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Accounting Standards Codification 815- Derivatives and hedging



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FOREWORD

Welcome to our **"Uniqus' ASC Insights Series: Guide to Accounting Standards"**, where we combine our collective wisdom to understand various Accounting Standard Codifications (ASCs) comprehensively and in a crisp manner. This series is an invaluable tool for accounting professionals, offering detailed explanations, illustrative examples, and our expert point of view. Designed to support your professional journey, this guide helps you navigate complex accounting scenarios and deepen your knowledge.

This is the twelfth publication in our "Uniqus' ASC Insights Series: Guide to Accounting Standards," focusing on **"ASC 815, Derivatives and Hedging".** In this installment, we delve into the specifics of ASC 815, exploring its implications, key considerations, and practical applications. Through clear illustrations and expert commentary, we aim to make the standard accessible and actionable for practitioners. This is one installment in a series of publications on this topic.

The primary objective of ASC 815 is to provide guidance on the financial accounting and reporting requirements for **derivatives and hedge accounting activities**. Accounting for derivatives is one of the most complex areas of U.S. GAAP, primarily because of the nuances involved in evaluating whether an instrument meets the definition of a derivative and whether a scope exception is available. The identification of possible embedded derivatives in a host contract also requires careful evaluation. Entities are also exposed to various operational risks, which they may mitigate by undertaking hedging relationships. ASC 815 also provides guidance on hedge accounting for qualified hedging relationships.

We hope you enjoy reading this document and find this series valuable!

Thank you.

Yours faithfully

For Uniqus Consultech Inc.



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PURPOSE

ASC 815 is the source of official guidance in U.S. GAAP on derivatives and hedging. This accounting standard, issued by the Financial Accounting Standards Board (FASB), provides comprehensive guidance on the recognition, measurement, and disclosure of derivative instruments and hedging activities.

Foundation of the guidance in ASC 815 is based on following key principles:

- A derivative instrument is either a right or obligation that meets the definition of an asset (expected future cash inflows due from another party) or a liability (expected future cash outflows owed to another party).
- Derivatives are recognized at fair value with changes in fair value reported in earnings, unless they are designated in a hedge accounting relationship.
- Implicit or explicit terms within a contract that does not in its entirety meet the definition of a derivative instrument (or embedded derivatives) which may or may not require bifurcation from the host instrument subject to certain conditions.
- Entities can choose to apply hedge accounting to qualifying transactions if certain criteria are met. If an entity elects to designate a derivative as the hedging instrument in a highly effective hedge relationship, its change in fair value may be accounted for differently than a non-designated derivative, depending on whether the relationship is a fair value hedge, a cash flow hedge or a hedge of a net investment in a foreign operation.

This publication provides an overview of the key accounting considerations and implementation matters relating to derivatives and hedge accounting. The technical views and accounting positions on the framework continue to improve depending on the results of further technical evaluations.

We sincerely hope you find the enclosed publication informative. We will be happy to participate in any discussions to clarify our views, which are enclosed in the attached publication. We look forward to hearing from you.



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BACKGROUND

A. Derivative Accounting

ASC 815 prescribes guidance on instruments and contracts that meet the definition of a derivative. Its nuanced approach is designed to enhance transparency, reduce complexity, and align financial reporting with the economic substance of derivative transactions.

The standard seeks to align financial reporting with the economic substance of these transactions, ensuring that companies accurately represent the impact of derivatives on their financial statements.

Navigating the accounting landscape for derivatives under ASC 815 poses a significant challenge within the realm of U.S. GAAP. This complexity arises primarily from the intricate process of determining whether a financial instrument qualifies as a derivative and assessing the availability of scope exceptions. Additionally, the meticulous evaluation of potential embedded derivatives within a host contract adds another layer of intricacy to the process.

Certain instruments and contracts falling within this definition may qualify for a scope exception. On the contrary, those that do not entirely meet the derivative definition still necessitate scrutiny to ascertain the presence of embedded derivatives, subject to the guidelines outlined in ASC 815.

The cornerstone of ASC 815 is the recognition of derivatives as either financial asset or financial liability and measurement of derivatives initially and subsequently at fair value in the statement of financial position.

B. Hedge Accounting

To mitigate certain risks, entities enter into separate contracts that meet the definition of a derivative instrument. Hedging is the practice of using derivative contracts to offset or minimize the risk of adverse price or interest movements in an underlying asset or liability. Hedge accounting, under ASC 815, establishes a formal connection between a derivative (the hedging instrument) and a hedged item. This connection ensures that the accounting treatment for the derivative is in line with the accounting for the hedged item. The primary goal is to prevent an earnings mismatch that would occur if only the derivative were accounted for at fair value through profit and loss. In essence, hedge accounting harmonizes the accounting treatment of both the derivative and the hedged item to avoid discrepancies in earnings reporting.

ASC 815 aims to align the timing of gains or losses from hedging instruments with changes in the fair value of hedged assets or liabilities, or the earnings impact of forecasted transactions.

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SUMMARY OF TOPIC

1. Derivative Accounting- Financial Reporting Considerations

This section summarizes key accounting considerations related to recognition and measurement of derivative accounting:

01 What is derivative?

In simple words, a derivative is an instrument whose value is dependent on the value of an underlying variable or variables, such as stock option, represents a derivative whose value depends on the price of the underlying stock

For a financial instrument or other contract to meet the definition of a derivative, all the following characteristics should be satisfied ***(ASC 815-10-15-83):***

Criteria	Implementation matters
a. Underlying, notional amount, payment provision	
The contract should contain: • One or more underlyings, and • One or more notional amounts or payment provisions or both.	• For a contract to be considered as a derivative • It must have one or more underlyings i.e. a variable (e.g., a price, rate, index, or the occurrence or non-occurrence of a specified event) that could cause the payments or other settlements required by a contract to fluctuate or change. • It must contain a notional amount or a payment provision. A notional amount is a quantity that interacts with an underlying in the determination of the cash flows or fair value of the contract. It may be in the form of monetary quantities (e.g., the principal amount of debt) or a number of equity shares (e.g., the number of equity shares that would be received upon conversion of a convertible instrument). 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. • Payment provision represents a fixed or determinable settlement triggered by specified changes in underlying. For e.g. Contract to pay a fixed amount a. if the company's share price falls below a particular dollar value or b. if the company's credit rating changes.

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Some contracts (e.g., requirement contracts[1]) do not specify a fixed number of units to be exchanged but instead provide for the delivery of the number of units that are needed during a specified period. These contracts may also specify either a maximum and/or minimum number of units or a range of units to be purchased or sold during a specified period. Under such circumstances it may be challenging to conclude whether the notional amount or payment provision criteria are met and shall require critical evaluation and judgment.

In our view, the absence of a specified fixed number of units does not in itself exempt the contract from being defined as a derivative under ASC 815. Under the circumstances wherein the buyer is relying exclusively on the seller to supply all of its needs in a given commodity, it is important from the buyer's perspective that the seller be knowledgeable of the anticipated needs under the contract. Under such circumstances, even though the notional amount is not specified in the contract, it can be reliably determined based on other provisions in the contract or in agreements contemporaneous to the contract. For example, a contract may specify minimum of 60 units and as many units as are needed to satisfy its actual needs in excess of 60 units. In such a case the notional amount will be at least equal to 60 units.

The entity should consider contract's settlement and default provisions to determine the notional amount, where otherwise not provided.

When the quantity to be delivered can be determined from the contractual relationship between the parties, the contract has a notional amount.

b. Initial net investment	
The contract should contain: • No Initial Net Investment or • Smaller Initial Net Investment	• In respect of contracts which contain Initial Net Investment, the amount of net investment should be smaller (less by more than nominal amount) than the amount needed to acquire (or incur) the effective notional amount of the asset (or liability) related to the contract's underlying. For example, ABC Inc. writes a call option to XYZ Inc. that allows XYZ Inc. to buy 1,000,000 barrels of crude oil at $38 per barrel over the next five days when the market price of crude is $43 per barrel, XYZ Inc. would be expected to pay at least $5 per barrel as a premium for the option. Even though the premium or initial investment is in excess of $5 million, it is significantly less than the current market value of the underlying crude of $43 million. Thus, the option would satisfy the initial investment characteristic of a derivative. • To the contrary if contract's initial investment approximates the initial investment needed to acquire (or incur) the related asset (or liability), the net investment characteristic is not met.

[1]A requirements contract is defined as a contract that requires one party to the contract to buy the quantity needed to satisfy its needs and is not permitted to buy more than its actual needs (for example, the party cannot buy excess units for resale).

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As per guidance, for contracts which requires initial net investment shall meet the characteristic, provided the initial net investment is less, by more than a nominal amount. ASC 815 does not include a quantitative threshold for determining what **"less, by more than a nominal amount,"** accordingly in this context, judgement is required to conclude.

In practice, an initial net investment of 90 percent or less of the effective notional amount is considered to meet the criterion. In other words, an initial net investment would typically be considered "smaller" if it were at least 10 percent less that the initial net investment needed to acquire (or incur) the related asset (or liability). For e.g.

PQR Inc. purchases a deep-in-the-money American call option on EFT stock, which is priced at $1,000 per share. The option has a 180-day maturity and a strike price of $100 per share. XYZ pays a premium of $900. Therefore, the initial investment in the option ($900) is less, by more than a nominal amount, than the effective notional amount applied to the underlying ($1000). Although the option has a significant initial net investment ($900), it is smaller, by more than a nominal amount i.e. it is 10 percent ($100) less that the initial net investment ($1,000) needed to acquire.



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c. Net Settlement	
The contract should facilitate net settlement in the form of one-way transfer of an asset (usually cash), from the counterparty in a loss position to the counterparty in a gain position to settle the obligation.	• The contract can be settled net by any of the following means: 1. Its terms implicitly or explicitly require or permit net settlement such as cashless exercise, allowing settlement through net amount of cash or a net number of shares or interest rate swap in which case net payments are based on the difference in interest amounts and not the full interest rate or the gross amount or fair value of the notional amount. 2. It can readily be settled net by a means outside the contract i.e. market mechanism such as futures exchange, wherein actual terms of a futures contract require one party to buy or sell a stated volume of a commodity at a certain price from or to the exchange. At any time during the life of a futures contract, a party can go to the exchange, close out the position by transferring it to another party and be relieved of its rights and obligations under the contract by either paying or receiving the net change in the fair market value of the contract. Transaction costs are minimal, and settlement requires no negotiation or due diligence. Once the position is closed, the party to the contract is in the same position as if the contract had been net settled. 3. It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement for e.g. Stock Purchase warrants provided underlying common stock is readily convertible to cash or a contract for the purchase of a US Treasury security, which can be readily converted to cash.

Circumstances under which terms of contract allows net settlement under the contingency situation shall also be construed as meeting the characteristic of net settlement. In other words, freestanding contracts that explicitly permit net settlement at the election of either party to the contract are considered to meet the net settlement criterion irrespective of whether the net settlement feature is dependent on the occurrence or non-occurrence of a contingent event. For e.g. PQR Inc. issues a warrant to a warrant holder W to purchase shares of PQR Inc.'s common stock. The warrant may be (1) exercised on a gross basis at P's discretion by notice of exercise and delivery of cash to PQR Inc. or (2) net share settled upon an initial public offering (IPO) or a sale of PQR Inc.

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02 Commonly used derivatives

Forwards

- Agreement to buy or sell an asset on a future date for an agreed-upon price.
- Forward contracts are traded in the over-the-counter (i.e., non-centralized) market.
- One of the parties to the contract assumes a long position and agrees to buy the underlying asset on a specified future date for an agreed-upon price. The other party assumes a short position and agrees to sell the asset on the same date for the same price.
- Notably, these contracts often start with no initial cost, resulting in a zero fair value at the initiation date.
- Example: ABC Inc. entered into 6 months Forward Currency Contracts with the bank, wherein ABC Inc. agrees to buy USD 1 million at agreed-upon price after six months. The forward contracts are subsequently accounted for at fair value, with changes in fair value recognized in earnings. At maturity if the spot rate is higher than the forward rate, ABC Inc. would have a gain on the contract and if the spot rate is lower than the forward rate, ABC Inc. would have a loss on the contract.

Futures

- Futures contract is similar to a forward contract in that it is an agreement between two parties to buy or sell an asset on a future date for an agreed-upon price except futures contracts are typically traded on exchanges.
- Example: Company enters into a futures contract to acquire 1,000 Tons of grains in one year, locking in a price of $62 per Ton.

Options

- Options grant the holder the choice to buy or sell an underlying asset at an agreed-upon price in the future, without an obligation, unlike forwards or futures contracts.
- To obtain an option, a premium is paid, unlike free entry into forwards or futures.
- Options are traded on exchanges and over-the-counter, with two types:
  - **Call option:** Grants the right to buy the asset at an agreed upon price by a specified date.
  - **Put option:** Grants the right to sell the asset at an agreed upon price by a specified date.
- The longer the time until maturity, the higher the value of both types of options tends to be.
- An option contract defines the strike price, also called the exercise price, at which the holder can act and the expiration date or maturity date.
- American Style Options offer flexibility, allowing exercise at any time until the expiration date, while European Style Options permit exercise only on the expiration date. Bermudan Style Options, a variation of American options, enable early exercise but only on predefined dates during the option's lifespan.

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Swaps

- Agreement between two parties to exchange cash flows in the future. The agreement specifies the dates on which the cash flows are to be paid and the way in which they will be calculated. The most common type of swaps are interest rate swaps (floating interest rate swapped against fixed rate of interest) and currency swaps (principal and interest payment fixed or variable in one currency is exchanged for principal and interest payment in another currency).

03 Scope Exceptions

Key Principle:

A contract that qualifies for scope exception does not require classification and measurement as a derivative asset or liability even if it meets the definition of a derivative in ASC 815.

Therefore, an entity should firstly evaluate whether a contract meets any of the available scope exceptions before applying the guidance in ASC 815 on classification, recognition, and measurement of derivatives.

ASC 815 relates primarily to whether a contract meets the definition of a derivative instrument. However, some contracts that meet the definition of derivative instrument are not within the scope of this Subtopic, while other contracts that do not meet the definition of derivative instrument are within the scope of this Subtopic.

ASC 815 scopes out the following contracts from derivative accounting guidance even if it meets all the characteristics of a derivative:

a. Regular-way security trades

b. Normal purchases and normal sales

c. Certain insurance contracts and market risk benefits

d. Certain financial guarantee contracts

e. Certain contracts that are not traded on an exchange

f. Derivative instruments that impede sales accounting

g. Investments in life insurance

h. Certain investment contracts

i. Certain loan commitments

j. Certain interest-only strips and principal-only strips

k. Certain contracts involving an entity's own equity

l. Leases

m. Residual value guarantees

n. Registration payment arrangements

o. Certain fixed-odds wagering contracts

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Topic 815—Derivatives Scope Refinements- Proposed Accounting Standard Update (ASU)

a. Key amendments in Proposed ASU

On July 23, 2024, the FASB issued a proposed ASU which is intended to refine the scope of the guidance on derivatives in ASC 815. The scope of proposed ASU relates to the application of derivative accounting to contracts that have features based on the operations or activities of one of the parties to the contract. Main Provisions of proposed ASU is summarized below:

Derivatives Scope Refinements	
• **Scope Exception for Contracts with Specific Underlyings**	• The proposed ASU would add a new scope exception in ASC 815-10-15-59(e) for contracts with underlyings that are based on: 1. "financial statement metrics of one of the parties to the contract" (e.g., "earnings before interest, taxes, depreciation, and amortization; net income; expenses; or total equity") and 2. the "occurrence or non-occurrence of an event specific to the operations or activities of one of the parties to the contract." • The exception could not be applied to contracts with an "underlying based on either: 1. a market rate, market price, or market index or 2. the price or performance of a financial asset or financial liability of one of the parties to the contract." • As a result of this refinement, entities would be able to avoid using derivatives accounting for more contracts or arrangements. • Examples of contracts with embedded derivatives that would qualify for this scope exception, includes: • bonds with interest payments that may vary based on ESG-linked metrics, • research and development funding arrangements, and • litigation funding arrangements.

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Example:

Case A: Underlyings Based on the Occurrence of Regulatory Approval and Achieving a Financial Statement Target

55-143B *Entity A and Entity B enter into a funding arrangement. Under the arrangement, Entity B provides funding of $50 million so that Entity A may develop and commercialize a drug compound. The arrangement has no clawback feature. Upon FDA approval of the drug, Entity A pays $20 million to Entity B. Entity A also pays an additional $80 million to Entity B upon sales of the drug exceeding $500 million.*

55-143C *The arrangement contains two underlyings: the occurrence or non-occurrence of FDA approval and sales of the drug exceeding $500 million. The occurrence of FDA approval relates to the drug that Entity A is developing as part of its operations. Achieving drug sales exceeding $500 million is related to Entity A's sales revenue. Neither underlying is based on a market rate, market price, or market index or the price or performance of a financial asset or financial liability of one of the parties to the contract. Therefore, those two underlyings each qualify for the scope exception in paragraph 815-10-15-59(e).* ***(Example is reproduced from the proposed ASU)***

Derivatives Scope Refinements	
• **Predominant Characteristics Assessment**	• ASC 815 currently includes guidance for situations when instruments (or embedded features) have multiple underlyings when one underlying qualifies for a non-exchange traded contract scope exception, but another underlying does not. The determination of whether an instrument with multiple underlyings qualifies for a non-exchange traded scope exception depends on the predominant characteristic of the instrument. • The proposed ASU would also change the predominance assessment to consider which underlying is expected to have the largest impact on changes in fair value.

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Example:

Predominant Characteristics Assessment

55-143F This Example illustrates the application of the predominant characteristics assessment in paragraph 815-10-15-60.

55-143G *On July 1, 20X1, Entity A enters into a five-year pay-fixed, receive-variable interest rate swap. If Entity A fails to meet a specified greenhouse gas emissions reduction target by June 30, 20X4, the fixed interest rate on the swap increases by 0.25 percent for the remaining term. The contract contains two underlyings: an interest rate (the floating leg of the swap) and the non-occurrence of Entity A achieving a specified greenhouse gas emissions reduction target. The non-occurrence of Entity A achieving a specified greenhouse gas emissions reduction target underlying is related to Entity A's greenhouse gas emissions from its operations; therefore, that underlying qualifies for the scope exception in paragraph 815-10-15-59(e). The interest rate underlying is a market rate (as described in paragraph 815-10-15-88(c)) and, therefore, does not qualify for any of the scope exceptions in paragraph 815-10-15-59.*

55-143H *The contract is subject to the predominant characteristics assessment in paragraph 815-10-15-60 because it has two underlyings and one (the non-occurrence of Entity A achieving a specified greenhouse gas emissions reduction target), but not both, of the underlyings qualifies for the scope exception in paragraph 815-10-15-59. Determining how to perform a fair value assessment is a matter of judgment that depends on the relevant facts and circumstances. Entity A determines which underlying is expected to have the largest effect on changes in the fair value of the contract. Specifically, Entity A computes how much the fair value of the contract moves if the interest rate underlying changes over the life of the contract while keeping the greenhouse gas emissions reduction target underlying constant. Entity A performs the same assessment for the greenhouse gas emission reduction target underlying while keeping the interest rate underlying constant. Entity A compares the results of the two assessments and determines that the interest rate underlying has the largest expected effect on changes in the fair value of the contract. Because the interest rate underlying is the predominant underlying and does not qualify for any of the scope exceptions in paragraph 815-10-15-59, Entity A concludes that the interest rate swap should be accounted for as a derivative under Topic 815.*
(Example is reproduced from the proposed ASU)

b. Current status

During its April 9, 2025 meeting, the Board directed the staff to draft a final Accounting Standards Update. Final ASU may be expected by late Q3 2025. Following summarizes key decisions related to transition provisions and effective date-

- Entity should apply the amendments on a prospective basis to new contracts, with the option to apply on a modified retrospective basis.
- Allow an instrument-by-instrument transition election or re-evaluation of the fair value option under the modified retrospective transition approach for contracts that were no longer accounted for as derivatives because of the amendments in a final Accounting Standards Update.
- The amendments will be effective for annual reporting periods (including interim reporting periods within annual reporting periods) beginning after December 15, 2026, for all entities.

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04 Recognition and Measurement Principles for Freestanding Derivatives

Initial Recognition and Measurement

- Derivative instruments is recognized in statement of financial position as either assets or liabilities depending on the rights or obligations under the contracts. These are recognized at "Mark-to-Market (MTM)" value and not at notional values.
- Derivative instruments shall be measured initially at fair value as per the principles of ASC 820.

Subsequent Measurement

- All derivative instruments (other than designated in a qualified hedging relationship) shall be measured subsequently at fair value.
- Changes in fair value shall be recognized in earnings.

Reassessment

- An entity should re-evaluate its application of ASC 815 as of each reporting period. This assessment should also occur at least quarterly or whenever the company prepares financial statements for an external party.
- If a financial instrument or a contract that did not initially meet the definition of a derivative later meets that definition, an entity should recognize the instrument as a derivative asset or a liability at its then current fair value.
- Alternatively, if an instrument that was initially recognized as a derivative later ceases to meet that definition, guidance in other U.S. GAAP shall be applied.

05 Embedded Derivatives and its accounting considerations

Embedded derivative is defined as implicit or explicit terms within a contract (that does not, in its entirety meet the definition of a derivative instrument) which affects some or all of the cash flows or the value of other exchanges required by the contract similar to derivative instruments. For example, a debt instrument wherein interest payments fluctuate with the changes in Standard & Poor's (S&P) 500 index (i.e., an equity-indexed note) would be considered a debt instrument with an embedded derivative.

An instrument that contains embedded derivatives is referred to as a hybrid instrument, which consists of both the host contract and the embedded derivative(s).

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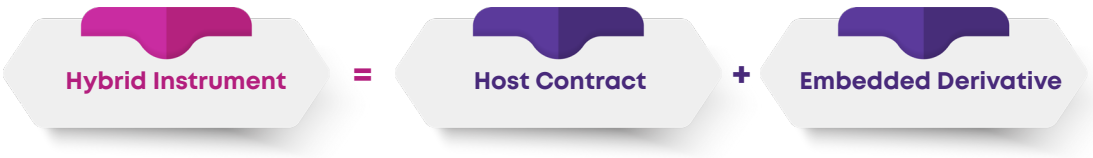
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Examples of Hybrid Instruments

Hybrid instruments	Host Contract	Embedded derivative
Preferred stock	Equity or debt host	· Conversion option · Redemption option
Convertible debt	Equity or debt host	· Conversion option
Debt	Debt host	· Contingent interest rate increase · Prepayment option · Extension option

Sometimes identification of embedded derivative in the contract is difficult and requires critical evaluation of contract. Entities should have controls in place that ensure all new contracts are evaluated for potential embedded derivatives.

Entities should pay particular attention to financial instrument contracts (such as, notes, bonds, preferred stock) because terms of many of these contracts meet the definition of embedded derivatives. However, embedded derivatives may also be present in leases, inventory purchase contracts, service contracts, insurance contracts.

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Framework for bifurcation of embedded derivative from the host contract

Following flow diagram summarizes key accounting considerations related to embedded derivatives:

An embedded derivative is clearly and closely related to its host contract when its underlying economic characteristics and risks, representing the factors influencing the derivative's value fluctuations, are clearly and closely related to the economic characteristics and risks of the host contract.

An entity that initially recognizes a hybrid **financial instrument** required to be separated into a host contract and a derivative instrument may irrevocably elect to initially and subsequently measure that hybrid financial instrument in its entirety at fair value (with changes in fair value recognized in earnings)

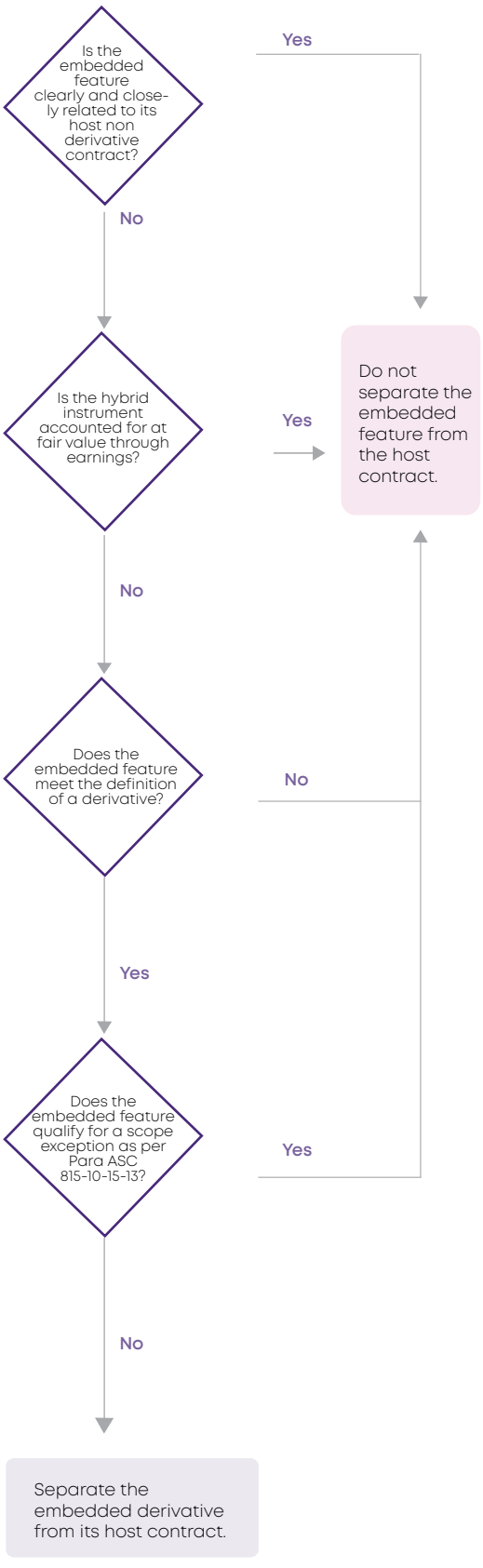
An embedded foreign currency derivative shall not be separated from the host contract and considered a derivative instrument under 815-15-25-1 if all of the following criteria are met:

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
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.

c. Other aspects of the embedded foreign currency derivative are clearly and closely related to the host contract.



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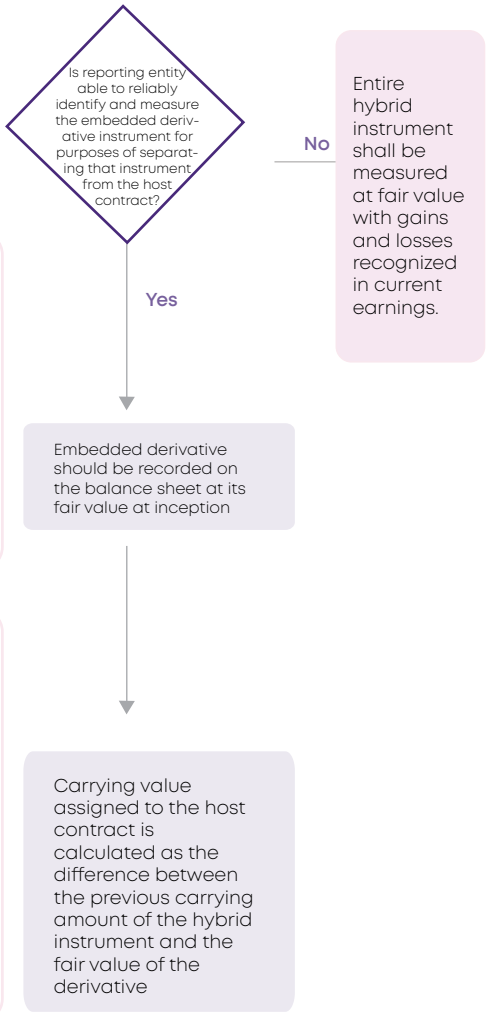
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Allocation of carrying amount of the hybrid instrument between the host contract and the embedded derivative

In separating a non-option embedded derivative from the host contract, the terms of that non-option embedded derivative shall be determined in a manner that results in its fair value generally being equal to zero at the inception of the hybrid instrument.

In separating an option-based embedded derivative from the host contract, the strike price of the embedded derivative shall be based on the stated terms documented in the hybrid instrument. As a result, the option-based embedded derivative at inception may have a strike price that does not equal the market price of the asset associated with the underlying.



Initial Recognition and Measurement

Embedded Derivative	· Separated derivative shall be classified on the balance sheet as an asset or liability at fair value with any changes in its fair value recognized currently in earnings similar to guidance for derivative instrument under ASC 815. · If a hybrid instrument contains more than one embedded derivative feature that would individually warrant separate accounting as a derivative instrument, those embedded derivative features shall be bundled together as a single, compound embedded derivative that shall then be bifurcated and accounted for separately from the host contract
Host Contract	Host contracts shall be accounted based on the guidance that is applicable to similar contracts that don't contain the embedded derivative.

Embedded derivatives should generally be presented on the balance sheet on a combined basis with the host contract, except in circumstances in which the embedded derivative is a liability and the host contract is equity.

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Reassessment

	If separation of an embedded derivative is required after the initial recognition of a hybrid instrument	**If separation of an embedded feature is no longer required after the initial recognition of a hybrid instrument**
An entity shall reassess whether an embedded feature qualifies as a derivative and, if so, for any derivative scope exception through its useful life. However, determination of whether an embedded feature is clearly and closely related to its host contract is performed only at the contract inception and not required to be reassessed.	• The embedded feature is bifurcated and recognized at its fair value when it satisfies the criteria for bifurcation. • The current fair value of the feature as of the reclassification date is reallocated to the embedded derivative from the current carrying amount of the instrument.	Embedded derivative is reallocated to its host contract at current fair value as at the date it ceases to meet the bifurcation criteria.



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Identification of Embedded features

To identify embedded derivatives, the entity should consider the economic payoff profile of the contractual terms rather than relying solely on how terms are structured in the contractual provisions of an instrument. In other words, the embedded features in a hybrid instrument are identified on the basis of the monetary or economic value that each feature conveys upon settlement for e.g. a term that is described as a conversion feature would be evaluated as a redemption feature if, upon exercise, it represents a right for the investor to receive a variable number of equity shares worth a fixed monetary amount.

In case of debt and equity instruments with contractual conversion terms the entity is required to separate embedded conversion features into multiple features on the basis of the nature of the payoff. For instance, terms of conversion may require entity to issue (1) a variable number of the issuer's equity shares with an aggregate fair value at settlement equal to a fixed monetary amount (a share-settled **redemption** feature) or (2) a fixed number of the issuer's equity shares (an equity **conversion** feature).

It is therefore appropriate to separate the stated conversion terms into a redemption feature and an equity conversion feature even though they are described in the same contractual conversion provision. Under the circumstances wherein provisions related to the redemption and conversion of the instrument are defined in separate sections of the relevant legal agreements, the terms of conversion should be evaluated in substance of economic payoff value.

For example: Redemption provisions require settlement at an amount of cash equal to the greater of a fixed monetary amount and the fair value of a fixed number of the debtor's equity shares. The conversion provisions require settlement in a fixed number of the issuer's equity shares. The requirement to potentially redeem the instrument for cash at an amount equal to the fair value of a fixed number of equity shares would be analyzed as a part of the equity conversion feature (not as part of the redemption feature). The requirement to potentially redeem the instrument for cash at a fixed monetary amount would be evaluated as a redemption feature.



Economic payoff profile Vs. Contractual terms

Assessment of embedded features related to the terms of settlement should be evaluated critically. Under the circumstances wherein an embedded feature's economic payoff profile differs from how the provision is described in the instrument's contractual terms, the feature must be evaluated by the entity on the basis of its payoff profile, and not on the basis of its contractual form.

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Illustrative example of Contractual term of Embedded features and its classification based on payoff profile

Redemption features: Embedded features involving settlement (in shares or cash) of the convertible host contract, for consideration of the same fixed monetary amount.

(a) Embedded feature settled in shares: It shall be construed as redemption feature if the number of shares delivered under the feature varies on the basis of the fair value of those shares (i.e., price per share paid by the investors) so that the total fair value of those shares will equal the outstanding principal amount and accrued and unpaid interest on the notes regardless of changes in the fair value of the shares. The following are some of the examples of such terms:

- **Automatic conversion:** Entity A issued notes. As per the terms of notes, if a qualified financing occurs before the maturity date, the outstanding principal amount of the notes and all accrued and unpaid interest on them automatically convert into shares of the capital stock issued in the qualified financing at a price no higher than the price paid per share by its investors in the qualified financing.

- **Voluntary conversion:** Entity A issued notes. As per the terms of notes, upon the election of a majority of the investors, the outstanding principal amount of the notes and all accrued and unpaid interest on them may be converted into shares of X's capital stock issued in any equity financing for capital raising purposes at a price no higher than the price per share paid by investors in such financing.

(b) Embedded feature settled in cash: Embedded feature which requires the outstanding principal amount plus all accrued and unpaid interest of the convertible instrument, as due and payable immediately shall be construed as redemption feature. The following are some of the examples of such terms:

- **Mandatory prepayment:** Entity A issued notes. As per the terms of notes, in the event of a change of control of Entity A, the outstanding principal amount of the notes and all accrued and unpaid interest on them are due and payable immediately before the closing of such change of control.

- **Default prepayment:** Entity A issued notes. As per the terms of notes, Upon the occurrence of an event of default and at any time thereafter during the continuance of such event, a majority of the investors may declare all outstanding obligations payable by Entity A under the notes to be immediately due and payable, and such amounts automatically become due upon the occurrence of a voluntary or involuntary bankruptcy or insolvency proceeding of Entity A.

Equity conversion feature: Embedded features which provide an equity-based return through conversion of the host contract.

Entity A issued convertible notes. As per the terms of the issue there will be conversion of the notes into Entity A's equity shares at a conversion price not higher than the quotient of $25 million and the amount of Entity A's fully diluted equity capital under following circumstances:

- If a qualified financing occurs before the maturity date, the outstanding principal amount of the notes and all accrued and unpaid interest on the notes automatically convert into shares.

- Upon the election of a majority of the investors, the outstanding principal amount of the notes and all accrued and unpaid interest on the notes may be converted into shares of Entity A's capital stock issued in any equity financing for capital raising purposes.

- If a qualified financing does not occur before the maturity date, the outstanding principal amount of the notes and all accrued and unpaid interest on them may be converted at the option of a majority of the investors into shares of Entity A's preferred stock.

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- If a change of control occurs before a qualified financing, the investors may elect to convert the outstanding principal amount of the notes and all accrued and unpaid interest on them immediately before such change of control into shares of Entity A's common stock.

06 Illustrative Examples

Example 1: Identification of embedded derivatives in the Contract with payments linked to foreign-exchange rates

ABC Inc. (the Company) is a US registrant that has a US dollar (USD) functional currency. On August 1, 2021, the Company enters into a contract for consulting services denominated in USD. The terms of the contract require quarterly payments in USD. The contract also requires a fixed adjustment to the quarterly payment amount when the USD / Japanese yen (JPY) exchange rate reaches a specified level.

Is there an embedded foreign currency derivative that must be separated from the host contract?

Analysis: As per the facts of given case, consulting services contract represents host contract. Further terms of contract requiring fixed adjustment to the quarterly payment amount when the USD / Japanese yen (JPY) exchange rate reaches a specified level is not clearly and closely related to the host contract.

Further the quarterly contract payments are not denominated in JPY (nor is it in substance JPY denominated), but are instead simply indexed to JPY, the embedded feature does not qualify for the scope exception in ***ASC 815-15-15-10*** and meets the definition of derivative.

Therefore, the contract payment adjustment is an embedded foreign currency derivative that should be separated from the consulting services contract.

Example 2: Evaluation of embedded features in debt host

The Company entered into a Financing Agreement with the lender. As per the terms of the Financing Agreement, the Lenders have granted a term loan credit facility to the company. The financing agreement includes the following features which need to be evaluated for bifurcation requirement:

- Optional Prepayment
- Mandatory Prepayment
- Interest rate related payment
- Interest Rate Conversion
- Contingent Tax Gross Up and increased cost due to change in law

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Analysis: As per the principles of ***ASC 815-15-25-1*** an embedded derivative shall be separated from the host contract and accounted for as a derivative instrument pursuant to Subtopic 815-10 if and only if **all** of the following criteria are met:

a. 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. **(Criterion A)**

b. The hybrid instrument is not remeasured at fair value under otherwise applicable generally accepted accounting principles (GAAP) with changes in fair value reported in earnings as they occur. **(Criterion B)**

c. A separate instrument with the same terms as the embedded derivative would, pursuant to Section 815-10-15, be a derivative instrument subject to the requirements of this Subtopic. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.) **(Criterion C)**

Embedded features must meet all three criteria of ASC 815-15-25-1, in order to be bifurcated from the host instrument; therefore, if a feature fails to meet Criterion A or Criterion B or Criterion C, then the other criterion will not be analyzed.

01 Optional Prepayment

Feature 1	**Optional Prepayment**
Feature type	**Borrower-held prepayment option**
Fact pattern	As per the terms of the Financing Agreement, the Borrower may at any time or from time to time voluntarily prepay the term loan in whole or in part. **Amount payable on prepayment**– As per terms of agreement, each prepayment shall be accompanied by the payment of : a. accrued interest to the date of such payment on the amount prepaid. b. Exit fee equal to 5% of principal amount of loan prepaid. c. Applicable premium defined as follows: 1. During the first 12 months from the Effective Date: an amount equal to the Make-Whole Amount (defined below) 2. After 12 months but 24 months before the Effective Date: an amount equal to 3.0% times the aggregate principal amount of the term loans being paid on such date 3. After 24 months but 36 months before the Effective Date: an amount equal to 1.0% times the aggregate principal amount of the term loans being paid on such date 4. After 36 months from the Effective Date: Zero

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Fact pattern	**Make-Whole Amount:** "Make-Whole Amount" means the sum of: **(a) The difference between the following two:** i. The total interest that *would have been* paid on the principal of the term loans (including all forms of interest and potential default interest) from the date of a triggering event until the one-year anniversary of the Effective Date, calculated using the interest rate in effect at the time of the triggering event. ii. The total interest the lenders *would earn* if the prepaid principal (or the outstanding principal in certain triggering events) were reinvested from the prepayment date until the one-year anniversary of the Effective Date at a rate equal to the Treasury Rate plus 0.50%. Treasury Rate will be a rate per annum equal to the rate determined by the administrative agent on the date three business days prior to the date of such prepayment, to be the yield expressed as a rate listed in The Wall Street Journal for United States Treasury securities most nearly equal to the period from the date of such prepayment, repayment or date of required repayment to and including the twelve (12) month anniversary of the Effective Date. **(b) Plus:** The Applicable Premium that *would have been* payable if the triggering event had occurred one day after the one-year anniversary of the Effective Date.



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Bifurcation Analysis:

Criterion A: Not clearly and closely related to the debt host?

Four-step decision sequence (ASC 815-15-25-42)

The optional prepayment feature appears to be a borrower-held call option (i.e., allows the borrower to call the issued debt by making prepayment).

The amount paid on settlement will be sum of the par value of the debt, accrued interest, prepayment penalty of 5% of principal amount prepaid (i.e. exit fees) and an interest make-whole premium (i.e. applicable premium). It may be argued that interest make-whole premium is a separate embedded feature requiring separate assessment. However the interest make-whole premium is considered an integral component of call option, it is not a distinct embedded feature that requires separate evaluation under ASC 815-15.

Under ASC 815-15, Optional Prepayment feature must be evaluated under the four-step decision sequence to determine whether the embedded feature is clearly and closely related to the debt host-

- **Step 1: Indexed payoff- Yes** – In respect of repayment of the loan within 12 months from the effective date, the amount paid upon settlement is adjusted on the basis of changes in the then-current U.S. Treasury rate. The calculation of the interest make-whole premium includes the U.S. Treasury rate.
- **Step 2**: – **Payoff indexed to an underlying other than interest rate or credit risk- No**- The payoff is indexed to an underlying interest rates.
- **Step 3:** - **Substantial premium or discount**- To determine if the premium or discount is substantial (10% or more), the potential payoff upon call option exercise will be compared with debt's initial net carrying amount.

The initial amount allocated to debt will be compared with the potential payoff. The potential payoff in the case of optional prepayment will be sum of the following:

(a) Principal amount of loan

(b) Prepayment penalty of 5% of the amount prepaid

(c) Applicable premium (described above)

- **Step 4:** N/A – The call option is not contingently exercisable, and hence further evaluation under 815-15-25-26 is required.

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ASC 815-15-25-26 evaluation

ASC 815-15-25-26 provides that an embedded feature with an interest-rate-related underlying (i.e., that alters net interest payments that otherwise would be paid on a debt instrument) is generally considered to be clearly and closely related to the host contract unless either condition (a) or (b) is met (in which case, the embedded derivative is not considered clearly and closely related).

(a) ASC 815-15-25-26 (a) May be settled in such a way that the investor would not recover its initial recorded investment (Referred as Negative Yield Test)

(b) ASC 815-15-25-26 (b) Investors may potentially double their initial rate of return and market rate of return (Referred as double-double test)

Condition 1: Negative Yield Test

If the Company exercises the call option, the prepayment amount will exceed the principal amount. Therefore, there is no circumstance in which the lenders will not contractually recover their initial investment.

Condition 1 is not present.

Condition 2: Double-Double Test

The double-double test in ASC 815-15-25-26(b) does not need to be applied since the call option can be exercised only by the Company, as ASC 815-15-25-37 states that this condition does "not apply to an embedded call option in a hybrid instrument containing a debt host contract if the right to accelerate the settlement of the debt can be exercised only by the debtor.

Condition 1 is not present, and Condition 2 does not need to be applied.

Criterion A met?

No – the feature is clearly and closely related to the debt host, regardless of whether a substantial premium exists.

Bifurcation required?

No – Since criterion A is not met.

Conclusion summary: Optional prepayment feature includes an interest-rate-related underlying (i.e., that alters net interest payments that otherwise would be paid on a debt instrument) and entitles lender recover their initial investment. Therefore, embedded feature is **clearly and closely related to the debt host requiring no bifurcation.**

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02 Mandatory Prepayment

Feature 2	**Mandatory Prepayment (Applicable Premium does not apply)**
Feature type	**Contingent Prepayment**
Fact pattern	**(a) Excess Cash Flow** As per the terms of the agreement, the Borrower shall prepay outstanding amount of loan if there is Excess Cash Flow (ECF). Excess Cash Flow represents the cash a company generates from its operations after covering its debt payments, interest, capital investments, taxes, and changes in its working capital needs. The prepayment amount will consist of the following: a. An amount equal to the result of • The ECF Percentage of the Excess Cash Flow for that year. The standard "ECF Percentage" is 50%. However, this percentage can go down based on the Gross Leverage Ratio. • ***minus*** any voluntary prepayments of loans made during that same year. (b) Accrued interest on the principal amount being prepaid at the date of prepayment (c) Exit fee of 5% of principal amount prepaid **(b) Receipt of Extra Ordinary Receipts** As per the terms of the Financing Agreement, upon the receipt by any Loan Party or any of its Subsidiaries of any Extraordinary Receipts, the Borrower shall prepay the outstanding principal amount of the Loans in accordance with Section 2.05(d) in an amount equal to 100% of the Net Cash Proceeds received to the extent that the aggregate amount of Net Cash Proceeds received by all Loan Parties and their Subsidiaries shall exceed for all Extraordinary Receipts $2,500,000 in any fiscal year. The prepayment amount will consist of the following: a. An amount equal to 100% of the Net Cash Proceeds b. Accrued interest on the principal amount being prepaid at the date of prepayment c. Exit fee of 5% of principal amount prepaid In accordance with the definition of 'Applicable Premium' in the Financing Agreement, it does not apply to the above-mentioned instances of mandatory repayment.

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Bifurcation Analysis:

Criterion A: not clearly and closely related to the debt host?

Four-step decision sequence (ASC 815-15-25-42)

Mandatory prepayment features require the accelerated cash settlement of a portion of the principal amount upon the occurrence of a future contingency based on the borrower's future activities. Mandatory prepayment features shall be evaluated under the four-step decision sequence to determine whether the embedded feature is clearly and closely related to the host contract.

- Step 1: Indexed payoff - No - The features accelerate payment of the principal and is not adjusted based on changes in an index
- Step 2: Payoff indexed to an underlying other than interest rate or credit risk - N/A – Based on response to Step 1
- Step 3: Substantial premium or discount- To determine if the premium or discount is substantial (10% or more), the potential payoff will be compared with debt's initial net carrying amount.

The initial amount allocated to debt will be compared with the potential payoff. Potential payoff will be determined as the sum of the following:

(a) The outstanding amount of loan for an amount

i. In case of Excess Cash Flow: Equal to the result of (to the extent positive) ECF percentage of excess cash flow of the Borrower for such fiscal year ***minus*** the aggregate principal amount of all payments made by the Borrower for such fiscal year.

ii. In case of receipt of Extra Ordinary Receipts: 100% of the Net Cash Proceeds

(b) Prepayment penalty of 5% of the amount prepaid.

The prepayment penalty will be 5% of the amount prepaid, therefore, the prepayment is not expected to include substantial premium or discount. This step is not met.

- Step 4: N/A- Based on the conclusion of Step 3.

ASC 815-15-25-26 evaluation

N/A – **ASC 815-15-25-26** is applicable only for embedded features in which the only underlying is an interest rate (including the debtor's market rate of interest) or an interest rate index. Therefore, **ASC 815-15-25-26** is not applicable to a put or call exercisable upon a contingency because that feature has an underlying other than an interest rate or interest rate index (i.e., the occurrence or non-occurrence of the contingent event).

The features are contingent upon the occurrence of Excess Cash Flow or receipt of Extra Ordinary Receipts. Therefore, ASC 815-15-25-26 is "Not Applicable".

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Criterion A met?

No – the features are clearly and closely related to the debt host

Bifurcation required?

No – Since criterion A is not met.

Conclusion summary: Mandatory prepayment feature under the circumstances wherein there exists excess cash flows or there are Extra Ordinary Receipts does not involve indexed payoff nor involve substantial premium or discount on settlement. It is not based solely on interest, rather based upon a contingency of the existence of excess cashflows or extra ordinary receipts. Therefore, embedded feature is **clearly and closely related to the debt host requiring no bifurcation**



Feature 3	**Interest-rate-related payment terms**
Feature type	**Features related to an interest rate**
Fact pattern	**(a) Choose-your-rate options** As per the terms of the agreement, at the option of the Borrower, the Term Loan any portion thereof shall be either a Reference Rate Loan or a SOFR Loan. Further, the Borrower may, at any time and from time to time, elect to have interest on all or a portion of the loans be charged at a rate of interest based upon Adjusted Term SOFR. On the last day of each applicable Interest Period, unless the Borrower properly has exercised the SOFR option with respect thereto, the interest rate applicable to such SOFR loans automatically shall convert to the rate of interest then applicable to Reference Rate Loans of the same type. The Company elected for Adjusted Term SOFR. **(b) Interest payments that are leveraged on the basis of market interest rates** The debt is indexed to SOFR. **(c) Interest rate floor** As per definition of Adjusted Term SOFR, it can never be less than 2.50% per annum. This rate is interest rate floor. Note-: Any prepayment will also incur a 5% penalty and a substantial redemption premium.

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Criterion A: not clearly and closely related to the debt host?

ASC 815-15-25-26 evaluation

ASC 815-15-25-26 provides that an embedded feature with an interest-rate-related underlying (i.e., that alters net interest payments that otherwise would be paid on a debt instrument) is generally considered to be clearly and closely related to the host contract unless either condition (a) or (b) is met (in which case, the embedded derivative is not considered clearly and closely related).

a. *ASC 815-15-25-26 (a) May be settled in such a way that the investor would not recover its initial recorded investment (Referred as Negative Yield Test)*

b. *ASC 815-15-25-26 (b) Investors may potentially double their initial rate of return and market rate of return (Referred as double-double test)*

The evaluation of the two conditions for interest rate floor and SOFR based interest rate under ASC 815-15-25-26 is as follows:

(a) Negative Yield Test

The test is performed on an undiscounted basis. If, at inception, there is any contractual possibility whatsoever that the undiscounted contractual net cash flows received by the creditor over the life of the instrument will not be at least 90 percent of the investment recorded by the investor at inception, the negative-yield test is passed and the debtor would consider the feature not to be clearly and closely related to the debt host.

All redemption features require repayment of the full principal along with accrued interest. Any prepayment will also incur a 5% penalty and a substantial redemption premium. Accordingly, the Agreement does not contain any clause that would prevent the lender from recovering its initial investment.

(b) Double- Double Test

The interest rate floor feature is to prevent the interest rate decreasing below a certain level and there is no possibility that the resulting interest rate would both double the investor's initial rate of return and double the market rate of return of the host contract. The floor, when in-the-money, will only result in a rate of 2.5% per annum.

Criterion A met?

No – the features are clearly and closely related to the debt host

Bifurcation required?

No – Since criterion A is not met.

Conclusion summary: Interest-rate-related payment terms require repayment of the full principal along with accrued interest and will not result double initial rate of return and the market rate of return of the host contract. **Therefore, the embedded feature is clearly and closely related to the debt host requiring no bifurcation.**

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04 Interest Rate Conversion

Feature 4	Interest Rate Conversion
Feature type	**Features related to an interest rate**
Fact pattern	**Voluntary conversion at the option of the Borrower** The Borrower may elect to have interest on all or a portion of the loans be charged at a rate of interest based upon Adjusted Term SOFR by the administrative agent at least three business days prior to (i) the proposed borrowing date of a loan (ii) in the case of the conversion of a Reference Rate Loan to a SOFR Loan, the commencement of the proposed interest period or (iii) in the case of the continuation of a SOFR Loan as a SOFR Loan, the last day of the then current interest period.

Bifurcation Analysis:

Criterion A: not clearly and closely related to the debt host?

ASC 815-15-25-26 evaluation

ASC 815-15-25-26 provides that an embedded feature with an interest-rate-related underlying (i.e., that alters net interest payments that otherwise would be paid on a debt instrument) is generally considered to be clearly and closely related to the host contract unless either condition (a) or (b) is met (in which case, the embedded derivative is not considered clearly and closely related).

a. *ASC 815-15-25-26 (a) May be settled in such a way that the investor would not recover its initial recorded investment (Referred as Negative Yield Test)*

b. *ASC 815-15-25-26 (b) Investors may potentially double their initial rate of return and market rate of return (Referred as double-double test)*

ASC 815-15-25-26 does not apply to features that are indexed to, or contingent on, something other than an interest rate or an interest rate index, including features that are indexed to both an interest rate or interest rate index and other underlyings.

The evaluation of the two conditions for **voluntary conversion** of interest rate is as follows:

(a) Negative Yield Test

The Interest rate conversion feature only changes the nature/timing of interest and does not impact the Borrower's obligation to make future payment of principle and accrued interest in full (even under future calls/puts/contingent mandatory redemption features. Therefore, the feature would not prevent the investor from recovering its initial investment. As such, the first condition is not met.

(b) Double-Double Test

This feature provides an option to the Borrower to choose interest-related base rates and there is no possibility that the embedded feature would both double the investor's initial rate of return or double the market rate of return of the host contract. As such, the second condition is not met.

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Criterion A met?

No – Interest-rate-conversion terms related to voluntary conversion option features is clearly and closely related to the debt host

Bifurcation required?

No – Since criterion A is not met.

Conclusion summary: Interest-rate-conversion terms related to voluntary conversion option requires repayment of the full principal along with accrued interest and will not result double initial rate of return and the market rate of return of the host contract. **Therefore, the embedded feature is clearly and closely related to the debt host requiring no bifurcation.**

05 Contingent Tax Gross Up and increased cost due to change in law

Feature 5	**Contingent Tax Gross Up and increased cost due to change in law**
Feature type	**Contingent Additional Payment**
Fact pattern	**(a) Indemnification for taxes:** All payments by the Company must be made in full, without deducting taxes, unless required by law. If taxes must be withheld, the responsible party (Withholding Agent) will · Deduct the required tax amount. · Pay the deducted tax to the government as per the law. · If the withheld tax is an "Indemnified Tax," the Company must increase the payment (an "Additional Amount") so that the recipient gets the full amount they would have received without the tax deduction. In addition to the above, all other applicable taxes will be paid by the Company, and the Company will indemnify and hold each secured party harmless from and against indemnified taxes payable by such secured party. **(b) Indemnification for increased costs upon the occurrence of change in law:** If a change in law causes a secured party (like a lender or agent) to: · Face new or increased taxes, duties, or charges related to this agreement (except for certain excluded taxes). · Be required to hold additional reserves, special deposits, or meet other financial requirements that increase their costs. · Experience any other new conditions that make lending more expensive or reduce the money they receive. · Then, the Borrower must compensate the secured party by paying extra amounts to cover these additional costs or losses.

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Feature 5	**Contingent Tax Gross Up and increased cost due to change in law**
Feature type	**Contingent Additional Payment**
Fact pattern	**(c) Funding Losses:** The Borrower shall compensate each lender for any loss, cost, and expense incurred by them because of the following actions of the Borrower: · The payment of any principal of any SOFR loan other than on the last day of the interest period · Conversion of any SOFR loan other than on the last day of the interest period · Failure to borrow, convert, continue or prepay any SOFR loan on the date specified in any notice of borrowing or SOFR notice delivered Note-: The Company has not elected the fair value option for the debt

Bifurcation Analysis:

Criterion A: not clearly and closely related to the debt host?

These embedded features require principal payments to be adjusted, based on the occurrence of events which are not related to or indexed to interest rate or credit risk. Therefore, applying the principles of ***ASC 815-15-25-42***, the embedded features are not clearly and closely related to debt host.

Criterion A met?

Yes – the features are not clearly and closely related to the debt host

Criterion B: debt not measured at FV?

Criterion B met?

Yes – the Borrower has not elected the fair value option for the debt

Criterion C: meets the definition of a derivative? (ASC 815-10-15-13)

Underlying and notional amount or payment provision

Yes – A feature that could adjust the payments of a debt host contract on the basis of a specified event or variable has both an underlying (the specified event or variable) and a notional amount (i.e., the debt's outstanding amount).

No/minimal net investment

Yes – The investment in the host instrument is not deemed to be an investment in the embedded feature per ASC 815-15-25-1(c)

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Criterion C: meets the definition of a derivative? (ASC 815-10-15-13)

Net settlement

Yes – A feature that adjusts payments of a debt host contract on the basis of a specified event or variable meets the net settlement condition because the feature is cash settled (neither party is required to deliver an asset that is associated with the underlying and whose principal amount, stated amount, face value, number of shares, or other denomination is equal to the feature's notional amount).

Criterion C met?

Yes – the features meet the definition of a derivative

Bifurcation required?

Yes – The embedded features meet all three criteria of ASC 815-15-25-1, therefore it should be bifurcated from the debt host.

Conclusion summary: Events related to Contingent Additional Payment are not clearly and closely related to the debt host and meets the definition of derivative, **therefore should be considered for bifurcation.**



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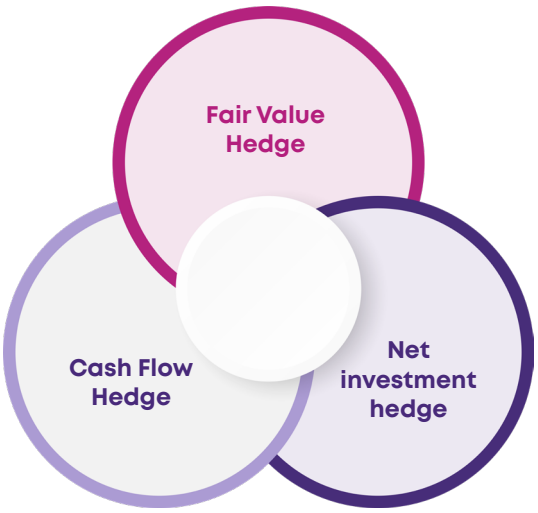
2. Hedge Accounting- Financial Reporting Considerations

This section summarizes key accounting considerations related to recognition and measurement of hedge accounting:

Types of Hedges

ASC 815 categorizes hedges into the following categories and provides specific accounting guidance for each category:

Hedge of the ***"exposure to changes in the fair value of a recognized asset or liability, or of an unrecognized firm commitment",*** that are attributable to a particular risk.



Hedge of the ***"exposure to variability in the cash flows of a recognized asset or liability, or a forecasted transaction,*** that is attributable to a particular risk.

Hedge of the ***"foreign currency exposure of a net investment in a foreign operation"***

1 Key Terms

Hedging instrument

A financial instrument used by entities to mitigate risk by offsetting existing financial exposures. These exposures may relate to market prices, interest rates, foreign exchange rates, or other variables.

For example:
Options, Futures, Forwards, Swaps entered into by an entity to manage specific risks effectively.

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Hedged item

Specific items that expose the company to the risk of changes in fair value or changes in future cash flows.

For example:

- **Interest rate risk** on a fixed-rate debt instrument hedged with an interest rate swap (Fair Value Hedge).
- **Forecasted foreign currency sales** exposed to exchange rate fluctuations hedged with a foreign exchange forward contract (Cash Flow Hedge).
- **Net investments in a foreign operations** hedged against fluctuations in the foreign currency's value relative to the reporting currency (Net Investment Hedge).

Firm commitment

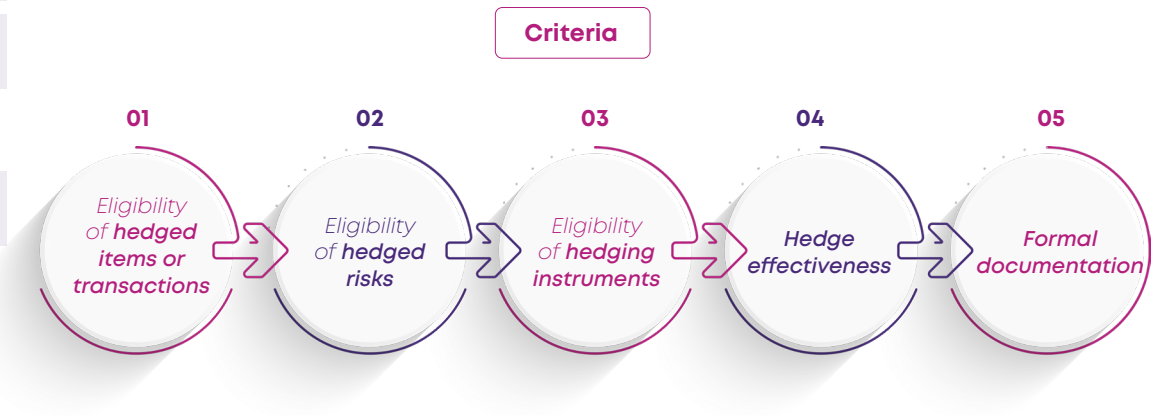
A firm commitment is a (legally) binding agreement between unrelated parties that specifies all significant terms and includes a disincentive for non-performance that is sufficiently large to make performance probable.

Forecasted transaction

A forecasted transaction is essentially a future transaction that is probable and does not meet the definition of a firm commitment.

2 Hedging Criteria

ASC815 requires an entity to meet the following criteria for the combination of the hedging instrument and the hedged item or transaction ('the hedging relationship') to qualify for hedge accounting.



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Guidance	Implementation matter
1. Qualifying Hedged Items	
· In a hedging relationship designated hedged item can be all or a portion of an · existing asset or liability, · an unrecognized firm commitment, · a forecasted transaction, or · the net investment in a foreign operation.	• **Fair value hedge:** Hedged item must have an **exposure to changes in market prices that can affect the fair value** of an existing asset, a liability, or an unrecognized firm commitment and thereby potentially affect the entity's earnings. For example- Fixed-rate debt (asset or liability), Inventory and Fixed-price supply contract (not a derivative). • **Cash flow hedge:** Hedged item is a variable-rate financial asset or liability or a forecasted transaction that exposes an entity to **variability in cash flows that could affect earnings. Example-** Variable-rate debt (asset or liability), Forecasted issuance of debt, Forecasted purchase of commodity. • **Net Investment hedge:** Hedged item is net investment in foreign operations. **Example-** foreign subsidiary).
· Items **prohibited** from designating as hedged items: · Items already remeasured at fair value, with changes in fair value recognized in earnings. Example includes -Bifurcated embedded derivatives, financial assets and financial liabilities for which the entity, has elected a fair value option, debt securities accounted for as trading securities, investment in equity securities measured at fair value as per ASC 321. · Investment in equity securities, such as Investment in the equity of a consolidated subsidiary, investments accounted for under the equity method. · Forecasted transactions and firm commitments that are related to business combinations, the acquisition or disposition of a subsidiary, a non-controlling interest, or an equity method investee. · Own-equity transactions such as non-controlling interests, Treasury stock transactions, Dividends to shareholders. fair value of issued shares classified in equity, forecasted issuances of shares classified in equity. · Implicit embedded derivatives or components of embedded derivatives.	

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Guidance	Implementation matter
2. Hedged risks	
• Designation of hedging transactions may address the following four risks- • Price risk (the total change in fair value or cash flows), • Interest rate risk, • Foreign exchange risk, • Credit risk.	• The hedged risk must result in exposure to a change in fair values or cash flows that could affect reported earnings, which is a requirement for all hedge accounting relationships.

- **Interest rate risk-** Interest rate risk addressed in a hedging transaction is based on type of hedged item.

Hedged item	Type of hedge	Interest rate Risk
Existing fixed-rate debt instrument	Fair value	Benchmark interest rate
Existing variable-rate debt instrument	Cash flow	Contractually specified interest rate
Forecasted issuance or purchase of fixed-rate debt instrument	Cash flow	Benchmark interest rate
Forecasted issuance or purchase of variable-rate debt instrument	Cash flow	Expected contractually specified interest rate

- **Credit risk-** Credit risk (or credit spread) is the risk premium required over the benchmark rate and is based on the difference between (1) the credit risk that is implicit in the benchmark rate and (2) the credit risk of the entity. Credit spread to be considered is that of the issuing entity.

- **Foreign currency risk-** Risk of exchange rate between foreign currency and functional currency. Changes in foreign currency exchange rates can actually affect both the instrument's fair value and the cash flows related to the instrument on a functional currency basis. Accordingly, an entity will sometimes have a choice between designating a hedge as a fair value hedge or a cash flow hedge.

3. Hedge instrument	
• An entity can use a derivative, a portion of a derivative, or a combination of derivatives (or parts thereof) as the hedging instrument in a hedging relationship, subject to certain restrictions.	• Prohibited hedge instruments • Components of a compound derivative. • Intra-entity derivatives, with an exception for foreign currency exchange hedges. • Most written options. • Basis swaps as hedges of variable-rate financial instruments. • Compound derivatives for net investment hedges (cross-currency interest rate swap exception).

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Guidance	Implementation matter
4. Hedge Effectiveness	
· Hedge accounting is permissible only if the changes in the fair value or cash flows of the hedged item that are attributable to the hedged risk are expected to be offset by the related changes in the fair value of the hedging instrument. · Hedge effectiveness can be assessed by comparing the changes in the fair value of the hedging instrument to the changes in the fair value or cash flows of the hedged item that are related to the risk being hedged.	· One of the key criteria for applying hedge accounting is the hedging relationship is expected to be highly effective both (1) at the inception of the hedging relationship and (2) on an ongoing basis. • **Hedge effectiveness at Inception-** Prospective hedge effectiveness assessment **(must be quantitative analysis)** should be performed at inception. • **Subsequent assessment-** The entity must perform prospective and retro-spective assessments of the hedging relationship's effectiveness whenever it reports financial statements or earnings and at least every three months. Entity has an option to perform subsequent assessments either quantitatively or qualitatively subject to certain conditions. · The primary expectation for undertaking hedge is that the relationship between a hedging instrument and the hedged item will be "highly effective" in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period that the hedge is designated. · More closely the terms of the hedged item and hedging instrument are aligned, the more likely the hedging relationship will be considered highly effective.



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Key Considerations for methods to assess hedge effectiveness-

- Methods used to assess the hedge effectiveness both prospectively and retrospectively should be clearly defined and documented at inception.
- Entity may elect to use different methods to perform prospective effectiveness assessments and retrospective effectiveness assessments, however, for similar hedges, an entity must use the same method for all its prospective assessments and the same method for all its retrospective assessments throughout the term of the hedging relationship.
- In our view most entities use the same method for both the prospective and retrospective effectiveness assessments.
- If an entity uses different methods for its prospective and retrospective hedge effectiveness assessments and the results of the retrospective assessment indicate that the hedging relationship was not highly effective in one period, the entity may not automatically be precluded from applying hedge accounting in the following period **if the results of the prospective effectiveness assessment indicate that the hedging relationship is expected to be highly effective in future periods.**
- In practice the term highly effective has been interpreted as the change in fair value of the designated portion of the hedging instrument is within 80% to 125% of the change in the fair value of the designated portion of the hedged item attributable to the risk being hedged.
- Even though qualifying hedging relationships might be highly effective, in many cases, the effectiveness will not be perfect (i.e., the gains and losses on the hedging instrument will not be perfectly offset by the losses and gains on the hedged item). High effectiveness does not guarantee that there will be no earnings volatility.

Guidance

5. Formal Documentation

- Concurrent designation and documentation of a hedge is critical; without it, an entity could not retroactively identify a hedged item, a hedged transaction, or a method of measuring effectiveness to achieve a desired accounting result.
- The documentation for a hedging relationship must describe:
  - The hedging relationship.
  - The entity's risk management objective and strategy for undertaking the hedge, including identification of all of the following:
    i. The hedging instrument.
    ii. The hedged item or transaction.
    iii. The nature of the risk being hedged.
  - The method used by an entity to retrospectively and prospectively assess the hedging instrument's effectiveness.

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3 Hedge Accounting Principles

	Accounting guidance	Excluded component
Fair value hedge	· The gain or loss on the **hedging instrument** shall be recognized currently in earnings (except for amounts excluded from the assessment of effectiveness). · The gain or loss on the **hedged item** attributable to the hedged risk shall adjust the carrying amount of the hedged item and be recognized currently in earnings. · All amounts recognized in earnings shall be presented in the same income statement line item as the earnings effect of the hedged item i.e. the gain or loss from any mismatch in the hedging relationship is immediately reflected in the income statement line item(s) being hedged.	· ASC 815 allows entities to exclude a portion of the change in the fair value of the hedging instrument, related to time value and/or cross-currency basis spread, from the hedge effectiveness assessment. · Excluded components follow a base recognition model known as the amortization approach. Under this approach, the initial value of the excluded component is systematically and rationally recognized in earnings over the hedging instrument's life.
Cash flow hedge	· The gain or loss on a derivative instrument designated and qualifying as a cash flow hedging instrument shall be reported as a component of other comprehensive income (outside earnings). · Amounts in accumulated other comprehensive income (AOCI) related to the derivative designated as a hedging instrument included in the assessment of hedge effectiveness are reclassified to earnings in the same period or periods during which the hedged forecasted transaction affects earnings and presented in the same income statement line item as the earnings effect of the hedged item.	· ASC 815 allows entities to exclude a portion of the change in the fair value of the hedging instrument, related to time value and/or cross-currency basis spread, from the hedge effectiveness assessment. · Excluded components follow a base recognition model known as the amortization approach. Under this approach, the initial value of the excluded component is systematically and rationally recognized in earnings over the hedging instrument's life. · Any variance between the change in the excluded component's fair value during the period and the amount amortized into earnings is recorded in Accumulated Other Comprehensive Income (OCI). · Alternatively, entities may choose to recognize the entire change in the fair value of excluded components immediately in earnings.

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	Accounting guidance	Excluded component
Foreign currency fair value hedges	• The gain or loss on the derivative hedging instrument shall be recognized currently in earnings (except for amounts excluded from the assessment of effectiveness) similar to fair value hedge. • The gain or loss on the nonderivative hedging instrument attributable to foreign currency risk shall be the foreign currency transaction gain or loss as determined under Subtopic 830-20. The foreign currency transaction gain or loss on a hedging instrument shall be determined, consistent with paragraph 830-20-35-1, as the increase or decrease in functional currency cash flows attributable to the change in spot exchange rates between the functional currency and the currency in which the hedging instrument is denominated. That foreign currency transaction gain or loss shall be recognized currently in earnings along with the change in the carrying amount of the hedged firm commitment. • When the hedged item is a foreign currency-denominated asset or liability, the reporting entity is required to remeasure it based on spot exchange rates in accordance with ASC 830.	

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	Accounting guidance	Excluded component
Foreign currency cash flow hedges	· The gain or loss on a derivative instrument designated and qualifying as a foreign currency cash flow hedging instrument shall be reported as a component of other comprehensive income (outside earnings) similar to any typical cash flow hedge · Amounts in AOCI are reclassified into earnings when the hedged item affects earnings or when it becomes probable that the forecasted transaction will not occur.	
Net investment hedge	· As in a cash flow hedging relationship, the hedged item is not adjusted in a net investment hedging relationship. · The gain or loss on the hedging instrument in a qualifying net investment hedging relationship is reported in the cumulative translation adjustment component of OCI.	



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4 Portfolio Hedging

ASC 815 allows a portfolio of similar assets or a portfolio of similar liabilities (or a specific portion thereof), or a group of individual forecasted transactions to be hedged. If similar assets, similar liabilities, firm commitments or forecasted transactions are aggregated and hedged as a portfolio, the individual items that make up the portfolio must share the risk exposure for which they are designated as being hedged i.e. the items that are included in a portfolio all need to share the same risk exposure for which they are being hedged (e.g., assets and liabilities cannot be included in the same hedged portfolio). Portfolio hedging is only available for fair value hedges and cash flow hedges but not for net investment hedges.

	Key Accounting Considerations	Excluded component
Fair value hedge	• **Homogeneity test:** Change in fair value attributable to the hedged risk for each individual item in the hedged portfolio must be expected to respond in a generally proportionate manner to the overall change in fair value of the aggregate portfolio attributable to the hedged risk. This is not possible unless unless the assets or liabilities being grouped are very similar • When hedging a portfolio of items, the entity must generally allocate the hedge accounting basis adjustments to each item in the portfolio. This becomes important when assessing impairment of a hedged item or determining gains and losses as a result of sales of hedged items. In addition, because the carrying value of that item has been adjusted to an amount that may differ from the cash proceeds to be received upon the sale or maturity of that item, the gain or loss upon disposition or maturity of that item is impacted.	• **Limit of acceptable variation of change in value:** As per guidance if the change in the fair value of a hedged portfolio attributable to the hedged risk were 10%, then the change in the fair values attributable to the hedged risk for each item in the portfolio should be within a relatively narrow range, such as 9% to 11%. It also states that a range of 7% to 13% would be inconsistent with this provision. • In our view 8% to 12% range may be considered as widest acceptable range when performing the homogeneity test for a fair value portfolio hedge.

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	Key Accounting Considerations	Excluded component
Cash flow hedge	· The designated hedged item in a cash flow hedge may be a group of items that share the same risk exposure for which they are being hedged. · Single derivative of appropriate size could be designated as hedging a given amount of aggregated forecasted transactions, such as; · Forecasted sales of a particular product to numerous customers within a specified time period, such as a month, quarter or year. · Forecasted purchases of a particular product from the same or different vendors at different dates within a specified time period. · Forecasted interest payments on several variable-rate debt instruments within a specified time period.	· Forecasted purchase and forecasted sale shall not both be included in the same group of individual transactions that constitute the hedged transaction since both do not share same risk exposure.

5 Portfolio Layer Method

On March 28, 2022, the FASB issued ASU 2022-01, which clarified the guidance in ASC 815 on fair value hedge accounting of interest rate risk for portfolios of financial assets.

Separate from the portfolio hedging guidance discussed above, ASC 815 provides an approach (the portfolio layer method) for hedging financial assets in a closed portfolio or beneficial interests secured by financial instruments. This method alleviates much of the complexity associated with applying fair value hedge accounting to a portfolio of financial instruments by combining the partial-term hedge concept and the ability to measure the hedged item using benchmark cash flows to simplify the determination of whether the individual assets in the portfolio share the risk exposure for which they are designated as being hedged.

This method also allows entities to essentially "ignore" prepayment risk (if applicable) when measuring the change in fair value of the hedged item or items, as long as the designated hedged item(s) (i.e., the hedged layer or layers in aggregate) is expected to be outstanding for the designated hedge period(s).

The portfolio layer method allows entities to (i) hedge multiple layers rather than just a single layer of a closed portfolio of financial assets or one or more beneficial interests secured by a portfolio of financial instruments and (ii) include non-prepayable financial assets in addition to prepayable financial assets in the closed portfolio being hedged.

Key Considerations related to Portfolio layer method:

a. Designating portfolio layer method hedges

· Under this method entities can designate, as the hedged item or items, a layer or layers of a closed portfolio consisting of financial assets or one or more beneficial interests secured by a portfolio of financial instruments, if certain criteria are met.

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b. Accounting for the hedge basis adjustment in a portfolio layer method hedge

- For one or more existing hedged layer or layers that are designated under the portfolio layer method, the gain or loss (that is, the change in fair value) on the hedged item attributable to the hedged risk shall not adjust the carrying value of the individual beneficial interest or individual assets in or removed from the closed portfolio. Instead, that amount shall be maintained on a closed portfolio basis and recognized currently in earnings.

- While the basis adjustment doesn't change the carrying amount of the individual assets in the closed portfolio, in certain circumstances an entity may need to allocate the basis adjustment to different line items (e.g., if the assets in the portfolio are presented in different line items in the statement of financial position).

- Further, an entity is prohibited from considering a basis adjustment maintained on a closed portfolio basis for existing portfolio layer hedges when measuring impairment or credit losses on the assets included in the closed portfolio.

- Fair value basis adjustment that is maintained on a closed portfolio basis in a portfolio layer method hedge be amortized to earnings. That amortization must begin no later than when the hedged item ceases to be adjusted for changes in its fair value attributable to the risk being hedged. However, an entity may choose to begin amortizing the basis adjustment on an outstanding portfolio layer hedge at any point before ceasing the hedging relationship.

c. De-designation of portfolio layer method hedges

- An entity may choose to discontinue or partially discontinue hedge accounting prospectively for all or a portion of any hedged layer associated with a closed portfolio at any time if a breach has not occurred. If multiple hedged layers are associated with the closed portfolio, the entity may voluntarily elect to de-designate or partially de-designate any hedges associated with that closed portfolio.

- If an entity fully or partially discontinues a hedging relationship voluntarily, it would allocate the basis adjustments associated with the de-designated amount to the remaining individual assets in the closed portfolio that supported the de-designated hedged layer or layers using a systematic and rational method. The entity would then amortize the allocated basis adjustments over a period that is consistent with the amortization of other discounts or premiums associated with the respective assets in accordance with other US GAAP.



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Example 1: Accounting for Fair value hedge of a firm commitment using a forward contract

- On 1 July 2024, ABC Inc. (or Company), a manufacturer of electrical wiring and cables, entered into a firm commitment to purchase 1,000 pounds of copper on 31 December 2024 in New York at the current forward rate of $320/pound. (The firm commitment is not accounted for as a derivative contract because it qualifies for, and the Company has elected, the Normal Purchase Normal Sale (NPNS) scope exception in ASC 815.)
- The Company has entered into the firm commitment because its supplier requires a fixed-price contract. However, the Company prefers to pay the market price at the time of delivery. It will record the copper inventories at the market price as of 31 December 2024.
- Therefore, on 1 July 2024, ABC Inc. enters into a six-month forward contract to sell 1,000 pounds of copper on 31 December 2024, in New York at the current forward rate of $320/pound. Thus, the forward contract essentially "unlocks" the firm commitment. The forward contract requires net cash settlement on 31 December 2024 and its fair value is zero at hedge inception.
- The Company and the derivative counterparty are of comparable creditworthiness and the initial Credit Valuation Adjustment (CVA) is negligible.
- The following chart outlines the key assumptions by relevant date over the period of the hedge (spot prices and forward prices show cost per pound of copper):

Date	Spot Price	Forward price for settlement on 31 Dec 2024	Fair value of forward contract (asset)	Fair value of firm commitment (liability)
1 July 2024	$ 300	$ 320	$ -	$ -
30 September 2024	290	300	18,700[2]	(19,020)[3]
31 December 2024	280	280	40,000[4]	(40,000)

- It is important to note that changes in fair value of the forward contract are highly effective in offsetting the expected changes in fair value of the firm commitment (it can be assumed that the forward price remains the same for both the firm commitment and the forward contract).
- Additionally, since the Company is assessing effectiveness based on changes in the forward price, the changes in the spot price are not relevant in this case. In this example, because the forward price has decreased, the commitment to buy copper at the higher price represents a liability.

[2]The fair value of the forward contract can be estimated by (1) multiplying the change in the forward price since inception of the contract by the notional amount of the contract and (2) discounting that amount at an appropriate rate for the remaining term of the forward. At 30 September 2024, the calculation is as follows: $19,700 = ($320 – $300) 1,000 pounds of copper, discounted at 6% (assumed to be an appropriate rate) for three months. Because the forward price has decreased, the value of the derivative has increased and, therefore, represents an asset. In addition, the company determined that a CVA of ($1,000) should be included in the fair value measurement of the forward contract, resulting in a fair value of $18,700 as of 30 September 2024.

[3]The fair value of the firm commitment before consideration of the Company's own nonperformance risk is ($19,700). A reduction of ($680) to the fair value of the liability reflects an increase in the company's own nonperformance risk.

[4]Calculation at 31 December 2024: $40,000 = ($320 – $280) 1,000. (No discounting is required on 31 December 2024 because the forward contract is at maturity.)

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Analysis:

ABC Inc's formal documentation of the hedging relationship is as follows:

Formal hedge designation documentation	
Risk management objective and nature of risk being hedged	• The objective of the hedge is to protect the fair value of the firm commitment from changes in the market price of copper. • Changes in the fair value of the forward contract are expected to be highly effective in offsetting changes in the overall fair value of the entire firm commitment.
Date of designation	1 July 2024
Hedging instrument	• Forward contract to sell 1,000 pounds of copper in New York on 31 December 2024 for $320/pound.
Hedged item	• Firm commitment to buy 1,000 pounds of copper in New York on 31 December 2024 for $320/pound. • The firm commitment qualifies for the normal purchase exception in ASC 815.
How hedge effectiveness will be assessed	• Hedge effectiveness (both prospective and retrospective) will be assessed based on a comparison of the overall changes in fair value of the forward contract (i.e., based on changes in the 31 December 2024 forward price) and changes in the fair value of the firm commitment to purchase copper (also based on changes in the New York forward price), as expressed by a cumulative dollar-off-set ratio. The Company will assess effectiveness based on changes in the forward price. • At inception, because the critical terms of the forward contract and firm commitment coincide (such as dates, quantities, delivery location and underlying commodity), the Company expects the hedge to be highly effective against changes in the overall fair value of the firm commitment. • However, changes in the credit risk of both counterparties in the fair value measurement of the forward contract and of the hedger and the supplier in the fair value measurement of the firm commitment (the hedged item) will likely cause some mismatch (between the fair value of the forward contract and that of the firm commitment) that needs to be considered. The hedge meets the criteria for a fair value hedge of a firm commitment.

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1 July 2024

No entry is required because the fair value of the forward contact is zero at hedge inception (no premium is paid or received at inception because the terms of the forward contract are at the current forward price).

30 September 2024

ABC Inc. makes the following entries to record the changes in fair value of the forward contract and the firm commitment:

Forward contract (asset)	$18,700	
Cost of goods sold		$18,700
To recognize the change in the fair value of the forward contract.		
Cost of goods sold	$19,020	
Firm commitment (liability)		$19,020
To recognize the change in the fair value of the firm commitment		

The cumulative dollar-offset ratio as of the assessment on 30 September 2024 is: ($18,700/$19,020) = 98.3%. This is within the 80% to 125% range considered to be "highly effective."

In practice the term highly effective has been interpreted as the change in fair value of the designated portion of the hedging instrument is within 80% to 125% of the change in the fair value of the designated portion of the hedged item attributable to the risk being hedged.

Consequence of not being highly effective in any period

If a fair value hedging relationship fails to qualify for hedge accounting in a certain assessment period because it fails the retrospective assessment, the overall change in fair value of the derivative for that period is recognized in earnings with no offset in the form of a basis adjustment to the hedged item. The same is true for the next period if the fair value hedging relationship fails the prospective assessment.

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31 December 2024

The forward contract and the firm commitment mature. The following journal entries are required:

Forward contract (asset)	$21,300	
Cost of goods sold		$21,300
To recognize the change in the fair value of the forward contract. (Calculated as $40,000 fair value of the contract at the end of the period less $18,700 fair value at the beginning of the period.)		
Cost of goods sold	$20,980	
Firm commitment (liability)		$20,980
To recognize the change in the fair value of the firm commitment. (Calculated as $40,000 fair value of the contract at the end of the period less $19,020 fair value at the beginning of the period.)		

The cumulative dollar-offset ratio as of the assessment date on 31 December 2024 is: ($40,000/$40,000) = 100%. The forward is perfectly effective in offsetting changes in the overall fair value of the firm commitment.

Cash	$40,000	
Forward Contract		$40,000
To record the cash settlement of the forward contract.		
Copper inventory	$320,000	
Cash		$320,000
To record the purchase of 1,000 pounds of copper at the $320/pound contracted price		
Firm commitment	$40,000	
Copper inventory		$40,000
To derecognize the firm commitment and adjust the carrying amount of the copper inventory.		

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- Loss on the firm commitment was offset by the gain on the forward contract. While there were differences in changes in the credit valuation adjustment on the forward contract and on the hedged firm commitment during the life of the hedge, those differences netted to zero by the final day of the hedge.
- However, the differences between the hedged firm commitment and the hedging instrument result in some volatility to cost of goods sold in each period (prior to sale) because the entire change in fair value of the forward contract and the firm commitment is required to be recorded in that income statement line.
- Over the life of the hedging relationship, the total net effect on net income is zero. However, as a result of the hedge, the copper inventory is initially reported at $280,000 rather than $320,000. The $280,000 is composed of the $320,000 paid to the copper supplier less the $40,000 gain from the hedge. It reflects the spot rate in effect on 31 December 2024, and is consistent with the Company's strategy to effectively acquire the inventory at the market price on the date of delivery from the supplier.
- ABC Inc. will benefit from the hedge in future periods through a lower cost of goods sold as the inventory is used in its production cycle and its finished product is sold.
- Balance Sheet and Income Statement extracts as at the year- end is summarized below:

Particulars	December 31, 2024	Basis
Income Statement		
Cost of goods sold	0	*{-21,300+20,980-18,700+19,020}*
Balance Sheet		
Asset		
Forward contract (asset)	0	*{18,700+21,300-40,000}*
Cash	-280,000	*(-320,000+40,000)*
Copper Inventory	280,000	*(320,000-40,000)*
Liability		
Firm commitment (liability)	0	*(-19,020-20,980+40,000)*

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Example 2: Accounting for Cash flow hedge for Interest Rate Swaps (IRS)

On January 1 (Year 1), a bank disburses a three-year term loan of $10,000,000 earning 12-months IBOR+2%.

To mitigate the risk of fall in 12-months IBOR, the bank enters into an IRS to receive fixed interest rate of 8% and pay variable rate based on 12-month IBOR with a notional amount of $ 10,000,000.



Receives	*12 IBOR + 2%*
Receives	*8%*
Pays	*12 IBOR*
Net receipt	**10%**

Assuming all other criteria pertaining to hedge accounting are met. Below table shows the net cash flows from the IRS and loan and the fair value of IRS

Y		1	2	3
IBOR		8%	7%	6%
Loan Interest		1,000,000	900,000	800,000
Swap receipt	**Fixed**	800,000	800,000	800,000
	Floating	-800,000	-700,000	-600,000
	Net	-	100,000	200,000
Net Receipt		**1,000,000**	**1,000,000**	**1,000,000**
FV of Swap		200,000	150,000	-
Change in FV		-	-50,000	-150,000

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Journal Entries:

Y1 – Jan	Dr.	Cr.
Loan Receivables	10,000,000	
To Cash		10,000,000
(To record loan origination @ IBOR+2%)		
No entry for recording IRS contract since the fair value at inception is zero.		

Y1 – Dec	Dr.	Cr.
Cash	1,000,000	
To Interest income		1,000,000
(To record interest income on loan)		
FV of IRS	200,000	
To OCI - FV gain/(loss) on cash flow hedge		200,000
(To record fair value of IRS)		



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Y2 – Dec	Dr.	Cr.
Cash	900,000	
To Interest income		900,000
(To record interest income on loan)		
Cash	100,000	
To AOCI - FV gain/(loss) on cash flow hedge		100,000
(To record net cash inflow on settlement of IRS)		
AOCI - FV gain/(loss) on cash flow hedge	100,000	
To Interest income		100,000
(To record net cash inflow on settlement of IRS)		
OCI - FV gain/(loss) on cash flow hedge	50,000	
To FV of IRS		50,000
(To record change in fair value of IRS)		

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Y3 – Dec	Dr.	Cr.
Cash	800,000	
To Interest income		800,000
(To record interest income on loan)		
Cash	200,000	
To AOCI - FV gain/(loss) on cash flow hedge		200,000
(To record net cash inflow on settlement of IRS)		
AOCI - FV gain/(loss) on cash flow hedge	200,000	
To Interest income		200,000
(To record net cash inflow on settlement of IRS)		
OCI - FV gain/(loss) on cash flow hedge	150,000	
To FV of IRS		150,000
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Extracts of Statements of Comprehensive Income

Particulars	Y1 Dec	Y2 Dec	Y3 Dec
Revenue-			
Interest Income	1,000,000	1,000,000	1,000,000
Other Comprehensive Income-			
FV gain/(loss) on cash flow hedge	200,000	(50,000)	(150,000)
	1,200,000	**950,000**	**850,000**

Balance Sheet Extracts

Particulars	Y1 Dec	Y2 Dec	Y3 Dec
Assets			
Cash	1,000,000	2,000,000	3,000,000
Interest Rate Swap	200,000	150,000	-
	1,200,000	**2,150,000**	**3,000,000**
Equity and Liabilities			
Accumulated Retained Earnings	1,000,000	2,000,000	3,000,000
Accumulated OCI	200,000	150,000	-
	1,200,000	**2,150,000**	**3,000,000**

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COMPARISON WITH IFRS

ASC 815, Derivative and Hedging under U.S. Generally Accepted Accounting Principles (GAAP), and IFRS 9, Financial Instruments under International Financial Reporting Standards (IFRS), both the standards provide guidance on Derivative and hedge accounting. Both accounting frameworks somewhat share similar requirements related to derivatives and hedging. For example, both sets of standards require derivatives to be accounted for at fair value, and both distinguish between fair value hedges and cash flow hedges. However, there are some key differences in the requirements entities must follow under the two sets of standards to qualify for, document, and apply hedge accounting as summarized below-

Subject	ASC 815	IFRS 9 and IAS 32
"Derivative" — definition	For an instrument to meet the definition of a derivative, the following characteristics must be present: • It contains "one or more underlyings" and "one or more notional amounts or payment provisions or both" (ASC 815-10). • It requires no or a small initial net investment. • It requires or permits net settlement (i.e., via contractual terms or via means outside the contract), or it provides for delivery of an asset that is readily convertible to cash.	For an instrument to meet the definition of a derivative, the following characteristics must be present: • Its value changes in response to an underlying (e.g., specified interest rate, commodity price, foreign currency rate, credit rating, and so forth, provided in the case of a non-financial variable that the variable is not specific to a party to the contract). • It requires no or a small initial net investment. • It is settled at a future date. Though the definition of a derivative under IFRS Accounting Standards does not include a net settlement characteristic, contracts to purchase or sell non-financial items are within the scope of IFRS 9 only if they can be settled net.
Embedded derivatives — initial recognition	• The bifurcation requirements apply to both assets and liabilities, including financial assets.	• Under IFRS framework, the bifurcation requirements do not apply to financial assets within the scope of IFRS 9. Therefore, if a hybrid contract contains a host that is a financial asset within the scope of IFRS 9, the bifurcation requirements does not apply.

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Subject	ASC 815	IFRS 9 and IAS 32
Embedded derivatives — debt with embedded put or call option	· A put, call, or prepayment option embedded in a debt contract is considered not clearly and closely related to a debt host contract if- (1) it is indexed to an underlying other than interest rates, credit risk, or inflation; (2) the debt involves a substantial discount or premium and the option is contingent; or (3) the option is not contingent and the neg-ative-yield or double-double test is passe	· A put, call, or prepayment option embedded in a debt contract is not considered closely related to a debt host contract unless (1) the exercise price is approximately equal on each exercise date to the debt host contract's amortized cost (before the separation of any equity component) or (2) the exercise price results in reimbursement to the lender for an amount up to the approximate present value of lost interest for the remaining term.
Embedded equity components — initial recognition	· Embedded equity-linked features that qualify as equity are separated from liabilities and accounted for as equity	· Embedded equity-linked features that qualify as equity are not separated from liabilities except in specified circumstances.
Hedge accounting — "highly effective" threshold to quality for hedge accounting	· The hedging instrument must be highly effective at offsetting changes in fair value or cash flows.	· The concept of a highly effective threshold does not exist; instead, IFRS 9 requires that (1) there is an economic relationship between the hedging instrument and the hedged item, (2) credit risk does not dominate the value changes that result from the economic relationship, and (3) the hedging relationship's hedge ratio reflects the hedge ratio of the actual quantities of the hedging instrument and the hedged item.
Hedge accounting — de-designation	· An entity may voluntarily discontinue hedge accounting at any time by removing the designation of the hedging relationship.	· An entity may perform de-designation only when the hedging relationship (or a part of the hedging relationship) ceases to meet the qualifying criteria.

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