a derivative 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, for example, a change in control or an initial public offering (IPO), the debt instrument could potentially be viewed as containing either:

- One conversion option (the combined approach) or
- 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. However, if the entity applied the separate approach, it would only account for the conversion feature upon an IPO as a derivative.

The level upon which the analysis should be applied is judgmental 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 for each
- Situations that would trigger settlement

We believe that because of the judgment involved, 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 features within a nonderivative host contract to determine which embedded features should be accounted for as derivatives, 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.

3.2.1 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 that of the host contract, the entity would not account for the embedded derivative separately as a derivative. 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 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 3.2.1.1 of this chapter 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, then the economic characteristics and risks of the embedded derivative would be clearly and closely related to that of the host contract and the embedded derivative would not be accounted for separately as a derivative. Conversely, if the host contract is akin to debt, then the economic characteristics and risks of the equity-like embedded derivative would be considered to be not clearly and closely related to that of the host contract. In this later case, if the other two conditions in ASC 815-15-25-1 are met, the embedded derivative would be accounted for as a derivative.

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 to 25-51A to help an entity assess this condition. (Refer also to Chapter 3 that follows 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 that 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.

3.2.1.1 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 which case 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 in the statement of financial position, 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 to be 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 to be 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. It should also be noted that the conclusion on whether 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. This is because the net settlement characteristic of a derivative is deemed to exist under ASC 815-15-15-107 for a put or call option embedded in a debt instrument. However, as noted in ASC 815-15-15-109, 15-107 does not apply to hybrid instruments that do not contain a debt host contract. As such, a put, call or redemption option that is embedded in an equity host contract would not be a derivative unless the net settlement characteristic of a derivative 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 it is more debt-like or equity-like and weighted based on relevant facts and circumstances in existence at the date of issuance. The template that follows is provided as a tool in evaluating and weighting features

commonly associated with preferred stock to arrive at a conclusion on the nature of the host contract as more debt-like or equity-like.

Factors to consider	Insights 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.	
Is the redemption right in the money or out of the money?	An in-the-money right would be given more weight.	
Is a conversion option also provided, and if so, 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 and (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.	

Factors to consider	Insights on weighting certain factors	Analysis
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.	
Voting rights (equity-like characteristic weighted commensurately with the level of influence the rights provide)		
Does the holder have voting rights and if so, are they entitled to vote on all or limited matters?		
How much influence can the holder's class of stock exercise based on its voting rights?		
Dividend rights		
Are the dividends mandatory or discretionary?	Mandatory dividends are a debt-like characteristic, while discretionary dividends are an equity-like characteristic.	

Factors to consider	Insights on weighting certain factors	Analysis
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 the instrument contains a redemption option held by the investor (holder), is the issuer's performance upon redemption guaranteed by the parent of the issuer or otherwise?		
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)?		
Conclusion: Because the factors to consider and the most likely outcome of the instrument, conclude as to the nature of the preferred stock host contract as more debt-like or equity-like and the weight placed on the various features in reaching that conclusion.		

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

3.2.1.2 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 potential embedded derivative(s) 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.

3.2.2 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 is whether the hybrid instrument would not otherwise be measured at fair value with changes in fair value reported in earnings. That is because if the hybrid instrument that contains the embedded derivative is accounted for at fair value with the changes in its fair value recorded in earnings, the embedded derivative is essentially already receiving the accounting treatment that would be required if it were accounted for separately as a derivative. 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 recorded in other comprehensive income, not earnings.

Fair value option

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 fair value option (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 other comprehensive income instead of earnings.

Refer to ASC 815-15-25-4 to 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.

3.2.3 Embedded component would be accounted for as a derivative

An entity does not account for an embedded derivative separately as a derivative unless a separate instrument with the same terms as the embedded derivative meets the definition of a derivative and does not qualify for one of the scope exceptions in ASC 815. Refer to Chapter 2 for the definition of a derivative and the general scope exceptions in ASC 815 as well as Section 3.1.2 within this chapter 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 to be 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.

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. Continuing along with the convertible bond example, let us 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 exchanged 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. We have observed that the initial net investment characteristic of a derivative is often met for an embedded feature. Refer to Section 2.2.1.3 of Chapter 2 for further discussion on the initial net investment characteristic of the definition of a derivative.

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 to 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.

3.3 Application of the embedded derivative guidance to various types of host contracts

The rest of this chapter will focus on how the guidance on embedded derivatives applies to the following hybrid instruments:

- Hybrid instruments with a debt host contract
- Hybrid instruments with an equity host contract
- Hybrid instruments with a lease host contract
- Hybrid instruments with an insurance host contract
- Hybrid instruments with an executory host contract

3.3.1 Hybrid instruments with a debt host contract

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

The focus when determining if there are features within a debt host contract that may require separate recognition as a derivative 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.

3.3.1.1 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 derivative that leverages the interest rate on the instrument to such a great degree that the economic characteristics and risks of the embedded interest 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 to be 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 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 potential 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 includes a situation whereby 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 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 features 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 3.3.1.5 of this chapter 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 one or both 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 of the fact that 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 however a subsequent acquirer may have paid a premium or discount on the secondary market).

- Interest-only and principal-only strips may qualify for the derivative scope exception described in ASC 815-10-15-72 to 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 callable at par value at any time during its 10-year term.	No.	The fixed-rate debt instrument is callable at par value only by the issuer.
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	No.	The instrument is callable only by the issuer, so the embedded call option feature

Instrument	Paragraph 815-15-25-26(b) Applicable to the Embedded Call Option?	Comments
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).		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 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.

3.3.1.1.1 Doubling the initial and market rate of return

A debt instrument may contain an embedded interest 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
Initial rate of return	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 initial rate of return 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.

	Commentary
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 may appear on the surface to be rather benign can meet the double-double test outlined in ASC 815-15-25-26(b) and therefore result in an embedded derivative that should be accounted for separately. Something to watch for is whether there is an inconsistency between how the variable interest rate is determined and how frequently the interest rate resets. Consider the following example of a financial instrument that pays an interest rate that is based on a rolling average of a variable rate, including the following assumptions:

- Interest is based on the 12-month rolling average of one-month LIBOR
- Interest rate resets monthly
- Interest is paid monthly
- One-month LIBOR is 1% at the initial recognition of the instrument
- The 12-month rolling average of one-month LIBOR 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 that pays interest based on one-month LIBOR that resets every month *and* an embedded derivative that adjusts the interest rate from one-month LIBOR to the 12-month rolling average of one-month LIBOR.

Continuing our example, consider the following scenario that while it may be remote, is possible of occurring:

- One-month LIBOR moves up to 4% and remains at 4% for 11 months
- In the twelfth month, one-month LIBOR drops to 1.5%

After LIBOR 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 initial rate of return of the host contract of 1% while also being more than twice the then current one-month LIBOR market rate of 1.5%. In this case, the embedded derivative that adjusts the interest rate from one-month LIBOR to the 12-month rolling average of one-month LIBOR 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 unless the hybrid instrument is accounted for in its entirety at fair value 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.

See the table in Section 3.3.1.1 of this chapter that comes from ASC 815-15-55-25 and provides application of the guidance in ASC 815-15-25-37 through 25-39 to specific debt instruments.

3.3.1.1.2 Interest rate reset features related to the elimination of LIBOR

The LIBOR, which is referenced in approximately $350 trillion of contracts, is expected to be eliminated by June 30, 2023. In the U.S., the Alternative Reference Rates Committee (ARRC) convened by the Federal Reserve Board has recommended the Secured Overnight Financing Rate (SOFR) as the preferred alternative to LIBOR. The replacement of LIBOR with an alternative rate will have 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[1]. The fact pattern discussed the following interest rate reset conventions:

- Term SOFR
- Compounded SOFR in-arrears
- Compounded SOFR in-advance
- Average SOFR in-advance

In this fact pattern, an entity needed to assess whether the above 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 is required because for example, the double-double test discussed at Section 3.3.1.1 of this chapter is met. However, the entity determined that these features should be considered terms of the debt host contract based on the following:

- 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.

3.3.1.1.3 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 to be clearly and closely related to their debt host contract, unless either of the conditions in ASC 815-15-25-26 are met. Those conditions are typically not met such that embedded interest rate caps or floors are generally not accounted for as a derivative.

3.3.1.1.4 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 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 bonds.

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 derivative creates significant leverage. A leveraged inflation feature would not be considered clearly

[1] A script of the remarks is available at https://www.sec.gov/news/speech/pearce-remarks-aicpa-2020.

and closely related to a debt host contract and would need to be separately recognized as a derivative if it has all the characteristics of a derivative 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 that CPI by itself.

3.3.1.1.5 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 or other events of default).

ASC 815-15-25-46 provides the following guidance on embedded derivatives that adjust the interest rate on an instrument based on the issuer's or borrower's creditworthiness:

> 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 which case, the feature may require separate accounting as a derivative 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, 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 of the instrument (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 a potential 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 potential 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, but the embedded derivative has the economic characteristics and risks of debt issued by another party. Therefore, the host contact and potential embedded derivative are not clearly and closely related. This guidance does affect the accounting for nonrecourse debt whereby 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.

3.3.1.2 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 as rights to receive all or portions of specified cash inflows received by a trust or other entity, including, but not limited to 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 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 IOs and POs (see ASC 815-10-15-72 to 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 in its entirety or contains an embedded derivative, an entity will have to assess whether the initial net investment characteristic of a derivative 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 2.2.1.3 of this chapter for more discussion on the Initial net investment characteristic of a derivative.

Various examples of the application of the embedded derivative analysis to beneficial interests and securitization structures are provided in ASC 815-15-55-222 to 55-226D. The following is a summary of select features that generally warrant further assessment to determine whether derivative recognition is necessary.

- Prepayment features that are 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 aka ROAPs)
- Credit default swaps, interest rate swaps, cross-currency swaps and other derivatives that an entity enters into as part of the securitization structure, particularly when the notional amount of the derivative 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 its initial recorded investment or meeting the double-double test described at Section 3.3.1.1 of this chapter

Refer to ASC 815-15-25-33 to 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 *aka* a 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 and (or) 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 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. Given 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, the credit default swaps would require derivative recognition.

3.3.1.3 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. Imagine that the bank and the gas producer agree that the gas producer will pay a greater rate of interest than it otherwise would when gas prices are high; and in exchange for this, the gas producer will pay a lesser rate of interest than it otherwise would 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 recorded in earnings, the embedded derivative would be accounted for separately.

3.3.1.4 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 from ASC 815-15-55 illustrate the application of the derivative scope exceptions for non-exchange traded contracts that are discussed in Section 2.3.5 of Chapter 2 to certain derivatives that may be embedded in debt host contracts.

Example 3.3.1: Participating mortgage (from ASC 815-15-55-8 to 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 3.3.2: Equity Kicker Feature (from ASC 815-15-55-10 to 55-11)

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.

A loan with an equity kicker of more than 50 percent of net earnings that is considered to be 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.

3.3.1.5 Redemption options and other features that can accelerate payoff

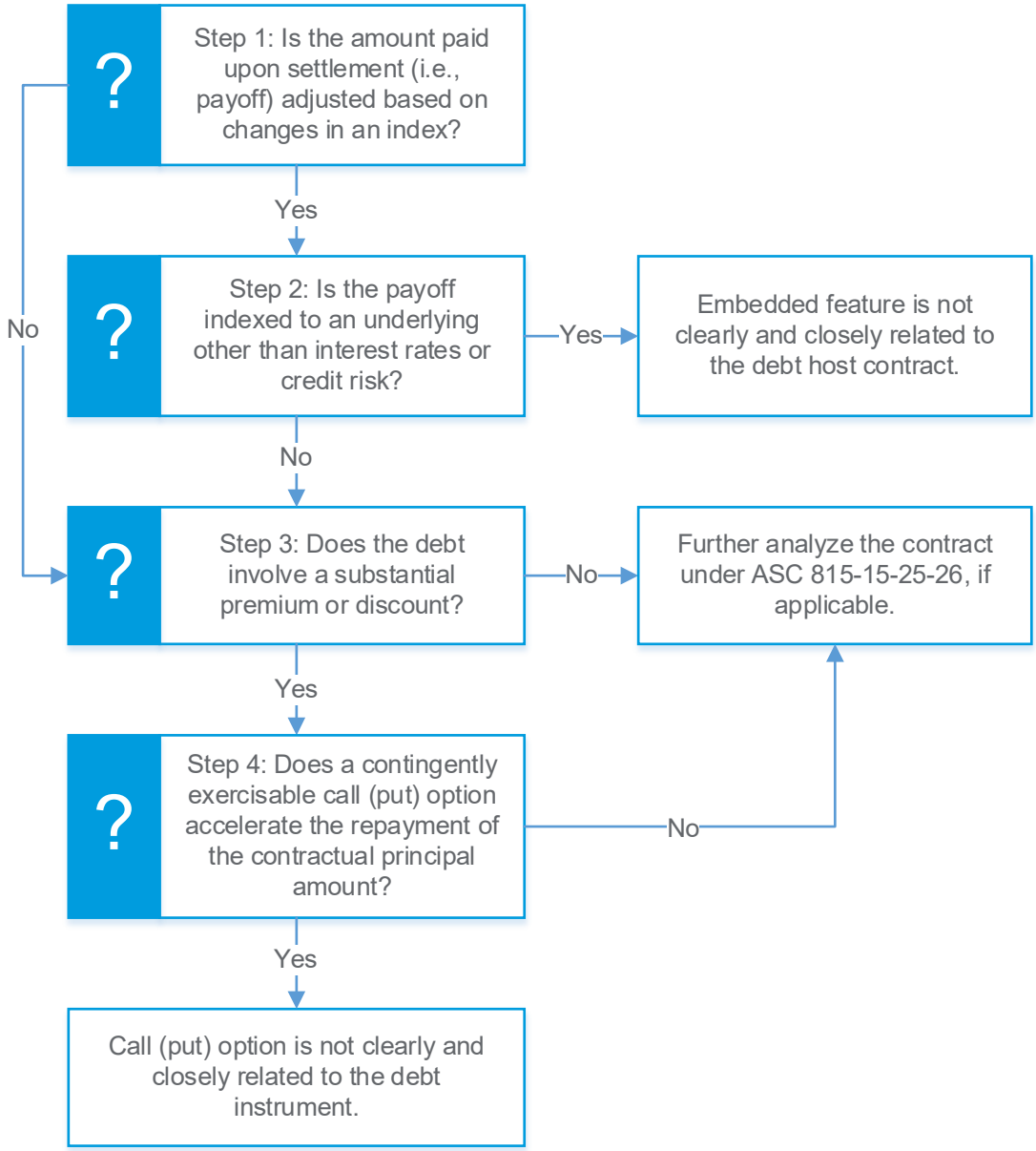
Redemption options can be thought of as put options or call options.

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 if it met all the characteristics of a derivative.

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 four-step 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 are met, if applicable. (Refer to Section 3.3.1.1 of this chapter).

An example of the type of put or call option that we have observed most frequently in practice 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. As such, 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 typically the holder would 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 in this analysis.

The guidance in ASC 815-15-25-26 discussed at Section 3.3.1.1 of this chapter should be considered before concluding 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 the only underlying in the potential derivative is an interest rate or interest rate index. If exercise of a put or call option is contingent on the occurrence of a certain event, such as a change in control, this would constitute a non-interest rate underlying and, as such, 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 to be 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.
2. Debt that is issued at par is callable at any time during its term. If the debt is called, the investor receives the	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

Instrument	Indexed Payoff? (Steps 1 and 2)	Substantial Discount or Premium? (Step 3)	Contingently Exercisable? (Step 4)	Embedded Option Clearly and Closely Related?
greater of the par value of the debt or the market value of 100,000 shares of XYZ common stock (an unrelated entity)?				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 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 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	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	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

Instrument	Indexed Payoff? (Steps 1 and 2)	Substantial Discount or Premium? (Step 3)	Contingently Exercisable? (Step 4)	Embedded Option Clearly and Closely Related?
amortization table based on the effective interest rate method).			repayment of principal.	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 investor will be repaid based on the value of Entity XYZ's common stock.	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.
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.

Distinguishing between conversion and redemption options

Standard conversion options allow for conversion of the debt 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 relate to a debt host contract, redemption options may be. Additionally, net settlement would generally exist under ASC 815-10-15-107 for conversion features in debt host contracts that are in substance redemption options because the value of the feature is not expected to vary with changes in the fair value of the underlying shares.

3.3.1.6 Conversion options

A convertible debt instrument is one of the most common hybrid instruments. Convertible debt is debt that contains a conversion feature which 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, an entity must determine whether the conversion option would meet the definition of a derivative if it was a freestanding instrument. This often hinges on whether the net settlement characteristic of a derivative 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 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 as 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 to be 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 to be 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.

If the determination is made that an option to convert to equity in a debt host contract is a derivative, 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.

3.3.1.7 Term extension feature

A term extension feature is defined in ASC 815-15-25-44 as an embedded derivative that does one of the following two things:

- 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 indicates 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 if all the characteristics of a derivative 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 to 15-71.

3.3.1.8 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.

3.3.1.9 Illustrative examples of applying the embedded derivative guidance to common features within debt host contracts

The chart that follows provides RSM's insights on whether the first and third criterion in ASC 815-15-25-1 are met for common embedded features found in debt host contracts. Criterion one is that the economic characteristics and risks of the potential 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 feature meets the definition of a derivative 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 feature would require separate recognition as a derivative.

	Are the economic characteristics and risks of the potential embedded derivative not clearly and closely related to the host contract?	**Does the embedded feature meet the definition of a derivative and is not eligible for a scope exception?**
Debt host contract, including preferred shares that are more akin to debt:		
Conversion options (Note 1)	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 if net settlement exists (e.g., contractually or because the conversion shares are actively traded). The price of

	Are the economic characteristics and risks of the potential embedded derivative not clearly and closely related to the host contract?	Does the embedded feature meet the definition of a derivative and is not eligible for a scope exception?
		the shares is an underlying, the number of shares it can convert into is a notional amount and there is generally no or little initial net investment associated with the conversion option. From the issuer's perspective, it may qualify for the scope exception for certain contracts involving an entity's own equity.
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 features that can accelerate the maturity typically meet the definition of a derivative in a debt host contract. 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 no or little initial net investment associated with the feature. The net settlement characteristic is present for features that can accelerate the maturity of a debt host contract due to ASC 815-10-15-107. Generally, embedded features require no or minimal initial net investment.
Interest rate floors, caps, collars	The economic characteristics and risks of interest rate floors, caps and collars are often considered to be 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. These instruments have an underlying (i.e., an interest rate or index) and have a notional amount (i.e., the face amount). Further, these embedded features typically require no or little 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 to be clearly and closely related to a debt host contract such that this criterion would not be met if the default interest or payments are	Features that provide for default interest and other credit sensitive payments typically meet the definition of a derivative. These features have an underlying because they provide for a

	Are the economic characteristics and risks of the potential embedded derivative not clearly and closely related to the host contract?	Does the embedded feature meet the definition of a derivative and is not eligible for a scope exception?
	based on the default or change in credit worthiness of the obligor (ASC 815-15-25-46 and 25-47).	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, these features typically require no or little 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 unless net settlement exists. Further, a term extending option would not be accounted for as a derivative 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 price or index or an equity price or index typically meet the definition of a derivative. The commodity price or index or equity price or index is considered an underlying. Further, these features typically have a payment provision or notional amount to which the index is applied and require no or minimal initial net investment. Typically, these features 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 to be clearly and closely related to a debt host contract unless a significant leverage factor is involved or	The definition of a derivative typically would be met because the embedded features that provide for inflation indexed payments have an underlying (i.e.,

	Are the economic characteristics and risks of the potential embedded derivative not clearly and closely related to the host contract?	Does the embedded feature meet the definition of a derivative and is not eligible for a scope exception?
	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).	inflation index), and typically, have a notional amount (the payment amount to which the index is applied), require no or little 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).

Note 1: 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.

3.3.2 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. Reference should be made to the preceding section entitled Hybrid instruments with a debt host contract when the nature of the host contract is determined to be more debt-like. Refer to Section 3.2.1.1 of this chapter 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.

3.3.2.1 Redemption options (Put and (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 such, 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, they generally require separate recognition as a derivative. (The issuer would not account for embedded put and call options as derivatives if all the requirements for the scope exception in ASC 815-10-15-74(a) are met. Refer to Section 2.3.11.1 of Chapter 2 for further discussion on this scope exception).

3.3.2.2 Conversion options

An equity instrument may contain an option whereby automatically, contingently, or at the holder's option the instrument will convert from one class of the issuer's shares to another class of the issuer's shares (most commonly, from preferred stock to common). An embedded option to convert into equity generally has economic characteristics and risks that are clearly and closely related to an equity host contract and would therefore not be accounted for separately as a derivative.

3.3.2.3 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. 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 useful in determining if the rights are embedded or freestanding and in understanding the accounting ramifications based on that determination.

3.3.2.4 Illustrative examples of applying the embedded derivative guidance to common features within equity host contracts

The chart that follows provides RSM's insights on whether the first and third criterion in ASC 815-15-25-1 are met for common embedded features found in equity host contracts. (Refer to the chart in Section 3.3.1.9 of this chapter if the host contract was deemed to be more debt-like). Criterion one is that the economic characteristics and risks of the potential 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 feature meets the definition of a derivative 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 feature would require separate recognition as a derivative.

	Are the economic characteristics and risks of the potential embedded derivative not clearly and closely related to the host contract?	**Does the embedded feature meet the definition of a derivative and is not eligible for a scope exception?**
Equity host contract:		
Option to convert to another class of equity (Note 1)	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 if net settlement exists (e.g., contractually or because the conversion shares are actively traded). Whether the conversion option is a derivative in an equity host contract 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.

	Are the economic characteristics and risks of the potential embedded derivative not clearly and closely related to the host contract?	Does the embedded feature meet the definition of a derivative and is not eligible for a scope exception?
Redemption features put/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 feature(s) embedded in an equity host contract typically meet the definition of a derivative 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 features in 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). 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.

Note 1: 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.

3.3.3 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 that is similar to that used for a debt host contract. In other words, the nature of the host contract is generally determined by excluding the potential embedded derivative(s) 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 attention to determine if separate recognition as a derivative is required.

3.3.3.1 Illustrative examples of applying the embedded derivative guidance to common features within lease host contracts

The chart that follows provides RSM's insights on whether the first and third criterion in ASC 815-15-25-1 are met for common embedded features found in lease host contracts. Criterion one is that the economic characteristics and risks of the potential 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 feature meets the definition of a derivative 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 feature would require separate recognition as a derivative.

	Are the economic characteristics and risks of the potential embedded derivative not clearly and closely related to the host contract?	Does the embedded feature meet the definition of a derivative and is not eligible for a scope exception?
Lease host contract:		
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 typically would be met because the embedded features that provide for inflation indexed rentals have an underlying (i.e., inflation index), and typically, have a notional amount (the payment amount to which the index is applied), require no or little 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 related to a lease host contract under ASC 815-15-25-22.	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.
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 gross sales	Both the clearly and closely related criterion and whether the feature meets the definition of a derivative are irrelevant because 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.	

	Are the economic characteristics and risks of the potential embedded derivative not clearly and closely related to the host contract?	Does the embedded feature meet the definition of a derivative and is not eligible for a scope exception?
for the month		
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 are generally irrelevant because an option to purchase a leased asset would typically qualify for the scope exception in ASC 815-10-15-59(b) as long as 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.	

3.3.4 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 to 55-56)
- Payment options for variable annuity contracts (ASC 815-15-55-57 to 55-61)
- Equity-indexed annuity contracts (ASC 815-15-55-62 to 55-72)
- Equity-indexed life insurance contracts (ASC 815-15-55-73 to 55-76)
- Modified coinsurance arrangements (ASC 815-15-55-107 to 55-109)

3.3.4.1 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" that are 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 Section 2.3.3 of Chapter 2 for an illustration of the concept of essentially assured.

3.3.4.2 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 (or) 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 policy holder 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 and for each component, indicates whether it should be accounted for separately as a derivative and the basis for that conclusion:

Component	Accounted for separately?	Basis for conclusion
Death benefit component (i.e., the previously discussed 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, upon the adoption of ASU 2018-12, death benefits that meet the criteria of market risk benefits are excluded from the scope of ASC 815.
Investment component (i.e., the previously discussed 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. 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	Depends	In accordance with ASC 815-15-55-55(b), such an investment component would be accounted for separately as a derivative if it meets all the conditions in ASC 815-15-25-1. Upon the adoption of ASU 2018-12, 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. 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	Depends	In accordance with ASC 815-15-55-55(d), upon the adoption of ASU 2018-12, payment options are not subject to ASC 815 if the payment is a market risk benefit within the scope of ASC 944. Prior to the adoption of ASU 2018-12, payment alternatives are subject to the scope of ASC 815 if interest rates, or other underlying variables affect the fair value.
A guarantee of a minimum interest rate that is used to compute periodic annuity	No	The net settlement characteristic of a derivative is not met because settlement can be achieved only by the investment of the account balance in lieu of an

Component	Accounted for separately?	Basis for conclusion
payments if and when the policyholder chooses to annuitize		immediate payout. Refer to ASC 815-10-15-99 and 815-15-55-58 for further information. Upon the adoption of ASU 2018-12, 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 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 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). Refer to ASC 815-10-55-59 for further information. This guidance is superseded upon the adoption of ASU 2018-12.
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 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. Refer to ASC 815-10-55-60 for further information. This guidance is superseded upon the adoption of ASU 2018-12.

3.3.4.3 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 its contract at any time and receive its account value less any surrender charges.

ASC 815-15-55-63 explains that the following are the two basic designs of equity-indexed annuities.

a. 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

b. 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 to 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.

3.3.4.4 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 to be 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 separate from the insurance contract.

Refer to ASC 815-15-55-73 to 55-76 for accounting guidance on equity-indexed life insurance contracts.

3.3.5 Hybrid instruments with an executory host contract

Executory contracts often do not contain the net settlement characteristic of a derivative. As a result, such a contract generally does not meet the definition of a derivative in its entirety, but should be evaluated to assess whether it contains any embedded derivative(s) (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 in its entirety, then the entity may elect to apply the normal purchases and normal sales scope exception discussed in Section 2.3.2 of Chapter 2 if the contract qualifies as such.

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

3.3.5.1 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.

> 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. Refer to Example 6 (paragraph 815-15-55-114) for an illustration of such options.

Example 6 that begins at ASC 815-15-55-114 is useful in understanding why the purchase contract in its entirety does not meet all the characteristics of a derivative. However, the embedded cap and floor do.

3.4 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 recognized in earnings (except as noted in ASC 825-10-45-5[2]), 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 derivatives separately from the host contract. (Refer to 4.1.3 for a discussion of the presentation of derivatives that have been separated from the host contract in the statement of financial position).

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 statement of financial position at fair value and generally changes in its fair value are 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(s) is accounted for based on the accounting guidance that applies 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. 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.

[2] 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(s) 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.

3.4.1 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.

There are nuances in determining the fair value of a separated embedded derivative that are summarized in the following table:

Type of embedded derivative	Determination of fair value
Non-option based (ASC 815-15-30-4 to 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 features that require recognition as a derivative, 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. 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 derivatives in that the holder cannot both exercise 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	

Type of embedded derivative	Determination of fair value
	derivatives. As such, complex valuation models such as Monte Carlo simulations are often necessary when valuing embedded derivatives.

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 such features would not require derivative recognition under ASC 815-15-25-1.

3.4.2 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 however 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).

3.4.3 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. Certain conclusions need to be reassessed on an ongoing basis. 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, the determination of whether the embedded derivative meets the definition of a derivative and in some cases whether it qualifies for a derivative scope exception could require reassessment each reporting period. Additionally, it is generally necessary to reperform the embedded derivative analysis if an embedded feature or host contract is modified.

The table below provides examples of why the accounting treatment for an embedded derivative may change, thus emphasizing the importance of reassessing conclusions reached on whether a derivative that is embedded in a hybrid instrument requires separate recognition.

Situation	Accounting ramifications
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 in ASC 815-10-15-119 is met. Similarly, as new

Situation	Accounting ramifications
	markets develop or contract, conclusions reached about whether a market mechanism exists may change.
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 reached on whether the condition in 815-40-25-20 to apply the scope exception are met.
Instrument modification	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 for example if 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 generally conclusions reached on whether an embedded feature has characteristics and risks that are clearly and closely related to the host contract are 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 feature is a derivative, and if so, whether it qualifies for a scope exception.

4. Presentation and Disclosure

4.1 General presentation requirements

Questions have arisen about the line-item presentation of derivatives in the financial statements. ASC 815 addresses the presentation of hedging results in the statement of financial performance, but is otherwise not prescriptive on financial statement presentation. The following discussion summarizes the guidance that is available about the presentation of derivatives, and includes observations of what we have seen in practice.

4.1.1 Presentation on the statement of financial position

Derivatives should be recognized at their fair value in the statement of financial position (unless the derivative 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 derivatives can generally be either an asset or liability depending on whether the derivative 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 statement of financial position 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.

Upon the adoption of ASU No. 2022-01, Derivatives and Hedging (Topic 815), ASC 815-20-45-4 addresses the classification in the statement of financial position 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 in the statement of financial position (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.

4.1.1.1 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; hence, 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 derivatives 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 of this, the carrying amount of individual derivatives may need to be broken out between current and noncurrent classification as well as between asset and liability classification on the statement of financial position.

We believe an entity should classify a derivative 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 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 statement of financial position
Within 12 months of the reporting period end	Current

Settlement date	Classification on the statement of financial position
After 12 months of the reporting period end	Noncurrent
Multiple settlements both within 12 months 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. An example follows: 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 the following: • Gross expected cash outflows with a net present value of approximately $3 million in the next 12 months • 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) Entity A reports this interest rate swap as a $3 million current liability and $13 million noncurrent asset in its classified statement of financial position.

4.1.1.2 Offsetting

It is not uncommon for an entity to have multiple derivatives 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 statement of financial position, 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 4.1.1: 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 chart summarizes the fair values of the various swaps that are outstanding at the reporting date and the statement of financial position presentation assuming that Bank A qualifies and elects to offset the amounts related to derivative contracts with the same counterparty:

	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 $20MM and liabilities of $5MM	Net liability of $8MM	Net liability of $1 MM	Assets of $20MM and liabilities of $14MM

Because Bank A's accounting policy is to offset derivative instruments and the related cash collateral with the same counterparty under a master netting arrangement on the statement of financial position 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 statement of financial position is permitted if the following "right of setoff" conditions from ASC 210-20-45-1 are met:

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 derivatives 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 or for different types of derivatives, 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 International Swaps and Derivatives Association (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 derivatives 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 derivatives. 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 derivatives 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 derivatives 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 derivatives.

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 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

4.1.1.3 Special considerations for certain centrally cleared derivatives

Regulations that include the Dodd-Frank Wall Street Reform and Consumer Protection Act and the European Market Infrastructure Regulation require certain over-the-counter derivatives to be centrally cleared. Entities that enter into derivatives 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 to the transaction. On a given day, the party to the derivative 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 to be settled such that the settlement payments and related derivative are considered to be a single unit of account, we would expect the derivative 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 carrying amounts with collateral on CTM transactions as permitted by ASC 210-20.

4.1.2 Presentation on the statement of financial performance

If an entity holds derivatives for trading purposes, ASC 815-10-45-9 requires the gains and losses (whether realized or unrealized) related to those derivatives to be shown net on the statement of financial performance, 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 derivatives that are not held for trading purposes should be reported on the statement of financial performance 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'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, *Nonmonetary Transactions*.

4.1.2.1 Presentation of the results of economic hedging

It's generally not appropriate to recognize the earnings impact of a derivative that is used for economic hedging purposes in multiple line items on the statement of financial performance. 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* as of 30 November 2006, 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*."

4.1.2.2 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, 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 statement of financial performance. 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).

4.1.2.3 Hedging instruments

The following table summarizes the presentation of derivatives and other hedging instruments that have been designated as the hedging instrument in each of the three types of accounting hedges discussed below.

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.) • Amounts recognized in earnings for the derivative or other hedging instrument are required to be presented in the same line item in the statement of financial performance 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. • As it relates to existing portfolio layer method hedges of interest rate risk, upon the adoption of ASU 2022-01, 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 that are included in the assessment of hedge effectiveness are recognized in OCI. • Any components that are excluded from the assessment of effectiveness are recognized in earnings (in the same line item in the statement of financial performance as the effect of the hedged item), either through an amortization or mark-to-market approach. • 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 6.2 of A guide to hedge accounting upon the adoption of ASU 2017-12 for illustrations for certain common types of hedged items. • As noted in ASC 815-20-45-1B, ASC 815 does not proscribe the classification in the statement of financial performance for amounts that are reclassified out of 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 that are included in the assessment of hedge effectiveness are recognized in OCI as part of the cumulative translation adjustment.

Type of hedge	Presentation in comprehensive income
	• 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. • Any components that are excluded from the assessment of effectiveness are recognized in earnings (ASC 815 does not proscribe 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 rational method is also reported in the cumulative translation adjustment section of OCI • 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 statement of financial performance as the effect of the hedged item) in the same period or periods during which the hedged forecasted transaction affects earnings.

4.1.3 Presentation of hybrid instruments and a derivative 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 disclose the amount of fair value carrying amounts included in the aggregate amount.

ASC 815 does not specifically address the presentation of a derivative that has been bifurcated (separated) from the host contract.

General practice and SEC preference is for bifurcated derivatives to be presented on the same statement of financial position line item as the host contract if the host contract is classified as an asset or liability. Thus, if, for example, a put option embedded in a debt instrument requires separate recognition as a derivative, it would be appropriate to present the combined carrying amounts of the debt host and put option derivative 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 on the same line item in the statement of financial position because the derivative is required to be recognized as an asset or liability, as opposed to shareholders' equity. As it relates to presentation on the statement of financial performance, an entity should exercise judgment when determining whether it should report changes in the fair value of a bifurcated derivative separate or apart from the activity associated with its host contract. An example of

this would be considering if the changes in fair value of a derivative that is bifurcated from a debt host contract should be classified in other income or loss or interest expense.

4.1.4 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 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 derivatives 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 derivatives 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 does not include an other-than-insignificant financing element at inception, other than a financing element inherently included in an at-the-market derivative 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 utilizing 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 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, and (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 includes an other-than-insignificant financing element at inception, generally all cash inflows and outflows of the derivative should be considered cash flows from financing activities by the borrower. See ASC 230-10-45-14 and 45-15 for further guidance.

Example 4.1.2: Financing element considerations for specific instruments

At-the-money plain-vanilla interest rate swap (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 floating legs will result in payments being made by one party in the earlier periods and being made by the counterparty in the later periods of the swap's term.

At-the-money or out-of-the-money option contract (ASC 815-10-45-14 to 45-15)

If a derivative instrument is an at-the-money or out-of-the-money option contract or contains an at-the-money or out-of-the-money option contract, a payment made at inception to the writer of the option for the option's time value by the counterparty should not be viewed as evidence that the derivative instrument contains a financing element. In contrast, if the contractual terms of a derivative have been structured to ensure that net payments will be made by one party in the earlier periods and subsequently returned by the counterparty in the later periods of the derivative's term, that derivative instrument should be viewed as containing a financing element even if the derivative has a fair value of zero at inception.

4.2 General disclosure requirements

Disclosures for derivatives, 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 relevant and 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.

4.2.1 ASC 815-10 Disclosure requirements for derivatives and related hedging activities

ASC 815 requires extensive financial statement disclosures for derivatives and related hedging activity. When an entity holds or issues derivatives, it is important that financial statement users can understand:

- How and why the entity uses derivatives
- How derivatives and related hedged items are accounted for
- How derivatives 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.

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.

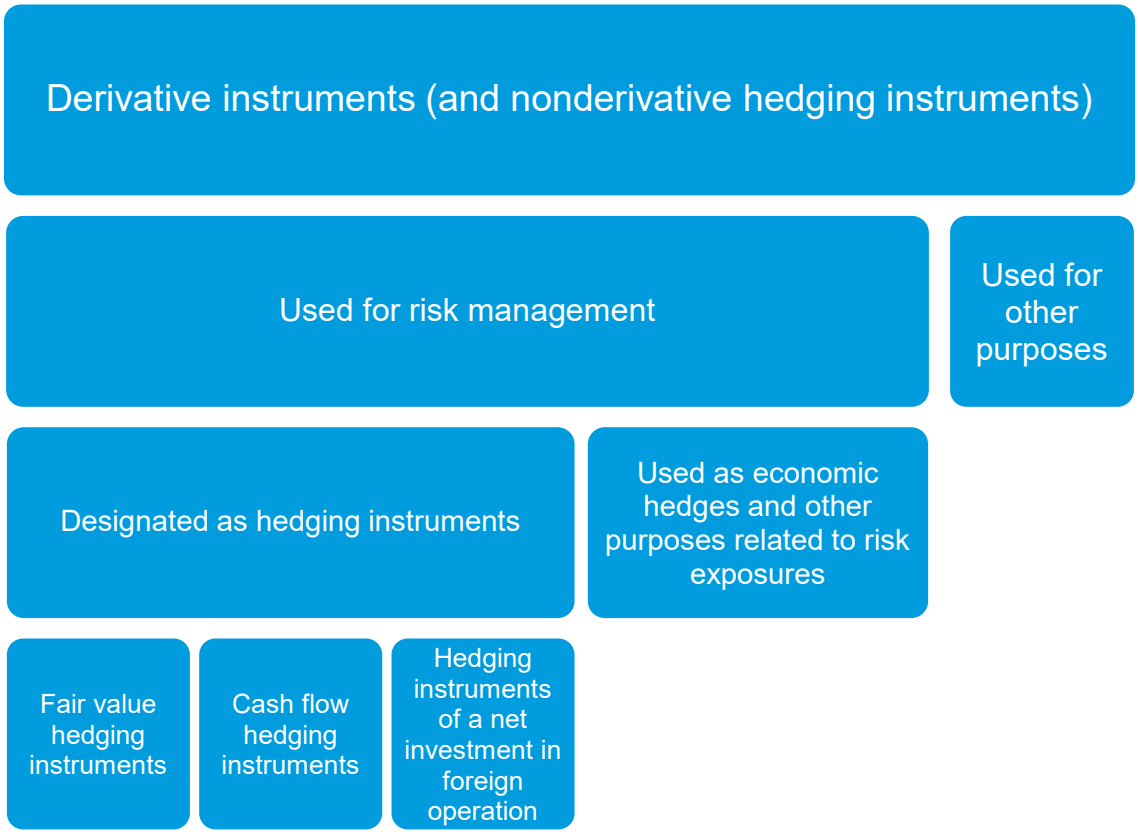
4.2.1.1 Qualitative disclosures: How and why the entity uses derivatives

In accordance with ASC 815-10-50-1A and 50-1B, an entity that holds or issues derivatives (or nonderivative hedging instruments) must disclose the following in its annual and interim financial statements.

- Its objectives for holding or issuing the derivative (or such nonderivative)
- 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], or overall price).

As explained in ASC 815-10-50-2, in these disclosures, an entity should distinguish between derivatives (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 derivatives (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 derivatives. ASC 815-10-50-4 requires the purpose of derivative activity to be disclosed for derivatives that are not designated as hedging instruments.

Example 4.2.1: 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 derivatives: 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 in the statement of financial position. The Company designates the derivatives used to manage both commodity price risk and interest rate risk as cash flow hedges. As such, the gain or loss on each derivative instrument is reported as a component of other comprehensive income and

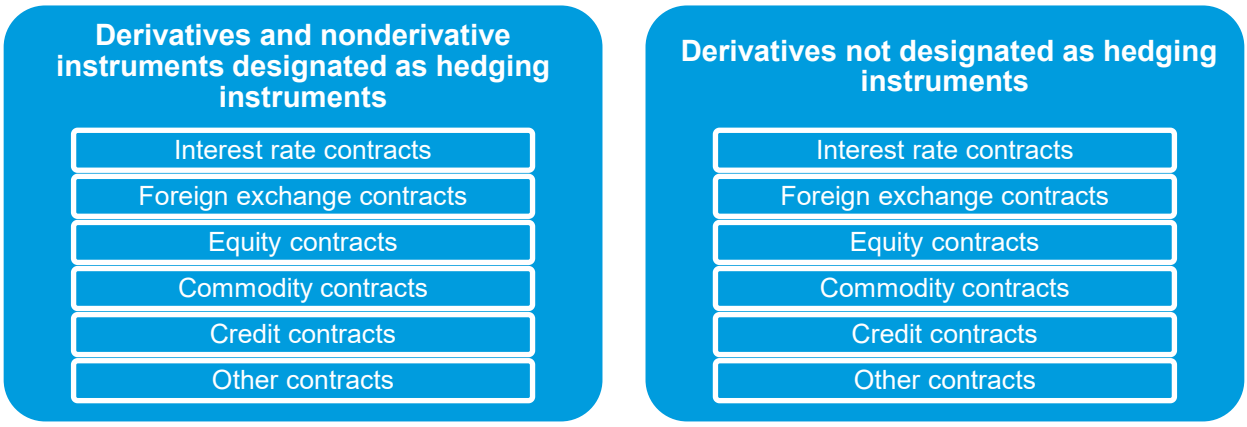
reclassified into earnings in the same line item in the statement of financial performance as the earnings effect of the hedged item, and in the same period or periods during which the hedged transaction affects earnings.

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 LIBOR. 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 LIBOR rate, with both rates applied to the notional amount.

4.2.1.2 Overall quantitative disclosures

ASC 815 contains extensive quantitative disclosure requirements regarding the location and fair value amounts of derivatives 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 derivatives 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 derivatives 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 derivatives used to mitigate the earnings volatility risk they pose
- Mortgage loans held for sale and related loan commitments and the derivatives 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 derivatives (and/or nonderivative hedging instruments) should disclose the following for each annual and interim reporting period for which it presents a statement of financial position and statement of financial performance:

a. The location (line item) and fair value amounts of derivatives and nonderivative hedging instruments reported on the statement of financial position in accordance with the following requirements:

   i. Fair value amounts should be presented on a gross basis even if the instruments qualify for net presentation on the statement of financial position.

   ii. Cash collateral should not be added to or netted against the fair value amounts.

   iii. The fair value asset and liability amounts should be segregated between: (a) derivative and nonderivative hedging instruments, presented separately by contract type (e.g., interest rate contracts, foreign exchange contracts, etc.) and (b) derivative instruments not designated as hedging instruments, presented separately by contract type.

   iv. 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.

   v. 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.

Example 4.2.2: 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

	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

b. The location (line item) and amount of the gains and losses reported on the statement of financial performance and the statement of financial position (e.g., gains and losses initially recognized in OCI) on derivatives (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:

   i. Derivatives (and nonderivative hedging instruments) in fair value hedges and related hedged items

ii. The gains and losses on cash flow hedging derivatives that were included in the effectiveness assessment and recognized in OCI during the current period

iii. 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

iv. The gains and losses on cash flow hedging derivatives that were included in the effectiveness assessment and recorded in accumulated OCI (AOCI) during the hedging relationship and reclassified into earnings during the current period

v. The portion of gains and losses on fair value hedging derivatives and cash flow hedging derivatives representing the amount (if any) excluded from the effectiveness assessment that is recognized in earnings, broken out by (1) amounts recognized in earnings through an amortization approach and (2) 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.

vi. 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.

vii. The amount of net gain or loss recognized in earnings when a hedged firm commitment no longer qualifies as a fair value hedge.

c. The total amount of each income and expense line item presented on the statement of financial performance where the results of fair value or cash flow hedges are recorded.

Spotlight on frequently overlooked disclosure requirement

The requirement to disclose the total amount of each income or expense line item presented on the statement of financial performance where the results of fair value or cash flow hedges are recorded is frequently overlooked. This is the top line item on the example disclosure that follows for *The Effect of Fair Value and Cash Flow Hedge Accounting On The Statement Of Financial Performance.*

ASC 815-10-50-4CCC explains that the gains and losses from hedging instruments in net investment hedges must be presented separately for all the following by type of contract:

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 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 4.2.3: Sample portion of footnote illustrating only the tabular disclosure of gains and losses from derivative instruments reported on the statement of financial

performance and the statement of financial position in a statement of financial position – 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, 20X0 and 20X9

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
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 Cash Flow 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 in the statement of financial performance, 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 recorded in other comprehensive income.

The Effect of Fair Value and Cash Flow Hedge Accounting on the Statement of Financial Performance for the Years Ended December 20X1 and 20X0

	Location and Amount of Gain or (Loss) Recognized in Income on Fair Value and Cash Flow Hedging Relationships[a]							
	20X1				20X0			
	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 statement of financial performance 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 on an amortization approach	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX
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	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX	XX,XXX

other comprehensive income into income								
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
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 statement of financial performance, 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 Statement of Financial Performance

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 Statement of Financial Performance

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	
		20X0	20X9
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 in the statement of financial performance, 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.

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.

4.2.1.2.1 Example tabular disclosure for hedged items in fair value hedges

Example 4.2.4: 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 Statement of Financial Position 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 used to designate hedging relationships in which the hedged time is the last layer expected to be remaining at the end of the hedging relationship. 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 (c) in the preceding paragraph that includes hedging relationships designated under the last-of-layer or portfolio layer method, an entity should separately disclose:

a. The amortized cost basis of the closed portfolio(s) of financial assets or the beneficial interest(s)

b. The amount that represents the hedged item(s) (that is, the hedged layer or layers)

c. The basis adjustment associated with the hedged item(s) (that is, the hedged layer or layers).

Example 20 (see paragraph 815-10-55-181) illustrates these disclosures.

4.2.1.2.2 Trading derivatives

The preceding comprehensive derivative disclosure in Section 4.2.1.2 of this chapter included a disclosure for the effect of derivatives not designated as hedging instruments on the statement of financial performance. ASC 815-10-50-4F and ASC 815-10-55-183 explain that if an entity's policy is to include derivatives 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 derivatives with its other trading activities provided that the following are disclosed.

a. The gains and losses on its trading activities (including both derivative and nonderivative instruments) recognized on 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 on 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 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 derivatives with other trading activities follows:

Example 4.2.5: Sample portion of footnote illustrating only the tabular disclosure of trading derivatives – 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, 20X0 and 20X9

	Trading Revenue	
Types of Instrument	**20X0**	**20X9**
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 Statement of Financial Performance	**Trading Revenue**

	20X0	20X9
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.

4.2.1.3 Basis adjustment considerations under the last-of-layer or portfolio layer method

ASC 815-20-25-12A allows an approach to fair value hedges referred to as the last-of-layer method (prior to the adoption of ASU 2022-01), or the portfolio layer method (after the adoption of ASU 2022-01). Under these methods, an entity is allowed to designate a closed portfolio of qualifying financial assets or beneficial interests as the hedged item in a fair value hedge of interest rate risk if certain criteria are met.

ASC 815-10-50-5B provides guidance on how the basis adjustments that are made to the hedged item through the application of fair value hedge accounting should be considered when meeting the non-ASC 815 disclosure requirements that are relevant to the assets within the closed portfolio (e.g., the requirements of ASC 310, ASC 320 and ASC 326). Additionally, upon the adoption of ASU 2022-01, 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.

4.2.1.4 Credit-risk-related contingent features

To alert the financial statement users to potential cash flow issues that may result from using derivatives, 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 occur such as a downgrade in credit rating. Pursuant to ASC 815-10-50-4H, an entity that holds or issues derivatives (or nonderivative hedging instruments) should disclose the following for every annual and interim reporting period for which a statement of financial position is presented:

a. The existence and nature of credit-risk-related contingent features and the circumstances in which these features could be triggered in derivatives (or nonderivative hedging instruments) that are in a net liability position at the end of the reporting period

b. The aggregate fair value amounts of derivatives (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

c. 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 and/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 4.2.6: 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 Company'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 Company 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 Company would be required to post an additional $XX million of collateral to its counterparties.

4.2.1.5 Credit derivatives

A credit derivative is a derivative (a) 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 and (b) that exposes the seller to potential loss from credit-risk-related events specified in the contract. Examples of credit derivatives include, but are not limited to, credit default swaps, credit spread options and credit index products.

A seller of credit derivatives (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 derivatives should disclose information about its credit derivatives 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 derivatives 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 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 would be required to make any payments under that derivative, ASC 815-10-50-4K requires that for each statement of financial position presented, the seller should disclose the following information for each credit derivative (or each group of similar credit derivatives):

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 derivatives is provided in ASC 815-10-50-4L. That is, 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/underlying asset classes (e.g., corporate debt, sovereign debt, and structured finance).

4.2.1.6 Additional disclosures for cash flow hedges

In addition to the disclosures above, ASC 815-30-50-1 requires the following disclosures in annual and interim financial statements for cash flow hedging instruments and the transactions they hedge:

a. 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

b. 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 (according to ASC 815-30-50-4 could be different than the net amount reported in AOCI)

c. 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 amounts to which the AOCI balance relates. To illustrate using the swap example in Section 4.1.1.1 of this chapter, the swap is in an asset position and has a fair value of $10 million recorded 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.

Example 4.2.7: Reclassification of AOCI to earnings over the next 12 months

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 by 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.

4.2.1.7 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 to 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 no longer meets the separation criteria, the entity is required to disclose both of the following pursuant to ASC 815-15-50-3:

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

4.2.1.8 Disclosures regarding statement of financial position offsetting

ASC 815-10-50-7 requires an entity to disclose its accounting policy as to whether it offsets 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 derivatives that are either offset or subject to an enforceable master netting arrangement or similar agreement as discussed in Section 4.1.1.2 of this chapter. These requirements are outlined in ASC 210-20-50-1 to 50-6.

For such derivatives, 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 as follows:

a. A reporting entity that has made an accounting policy 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 positions.

c. A reporting entity that has made an accounting policy to not offset fair value amounts shall separately disclose recognized for the right to reclaim cash collateral or the obligation to return cash collateral under master netting arrangements.

4.2.1.9 Additional disclosures for contracts in an entity's own equity

ASC 815-40, *Contracts in Entity's Own Equity*, applies to not only certain derivatives 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.

4.2.1.10 Disclosures by not-for-profit organizations

As indicated in ASC 815-10-50-4G, not-for-profit organizations (NFPs) within the scope of ASC 954, *Health Care Entities*, 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 2018-12

A.1.1 Overview

This ASU makes the following targeted improvements to the existing recognition, measurement, presentation and disclosure requirements regarding long-duration contracts that are issued by an insurance entity. The amendments set forth in the ASU aim to:

- Improve the timeliness of recognizing changes in the liability for future policy benefits and modify the rate used to discount future cash flows
- Simplify and improve the accounting for certain market-based options or guarantees associated with deposit (or account balance) contracts
- Simplify the amortization of deferred acquisition costs
- Improve the effectiveness of the required disclosures

A.1.1 Effective date and transition considerations

For public business entities, ASU 2018-12 is effective for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years,. For all other entities, this ASU is effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Early application of the ASU is permitted.

Any change to liabilities for future policy benefits and deferred acquisitions costs should be applied to outstanding contracts based on their carrying amounts at the beginning of the earliest period presented, subject to certain adjustments. Insurance entities will be able to choose to apply the amendments retrospectively using actual historical information as of contract inception. Entities will measure market risk benefits at fair value at the beginning of the earliest period presented and will recognize the cumulative effect of the changes in the entity's credit risk in AOCI with the difference between a contract's fair value and carrying value (other than the effect of changes in credit risk) recognized in the opening balance of retained earnings.

A.2 ASU 2022-01

A.2.1 Overview

Before the FASB issued ASU 2017- 12, entities found it difficult to achieve fair value hedge accounting for closed portfolios of prepayable financial assets for interest rate risk. ASU 2017-12 created the "last-of-layer" method, which makes hedge accounting for closed portfolios of prepayable financial assets more achievable. A "last-of-layer" hedge allows entities to hedge an amount of a portfolio that is anticipated to be outstanding during the term of the hedge. ASU 2022-01 essentially takes the single layer hedge approach of the "last-of-layer" hedge from ASU 2017-12 and expands it to multiple layers and refers to this hedge accounting method as the portfolio layer method.

A.1.1 Effective date and transition considerations

For public business entities, ASU 2022-01 is effective for fiscal years beginning after December 15, 2022, and interim periods within those fiscal years. For all other entities, this ASU is effective for fiscal years beginning after December 15, 2023, and interim periods within those fiscal years. Early application of this ASU is permitted. If an entity adopts ASU 2022-01 in an interim period, the effect of adoption related to basis adjustments should be reflected as of the beginning of the fiscal year of adoption. Upon adoption, entities may designate multiple hedged layers prospectively. Entities must apply the amendments related to hedge basis adjustments, except for those related to disclosures, on a modified retrospective basis using a cumulative-effect adjustment to the opening balance of retained earnings on the date of initial

application. Entities may either apply the amendments related to disclosures prospectively from the date of initial application or retrospectively to each prior period presented after the date adopting ASU 2017-12.

In addition, entities may elect to reclassify debt securities classified in the held-to-maturity category at the date of adoption to the available-for-sale category only if the entity applies portfolio layer method hedging to a closed portfolio that includes those debt securities.

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
ARRC	Alternative Reference Rates Committee
ASC	FASB's Accounting Standards Codification
ASU	Accounting Standards Update
CDO	Collateralized debt obligation
CPI	Consumer Price Index
FASB	Financial Accounting Standards Board
FVO	Fair value option
GAAP	Generally accepted accounting principles
IPO	Initial public offering
ISO	Independent system operator
LIBOR	London Interbank Offered Rate
ROAP	Removal of accounts provisions
RTO	Regional Transmission Organizations
S&P 500	Standard and Poor's 500 index
SEC	Securities and Exchange Commission
SOFR	Secured Overnight Financing Rate

Definitions

Several terms with specific meaning are used throughout this guide. Those terms and the corresponding definition in the Master Glossary of the ASC are provided in the table that follows, except for the definition of *private company*, which is not defined in the Master Glossary, but for which we have provided a definition for purposes of its use in this guide.

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.

Term	Definition
Beneficial interest	Beneficial interests are defined in the ASC Master Glossary as rights to receive all or portions of specified cash inflows received by a trust or other entity, including, but not limited to the following: • Senior and subordinated shares of interest, principal, or other cash inflows to be passed-through or paid-through • Premiums due to guarantors • Commercial paper obligations 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.
Clearly and closely related (for the purpose of determining whether a contract qualifies for the normal purchases and normal sales scope exception)	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.
Contractual net settlement	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.
Debt security	Any security representing a creditor relationship with an entity. The term debt security also includes all of the following: a. Preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor b. 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 statement of financial position c. U.S. Treasury securities

Term	Definition
	d. U.S. government agency securities e. Municipal securities f. Corporate bonds g. Convertible debt h. Commercial paper i. All securitized debt instruments, such as collateralized mortgage obligations and real estate mortgage investment conduits j. Interest-only and principal-only strips. The term debt security excludes all of the following: a. Option contracts b. Financial futures contracts c. Forward contracts d. Lease contracts e. Receivables that do not meet the definition of *security* and, so, are not debt securities, for example: 1. Trade accounts receivable arising from sales on credit by industrial or commercial entities 2. Loans receivable arising from consumer, commercial, and real estate lending activities of financial institutions
Derivative	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.
Discount	The difference between the net proceeds, after expense, received upon issuance of debt and the amount repayable at its maturity. See *premium*.

Term	Definition
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 ownership interest in an entity at fixed or determinable prices. The term equity security does not include any of the following: a. Written equity options (because they represent obligations of the writer, not investments) b. Cash-settled options on equity securities or options on equity-based indexes (because those instruments do not represent ownership interests in an entity) 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.
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: a. Receive cash or another financial instrument from a second entity b. Exchange other financial instruments on potentially favorable terms with the second entity.
Host contract	A contract that embodies both an embedded derivative and a host contract.
Lease term	The noncancellable period for which a lessee has the right to use an underlying asset, together with all of the following: a. Periods covered by an option to extend the lease if the lessee is reasonably certain to exercise that option b. Periods covered by an option to terminate the lease if the lessee is reasonably certain not to exercise that option c. 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 statement of financial position. Examples include but are not limited to accounts receivable (with terms exceeding one year) and notes receivable.
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: a. Revolving (in which the amount of the overall commitment is reestablished upon repayment of previously drawn amounts) b. Nonrevolving (in which the amount of the overall commitment is not reestablished upon repayment of previously drawn amounts).

Term	Definition
	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.
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: a. Interest rate risk b. Currency risk c. Other price 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.
Normal purchases and normal sales	Normal purchases and normal sales are contracts that provide for the purchase or sale of something other than a financial instrument or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business.
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.
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.
Premium	The excess of the net proceeds, after expense, received upon issuance of debt over the amount repayable at its maturity. See discount.
Readily convertible to cash	Assets that are readily convertible to cash have both of the following: a. Interchangeable (fungible) units

Term	Definition
	b. 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 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.
Underlying	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: c. A security price or security price index d. A commodity price or commodity price index e. An interest rate or interest rate index f. A credit rating or credit index g. An exchange rate or exchange rate index h. An insurance index or catastrophe loss index i. A climatic or geological condition (such as temperature, earthquake severity, or rainfall), another physical variable, or a related index j. The occurrence or nonoccurrence of a specified event (such as a scheduled payment under a contract)

Literature listing

ASC topic or subtopic	Title
210-20	Balance Sheet – Offsetting
230	Statement of Cash Flows
235	Notes to Financial Statements
310	Receivables
310-10	Receivables—Overall
320	Investments—Debt Securities
325-30	Investments—Other—Investments in Insurance Contracts
326	Financial Instruments—Credit Losses
450	Contingencies
460	Guarantees
480	Distinguishing Liabilities from Equity
606	Revenue from Contracts with Customers
718	Compensation—Stock Compensation

ASC topic or subtopic	Title
815	Derivatives and Hedging
815-10	Derivatives and Hedging—Overall
815-15	Derivatives and Hedging—Embedded Derivatives
815-40	Derivatives and Hedging—Contracts in Entity's Own Equity
815-45	Derivatives and Hedging—Weather Derivatives
820	Fair Value Measurement
825-10	Financial Instruments—Overall
825-20	Financial Instruments—Registration Payment Arrangements
840	Leases
842	Leases
860	Transfers and Servicing
845	Nonmonetary Transactions
944	Financial Services—Insurance
944-20	Financial Services—Insurance—Insurance Activities
954	Health Care Entities
960	Defined Benefit Pension Plans

Other literature	Title
ASU 2018-12	Financial Services—Insurance (Topic 944): Targeted Improvements to the Accounting for Long-Duration Contracts
ASU 2020-01	Investments—Equity Securities (Topic 321), Investments—Equity method and Joint Ventures (Topic 323), and Derivatives and Hedging (Topic 815) —Clarifying the Interactions Between Topic 321, Topic 323, and Topic 815 (a Consensus of the Emerging Issues Task Force)

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