




815-10-15 Scope and Scope Exceptions - General

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Accounting Research Manager Interpretive Guidance:	Derivatives and Hedging — Interpretations of U.S. GAAP 
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General


> Entities

15-1 This Subtopic applies to all entities. Some entities, such as not-for-profit entities (NFPs) and defined benefit pension plans, do not report earnings as a separate caption in a statement of financial performance. The application of this Subtopic to those entities is set forth in paragraphs 815-10-35-3 :  and 815-25-35-19 : .

> Instruments


15-2 The scope of this Subtopic relates primarily to whether a contract meets the definition of a [derivative instrument](#)  (see paragraph 815-10-15-83 :). However, as discussed in this Subsection, 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. Some of the disclosure requirements in Section 815-10-50 :  apply to nonderivative instruments that are designated and qualify as hedging instruments pursuant to paragraphs 815-20-25-58 :  and 815-20-25-66 : .

15-3 If events occur after the inception or acquisition of a contract that cause the contract to meet the definition of a derivative instrument, then that contract shall be accounted for at that later date as a derivative instrument under this Subtopic unless one of the scope exceptions in this Subsection applies.

15-4 If a contract meets the definition of both a derivative instrument and a [firm commitment](#)  under this Subtopic, then an entity shall account for the contract as a derivative instrument unless one of the scope exceptions in this Subsection applies.

> > Unit of Accounting for Scope Purposes

15-4A This Section addresses the following unit of accounting questions on scope:

- a. Viewing a contract as freestanding or embedded. Whether a feature should be viewed as freestanding or embedded in determining the scope application of this Subtopic and Subtopic 815-15 :  is addressed beginning in paragraph 815-10-15-5 : .

b. Viewing two or more contracts as a unit in applying the scope of this Subtopic. Whether two or more legally separate transactions should be viewed as a unit in determining the scope application of this Subtopic is addressed beginning in paragraph 815-10-15-8 : .

15-4B Paragraph 815-10-25-5A : explains that Section 815-10-25 : addresses the following unit of accounting questions with respect to recognition:

a. Viewing two freestanding derivative instruments as a unit. Whether two or more contracts that are derivative instruments within the scope application of this Subtopic should be viewed as a unit for recognition and other purposes—including for hedge accounting purposes—is addressed beginning in paragraph 815-10-25-6 :

b. Viewing combinations of options as separate options or as a single forward contract. Whether combinations of options that individually are within the scope application of this Subtopic or Subtopic 815-15 : should be viewed as separate options or as a single forward is addressed beginning in paragraph 815-10-25-7 :

> > > Viewing a Contract as Freestanding or Embedded

15-5 The notion of an [embedded derivative](#) , as discussed in paragraph 815-15-25-1 : , does not contemplate features that may be sold or traded separately from the contract in which those rights and obligations are embedded. Assuming they meet this Subtopic's definition of a derivative instrument, such features shall be considered attached [freestanding](#) derivative instruments rather than embedded derivatives by both the writer and the current holder.

15-6A put or call option that is added or attached to a debt instrument by a third party contemporaneously with or after the issuance of the debt instrument shall be separately accounted for as a derivative instrument under this Subtopic by the investor (that is, by the creditor). An option that is added or attached to an existing debt instrument by another party results in the investor having different counterparties for the option and the debt instrument and, thus, the option shall not be considered an embedded derivative. Paragraph 815-15-25-2 :

states that notion of an embedded derivative in a hybrid instrument refers to provisions incorporated into a single contract, and not to provisions in separate contracts between different counterparties.

15-7 If a debt instrument includes in its terms at issuance an option feature that is explicitly transferable independent of the debt instrument and thus is potentially exercisable by a party other than either the issuer of the debt instrument (the debtor) or the holder of the debt instrument (the investor), that option shall be considered under this Subtopic as an attached freestanding derivative instrument, rather than an embedded derivative, by both the writer and the holder of the option.

> > > Viewing Two or More Contracts as a Unit in Applying the Scope of This Subtopic


15-8 In some circumstances, an entity could enter into two or more legally separate transactions that, if combined, would generate a result that is economically similar to entering into a single [transaction](#) that would be accounted for as a derivative instrument under this Subtopic. For guidance on circumstances in which two or more contracts that have been determined to be derivative instruments within the scope of this

Subtopic must be viewed as a unit, see the guidance beginning in paragraph 815-10-25-6 : . For guidance on circumstances in which two or more contracts that have been determined to be options within the scope of this Subtopic must be viewed in combination, see the guidance beginning in paragraph 815-10-25-7 :


15-9If two or more separate transactions may have been entered into in an attempt to circumvent the provisions of this Subtopic, the following indicators shall be considered in the aggregate and, if present, shall cause the transactions to be viewed as a unit and not separately:

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




> > Instruments within Scope

15-10 The guidance in the General Subsections of this Subtopic applies to all derivative instruments, as that term is defined in paragraph 815-10-15-83 : , unless explicitly excluded by this Subsection (see paragraphs 815-10-15-13 through 15-82 :). The General Subsections of this Subtopic also identify incremental guidance that applies specifically to [forward commitment dollar rolls](#) .

> > > Interests in Securitized Financial Assets

15-11The holder of an interest in securitized financial assets (other than those identified in paragraphs 815-10-15-72 through 15-73 :) shall determine whether the interest is a freestanding derivative instrument or contains an embedded derivative that under Section 815-15-25 :  would be required to be separated from the host contract and accounted for separately.


> > > Forward Commitment Dollar Rolls

15-12A forward commitment dollar roll that does not meet the definition of a derivative instrument is within the scope of the guidance specified for such contracts in this Subtopic (see paragraphs 815-10-25-15 : , 815-10-30-4 : , and 815-10-35-4 : ).


> > Instruments Not within Scope

15-13Notwithstanding the conditions in paragraphs 815-10-15-83 through 15-139 : , the following contracts are not subject to the requirements of this Subtopic if specified criteria are met:


- a. Regular-way security trades
- b. Normal purchases and normal sales
- c. Certain insurance contracts
- 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](#)  .

Pending Content


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- n. [Registration payment arrangements](#) 
- o. Certain fixed-odds wagering contracts.


15-14 The following are the criteria that must be met for each scope exception.

> > > Regular-Way Security Trades

15-15 [Regular-way security trades](#)  are defined as contracts that provide for delivery of a security within the period of time (after the trade date) generally established by regulations or conventions in the marketplace or exchange in which the transaction is being executed. For example, a contract to purchase or sell a publicly traded equity security in the United States customarily requires settlement within three business days. If a contract for purchase of that type of security requires settlement in three business days, the regular-way security trades scope exception applies, but if the contract requires settlement in five days, the regular-way security trades scope exception does not apply unless the reporting entity is required to account for the contract on a trade-date basis.

15-16 Except as provided in (a) in the following paragraph, a contract for an existing security does not qualify for the regular-way security trades scope exception if either of the following is true:

- a. It requires or permits net settlement (as discussed in paragraphs 815-10-15-100 through 15-109 :).
- b. A market mechanism exists to facilitate net settlement of that contract (as discussed in paragraphs 815-10-15-110 through 15-118 :).

15-17 The scope exception for regular-way security trades applies only to a contract that requires delivery of securities that are **readily convertible to cash**  except that the scope exception also shall or may apply in any of the following circumstances:

- a. If an entity is required, or has a continuing policy, to account for a contract to purchase or sell an existing security on a trade-date basis, rather than a settlement-date basis, and thus recognizes the acquisition (or disposition) of the security at the inception of the contract, then the entity shall apply the regular-way security trades scope exception to that contract.
- b. If an entity is required, or has a continuing policy, to account for a contract for the purchase or sale of when-issued securities or other securities that do not yet exist on a trade-date basis, rather than a settlement-date basis, and thus recognizes the acquisition or disposition of the securities at the inception of the contract, that entity shall apply the regular-way security trades scope exception to those contracts.
- c. Contracts for the purchase or sale of when-issued securities or other securities that do not yet exist, except for those contracts accounted for on a trade-date basis, are excluded from the requirements of this Subtopic as a regular-way security trade only if all of the following are true:
 1. There is no other way to purchase or sell that security.
 2. Delivery of that security and settlement will occur within the shortest period possible for that type of security.
 3. It is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery of a security when it is issued. (The entity shall document the basis for concluding that it is probable that the contract will not settle net and will result in physical delivery.)

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

15-18 Note that contracts that require delivery of securities that are not readily convertible to cash (and thus do not permit net settlement) are not subject to the requirements of this Subtopic unless there is a market mechanism outside the contract to facilitate net settlement (as described in paragraph 815-10-15-110 :).

15-19 A contract for the purchase or sale of when-issued securities or other securities that do not yet exist is eligible to qualify for the regular-way security trades scope exception (as discussed in paragraph 815-10-15-17 :) even though either of the following is true:


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

See Example 9 (paragraph 815-10-55-118 : )

15-20 Net settlement (as described in paragraphs 815-10-15-100 : and 815-10-15-110 :) of contracts in a group of contracts similarly designated as regular-way security trades would call into question the continued application of the scope exception to such contracts.

15-21 This Subtopic does not change whether an entity recognizes regular-way security trades on the trade date or the settlement date.

>>> Normal Purchases and Normal Sales

15-22 Normal purchases and normal sales are contracts that provide for the purchase or sale of something other than a **financial instrument**  or derivative instrument that will be delivered in quantities expected to be used or sold by the reporting entity over a reasonable period in the normal course of business.

15-23 The assessment of whether a contract qualifies for the normal purchases and normal sales scope exception (including whether the underlying of a price adjustment within the contract is not clearly and closely related to the asset being sold or purchased) shall be performed only at the inception of the contract.

15-24 The normal purchases and normal sales scope exception sometimes will result in different parties to a contract reaching different conclusions about whether the contract is required to be accounted for as a derivative instrument. For example, the contract may be for ordinary sales by one party but not for ordinary purchases by the counterparty.

15-25 Following are discussions of four important elements needed to qualify for the normal purchases and normal sales scope exception:

- a. Normal terms (including normal quantity)
- b. Clearly and closely related underlying
- c. Probable physical settlement
- d. Documentation.

15-26 Also discussed is guidance that should be considered in determining whether each of the following specific types of contracts qualifies for the normal purchases and normal sales scope exception:

- a. Freestanding option contracts
- b. Forward (non-option-based) contracts
- c. Forward contracts that contain optionality features
- d. Power purchase or sale agreements.

> > > Normal Terms (Including Normal Quantity)


15-27 To qualify for the scope exception, a contract's terms must be consistent with the terms of an entity's normal purchases or normal sales, that is, the quantity purchased or sold must be reasonable in relation to the entity's business needs. Determining whether or not the terms are consistent requires judgment.

15-28 In making those judgments, an entity should consider all relevant factors, including all of the following:

- a. The quantities provided under the contract and the entity's need for the related assets
- b. The locations to which delivery of the items will be made
- c. The period of time between entering into the contract and delivery
- d. The entity's prior practices with regard to such contracts.

15-29 Further, each of the following types of evidence should help in identifying contracts that qualify as normal purchases or normal sales:

- a. Past trends
- b. Expected future demand
- c. Other contracts for delivery of similar items
- d. An entity's and industry's customs for acquiring and storing the related commodities
- e. An entity's operating locations.

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

> > > Clearly and Closely Related Underlying

15-30 Contracts that have a price based on an underlying that is not clearly and closely related to the asset being sold or purchased (such as a price in a contract for the sale of a grain commodity based in part on changes in the Standard and Poor's index) or that are denominated in a foreign currency that meets none of the criteria in paragraph 815-15-15-10(b) : shall not be considered normal purchases and normal sales.

15-31 The phrase *not clearly and closely related* in the preceding paragraph with respect to the normal purchases and normal sales scope exception is used to convey a different meaning than in paragraphs 815-15-25-1(a) :

and 815-15-25-16 through 25-51 : with respect to the relationship between an embedded derivative and the host contract in which it is embedded. The guidance in this discussion of normal purchases and normal sales does not affect the use of the phrase *not clearly and closely related* in paragraphs other than the preceding paragraph. For purposes of determining whether a contract qualifies for the normal purchases and normal sales scope exception, the application of the phrase *not clearly and closely related* to the asset being sold or purchased shall involve an analysis of both qualitative and quantitative considerations. The analysis is specific to the contract being considered for the normal purchases and normal sales scope exception and may include identification of the components of the asset being sold or purchased.

15-32 The underlying in a price adjustment incorporated into a contract that otherwise satisfies the requirements for the normal purchases and normal sales scope exception shall be considered to be not clearly and closely related to the asset being sold or purchased in any of the following circumstances:

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



15-33 For example, in the case in which the price adjustment focuses on the changes in the fair value of the asset being purchased or sold, if the terms of the price adjustment are expected, at the inception of the contract, to affect the purchase or sales price in a manner comparable to the outcome that would be obtained if, at each delivery date, the parties were to reprice the contract amount under the then-existing conditions for the asset being delivered on that date, the price adjustment's underlying is considered to be clearly and closely related to the asset being sold or purchased and the price adjustment would not be an impediment to the contract qualifying for the normal purchases and normal sales scope exception.

15-34 If the underlying in a price adjustment incorporated into a purchase or sales contract is not an impediment to qualifying for the normal purchases and normal sales scope exception because it is considered to be clearly and closely related to the asset being sold or purchased, the contract must meet the other requirements in this Subsection to qualify for the normal purchases and normal sales scope exception.

>>> Probable Physical Settlement

15-35 For a contract that meets the net settlement provisions of paragraphs 815-10-15-100 through 15-109 : and the market mechanism provisions of paragraphs 815-10-15-110 through 15-118 : to qualify for the normal purchases and normal sales scope exception, it must be probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery.


15-36 The normal purchases and normal sales scope exception only relates to a contract that results in gross delivery of the commodity under that contract. The normal purchases and normal sales scope exception shall

not be applied to a contract that requires cash settlements of gains or losses or otherwise settle gains or losses periodically because those settlements are net settlements. Paragraph 815-20-25-22 :  explains how an entity may designate such a contract as a hedged item in an [all-in-one hedge](#)  if all related criteria are met.

15-36A Certain contracts for the purchase or sale of electricity on a forward basis that necessitate transmission through, or delivery to a location within, an electricity grid operated by an independent system operator result in one of the contracting parties incurring charges (or credits) for the transmission of that electricity based in part on locational marginal pricing differences payable to (or receivable from) the independent system operator. For example, this is the case when the delivery location under the contract (for example, a hub location) is not the same location as the point of ultimate consumption of the electricity or the point from which the electricity exits the electricity grid for transmission to a customer load zone. Delivery to the point of ultimate consumption or the exit point is facilitated by the independent system operator of the grid. The purchase or sale contract and the transmission services do not constitute a series of sequential contracts intended to accomplish the ultimate acquisition or sale of a commodity as discussed in paragraph 815-10-15-41 : , and the use of locational marginal pricing to determine the transmission charge (or credit) does not constitute net settlement, even in situations in which legal title to the associated electricity is conveyed to the independent system operator during transmission.

> > > Documentation

15-37 For contracts that qualify for the normal purchases and normal sales exception under any provision of paragraphs 815-10-15-22 through 15-51 : , the entity shall document the designation of the contract as a normal purchase or normal sale, including either of the following:

- a. For contracts that qualify for the normal purchases and normal sales exception under paragraph 815-10-15-41 : or 815-10-15-42 through 15-44 : , the entity shall document the basis for concluding that it is probable that the contract will not settle net and will result in physical delivery.
- b. For contracts that qualify for the normal purchases and normal sales exception under paragraphs 815-10-15-45 through 15-51 : , the entity shall document the basis for concluding that the agreement meets the criteria in that paragraph, including the basis for concluding that the agreement is a [capacity contract](#) 

15-38 The documentation requirements can be applied either to groups of similarly designated contracts or to each individual contract. Failure to comply with the documentation requirements precludes application of the normal purchases and normal sales scope exception to contracts that would otherwise qualify for that scope exception.

15-39 The normal purchases and normal sales scope exception could effectively be interpreted as an election in all cases. However, once an entity documents compliance with the requirements of paragraphs 815-10-15-22 through 15-51 : , which could be done at the inception of the contract or at a later date, the entity is not permitted at a later date to change its election and treat the contract as a derivative instrument.

> > > Application to Freestanding Option Contracts

15-40 Option contracts that would require delivery of the related asset at an established price under the contract only if exercised are not eligible to qualify for the normal purchases and normal sales scope exception, except as indicated in paragraphs 815-10-15-45 through 15-51 : .


> > > Application to Forward (Non-Option-Based) Contracts

15-41 Forward contracts are eligible to qualify for the normal purchases and normal sales scope exception. However, forward contracts that contain net settlement provisions as described in either paragraphs 815-10-15-100 through 15-109 : or 815-10-15-110 through 15-118 : are not eligible for the normal purchases and

normal sales scope exception unless it is probable at inception and throughout the term of the individual contract that the contract will not settle net and will result in physical delivery. Contracts that are subject to unplanned netting (referred to as a book-out in the electric utility industry) do not qualify for this scope exception except as specified in paragraph 815-10-15-46 : .Net settlement (as described in paragraphs 815-10-15-100 through 15-109 : and 815-10-15-110 through 15-118 :) of contracts in a group of contracts similarly designated as normal purchases and normal sales would call into question the classification of all such contracts as normal purchases or normal sales. Contracts that require cash settlements of gains or losses or are otherwise settled net on a periodic basis, including individual contracts that are part of a series of sequential contracts intended to accomplish ultimate acquisition or sale of a commodity, do not qualify for the normal purchases and normal sales scope exception.

> > > Application to Forward Contracts that Contain Optionality Features

15-42 Forward contracts that contain optionality features that do not modify the quantity of the asset to be delivered under the contract are eligible to qualify for the normal purchases and normal sales scope exception. Except for power purchase or sales agreements addressed in paragraphs 815-10-15-45 through 15-51 : , if an option component permits modification of the quantity of the assets to be delivered, the contract is not eligible for the normal purchases and normal sales scope exception, unless the option component permits the holder only to purchase or sell additional quantities at the market price at the date of delivery. For forward contracts that contain optionality features to qualify for the normal purchases and normal sales scope exception, the criteria discussed in the preceding paragraph must be met.

15-43 If the optionality feature in the forward contract can modify the quantity of the asset to be delivered under the contract and that option feature has expired or has been completely exercised (even if delivery has not yet occurred), there is no longer any uncertainty as to the quantity to be delivered under the forward contract. Accordingly, following such expiration or exercise, the forward contract would be eligible for designation as a normal purchase or normal sale, provided that the other applicable conditions in this Subsection are met. Example 10 (see paragraph 815-10-55-121 : ) illustrates this guidance.

15-44 The inclusion of a purchased option that would, if exercised, require delivery of the related asset at an established price under the contract within a single contract that meets the definition of a derivative instrument disqualifies the entire contract from being eligible to qualify for the normal purchases and normal sales scope exception in this Subsection except as provided in the following paragraph through paragraph 815-10-15-51 : with respect to certain power purchase or sales agreements.


> > > Application to Power Purchase or Sale Agreements

15-45 Notwithstanding the criteria in paragraphs 815-10-15-41 through 15-44 : , a power purchase or sales agreement (whether a forward contract, option contract, or a combination of both) that is a capacity contract for the purchase or sale of electricity also qualifies for the normal purchases and normal sales scope exception if all of the following applicable criteria are met:

a. For both parties to the contract, both of the following criteria are met:

1. The terms of the contract require physical delivery of electricity. That is, the contract does not permit net settlement, as described in paragraphs 815-10-15-100 through 15-109 : . For an option contract, physical delivery is required if the option contract is exercised. Certain contracts for the purchase or sale of electricity on a forward basis that necessitate transmission through, or delivery to a location within, an electricity grid operated by an independent system operator result in one of the contracting parties incurring charges (or credits) for the transmission of that electricity based in part on locational marginal pricing differences payable to (or receivable from) the independent system operator. For example, this is the case when the delivery location under the contract (for example, a hub location) is not the same location as the point of ultimate consumption of the electricity or the point from which the electricity exits

the electricity grid for transmission to a customer load zone. Delivery to the point of ultimate consumption or the exit point is facilitated by the independent system operator of the grid. The use of locational marginal pricing to determine the transmission charge (or credit) does not constitute net settlement, even in situations in which legal title to the associated electricity is conveyed to the independent system operator during transmission.

2. The power purchase or sales agreement is a capacity contract. Differentiating between a capacity contract and a traditional option contract (that is, a financial option on electricity) is a matter of judgment that depends on the facts and circumstances. For power purchase or sale agreements that contain option features, the characteristics of an option contract that is a capacity contract and a traditional option contract, which are set forth in paragraph 815-10-55-31 :  shall be considered in that evaluation; however, other characteristics not listed in that paragraph may also be relevant to that evaluation.

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

c. For the buyer of electricity, all of the following criteria are met:

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

2. The buyer of the electricity under the power purchase or sales agreement is an entity that meets both of the following criteria:

i. The entity is engaged in selling electricity to retail or wholesale customers.


ii. The entity is statutorily or otherwise contractually obligated to maintain sufficient capacity to meet electricity needs of its customer base.


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

15-46 Power purchase or sales agreements that meet only the applicable criteria in paragraph 815-10-15-45 : qualify for the normal purchases and normal sales scope exception even if they are subject to being booked out or are scheduled to be booked out.

15-47 Forward contracts for the purchase or sale of electricity that do not meet those applicable criteria as well as other forward contracts are nevertheless eligible to qualify for the normal purchases and normal sales scope exception by meeting the criteria in this Subsection (other than paragraph 815-10-15-45 :), unless those contracts are subject to unplanned netting (that is, subject to possibly being booked out).

15-48 Because electricity cannot be readily stored in significant quantities and the entity engaged in selling electricity is obligated to maintain sufficient capacity to meet the electricity needs of its customer base, an option contract for the purchase of electricity that meets the criteria in paragraph 815-10-15-45 : qualifies for the normal purchases and normal sales scope exception in that paragraph.

15-49 This guidance does not affect the accounting for requirements contracts that would not be required to be accounted for under the guidance in this Subtopic pursuant to paragraphs 815-10-55-5 through 55-7 : .

15-50 Contracts that qualify for the normal purchases and normal sales scope exception based on this guidance do not require compliance with any additional guidance in paragraphs 815-10-15-22 through 15-44 : . However, contracts that have a price based on an underlying that is not clearly and closely related to the electricity being sold or purchased or that are denominated in a foreign currency that meets none of the criteria in paragraph 815-15-15-10(b) :  shall not be considered normal purchases and normal sales.


15-51 This guidance shall not be applied by analogy to the accounting for other types of contracts not meeting the stated criteria.

> > > Certain Insurance Contracts

15-52A contract is not subject to the requirements of this Subtopic if it entitles the holder to be compensated only if, as a result of an identifiable insurable event (other than a change in price), the holder incurs a liability or there is an adverse change in the value of a specific asset or liability for which the holder is at risk. Only those contracts for which payment of a claim is triggered only by a bona fide insurable exposure (that is, contracts comprising either solely insurance or both an insurance component and a derivative instrument) may qualify for this scope exception. To qualify, the contract must provide for a legitimate transfer of risk, not simply constitute a deposit or form of self-insurance.

15-53 The following types of contracts written by insurance entities or held by the insureds are not subject to the requirements of this Subtopic for the reasons given:

- a. Traditional life insurance contracts. The payment of death benefits is the result of an identifiable insurable event (death of the insured) instead of changes in a variable.
- b. Traditional property and casualty contracts. The payment of benefits is the result of an identifiable insurable event (for example, theft or fire) instead of changes in a variable.



15-54 In addition, some contracts with insurance or other entities combine derivative instruments with other insurance products or nonderivative contracts, for example, indexed annuity contracts, variable life insurance contracts, and property and casualty contracts that combine traditional coverages with foreign currency options. Contracts that consist of both derivative portions and nonderivative portions are addressed in paragraph 815-15-25-1 : . However, insurance entities enter into other types of contracts that may be subject to the provisions of this Subtopic.

15-55A A property and casualty contract that provides for the payment of benefits or claims as a result of both an identifiable insurable event and changes in a variable would in its entirety not be subject to the requirements of this Subtopic (and thus not contain an embedded derivative that is required to be separately accounted for as a derivative instrument) provided all of the following conditions are met:

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

15-56 If there is an actuarially determined minimum amount of expected claim payments that are the result of insurable events that are highly probable of occurring under the contract, that portion of the contract does not qualify for the insurance scope exception if both of the following conditions are met:

- a. Those minimum payment cash flows are indexed to or altered by changes in a variable.
- b. Those minimum payment amounts are expected to be paid each policy year (or on another predictable basis).

15-57 If an insurance contract has an actuarially determined minimum amount of expected claim payments that are highly probable of occurring, then effectively the amount of those claims is the contract's minimum **notional amount**  in determining the embedded derivative under Section 815-15-25 : .

> > > Certain Financial Guarantee Contracts

15-58 Financial guarantee contracts are not subject to this Subtopic only if they meet all of the following conditions:

a. They provide for payments to be made solely to reimburse the guaranteed party for failure of the debtor to satisfy its required payment obligations under a nonderivative contract, either:

1. At prespecified payment dates

2. At accelerated payment dates as a result of either the occurrence of an event of default (as defined in the financial obligation covered by the guarantee contract) or notice of acceleration being made to the debtor by the creditor.


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

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

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

> > > **Certain Contracts That Are Not Traded on an Exchange**

15-59 Contracts that are not exchange-traded are not subject to the requirements of this Subtopic if the underlying on which the settlement is based is any one of the following:

a. A climatic or geological variable or other physical variable. Climatic, geological, and other physical variables include things like the number of inches of rainfall or snow in a particular area and the severity of an earthquake as measured by the Richter scale. (See Example 13 [paragraph 815-10-55-135 : ].)

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

1. The nonfinancial assets are unique.


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

c. The fair value of a nonfinancial liability of one of the parties to the contract provided that the liability does not require delivery of an asset that is readily convertible to cash.

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


15-60 If a contract has more than one underlying and some, but not all, of them qualify for one of the scope exceptions in the preceding paragraph, the application of this Subtopic to that contract depends on its predominant characteristics. That is, the contract is subject to the requirements of this Subtopic if all of its underlyings, considered in combination, behave in a manner that is highly correlated with the behavior of any of the component variables that do not qualify for a scope exception.

15-61A A contract based on any variable that is not specifically excluded by paragraph 815-10-15-59 : is subject to the requirements of this Subtopic if it has the other two characteristics (initial net investment and net settlement) identified in this Subsection.

15-62 Example 14 (see paragraph 815-10-55-142 : ) illustrates the application of paragraph 815-10-15-59(b) : .

> > > Derivative Instruments That Impede Sale Accounting


15-63A derivative instrument (whether freestanding or embedded in another contract) whose existence serves as an impediment to recognizing a related contract as a sale by one party or a purchase by the counterparty is not subject to this Subtopic. For example, the existence of a guarantee of the residual value of a leased asset by the lessor may be an impediment to treating a contract as a sales-type lease, in which case the contract would be treated by the lessor as an operating lease. Another example is the existence of a call option enabling a transferor to repurchase transferred assets that is an impediment to sales accounting under Topic 860 :



 Such a call option on transferred financial assets that are not readily obtainable would prevent accounting for that transfer as a sale. The consequence is that to recognize the call option would be to count the same thing twice. The holder of the option already recognizes in its financial statements the assets that it has the option to purchase.

Pending Content

Transition Date: (P) December 16, 2018; (N) December 16, 2019 | **Transition Guidance:** 842-10-65-1 : 

A derivative instrument (whether freestanding or embedded in another contract) whose existence serves as an impediment to recognizing a related contract as a sale by one party or a purchase by the counterparty is not subject to this Subtopic. An example is the existence of a call option enabling a transferor to repurchase

transferred assets that is an impediment to sales accounting under Topic 860 : . Such a call option on transferred financial assets that are not readily obtainable would prevent accounting for that transfer as a sale. The consequence is that to recognize the call option would be to count the same thing twice. The holder of the option already recognizes in its financial statements the assets that it has the option to purchase.


15-64 A derivative instrument held by a transferor that relates to assets transferred in a transaction accounted for as a financing under Topic 860 : , but which does not itself serve as an impediment to sale accounting, is not subject to the requirements of this Subtopic if recognizing both the derivative instrument and either the transferred asset or the liability arising from the transfer would result in counting the same thing twice in the transferor's balance sheet. However, if recognizing both the derivative instrument and either the transferred asset or the liability arising from the transfer would not result in counting the same thing twice in the transferor's balance sheet, the derivative instrument shall be accounted for in accordance with this Subtopic. For related implementation guidance, see paragraph 815-10-55-41 : .

15-65 Paragraph Not Used : 

15-66 Paragraph Not Used : 

> > > Investments in Life Insurance

15-67A policyholder's investment in a life insurance contract that is accounted for under Subtopic 325-30 :

 is not subject to this Subtopic. This scope exclusion does not affect the accounting by the issuer of the life insurance contract.

> > > Certain Investment Contracts

15-68A A contract that is accounted for under either paragraph 960-325-35-1 : or 960-325-35-3 : is not subject to this Subtopic. This scope exception applies only to the party that accounts for the contract under Topic 960 :

15-68A The wrapper of a synthetic guaranteed investment contract that meets the definition of a **fully benefit-responsive investment contract** that is held by an employee benefit plan is excluded from the scope of this Subtopic.

> > > **Certain Loan Commitments**

15-69 For the holder of a commitment to originate a loan (that is, the potential borrower), that commitment is not subject to the requirements of this Subtopic. For issuers of commitments to originate mortgage loans that will be held for investment purposes, as discussed in paragraphs 948-310-25-3 through 25-4 : , those commitments are not subject to this Subtopic. In addition, for issuers of **loan commitments** to originate other types of loans (that is, other than mortgage loans), those commitments are not subject to the requirements of this Subtopic.

15-70 The preceding paragraph does not affect the accounting for commitments to purchase or sell mortgage loans or other types of loans at a future date. Those types of loan commitments must be evaluated under the definition of a derivative instrument to determine whether this Subtopic applies.

15-71 Notwithstanding the characteristics discussed in paragraph 815-10-15-83 : , loan commitments that relate to the origination of mortgage loans that will be held for sale, as discussed in paragraph 948-310-25-3 : , shall be accounted for as derivative instruments by the issuer of the loan commitment (that is, the potential lender).

> > > **Certain Interest-Only Strips and Principal-Only Strips**

15-72 An interest-only strip or principal-only strip is not subject to the requirements of this Subtopic provided the strip has both of the following characteristics:

- a. It represents the right to receive only a specified proportion of the contractual interest cash flows of a specific debt instrument or a specified proportion of the contractual principal cash flows of that debt instrument.
- b. It does not incorporate any terms not present in the original debt instrument.

15-73 An allocation of a portion of the interest or principal cash flows of a specific debt instrument as reasonable compensation for stripping the instrument or to provide adequate compensation to a servicer (as defined in Topic 860 :) would meet the intended narrow nature of the scope exception provided in this paragraph. However, an allocation of a portion of the interest or principal cash flows of a specific debt instrument to provide for a guarantee of payments, for servicing in excess of adequate compensation, or for any other purpose would not meet the intended narrow nature of the scope exception.

> > > **Certain Contracts Involving an Entity's Own Equity**

15-74 Notwithstanding the conditions of paragraphs 815-10-15-13 through 15-139 : , the reporting entity shall not consider the following contracts to be derivative instruments for purposes of this Subtopic:

- a. Contracts issued or held by that reporting entity that are both:
 1. Indexed to its own stock
 2. Classified in stockholders' equity in its statement of financial position.

- b. Contracts issued by the entity that are subject to Topic 718 : or Subtopic 505-50 : . If any such contract ceases to be subject to Topic 718 : or Subtopic 505-50 : in accordance with paragraphs 718-10-35-9 through 35-14 : , the terms of that contract shall then be analyzed to determine whether the contract is subject to this Subtopic. An award that ceases to be subject to Topic 718 : or Subtopic 505-50 : in accordance with those paragraphs shall be analyzed to determine whether it is subject to this Subtopic.
- c. Any of the following contracts:
1. A contract between an acquirer and a seller to enter into a business combination
 2. A contract to enter into an [acquisition by a not-for-profit entity](#) .
 3. A contract between one or more NFPs to enter into a [merger of not-for-profit entities](#) .
- d. Forward contracts that require settlement by the reporting entity's delivery of cash in exchange for the acquisition of a fixed number of its equity shares (forward purchase contracts for the reporting entity's shares that require physical settlement) that are accounted for under paragraphs 480-10-30-3 through 30-5 : , 480-10-35-3 : , and 480-10-45-3 : .

15-75 The scope exceptions in the preceding paragraph do not apply to either of the following:

- a. The counterparty in those contracts. For example, the scope exception in (b) in the preceding paragraph related to stock-based compensation arrangements does not apply to equity instruments (including stock options) received by nonemployees as compensation for goods and services.
- b. A contract that an entity either can or must settle by issuing its own equity instruments but that is indexed in part or in full to something other than its own stock. That contract can be a derivative instrument for the issuer under paragraphs 815-10-15-13 through 15-139 : , in which case it would be accounted for as a liability or an asset in accordance with the requirements of this Subtopic. For example, a forward contract that is indexed to both an entity's own stock and currency exchange rates does not qualify for the exception in (a) in the preceding paragraph with respect to that entity's accounting because the forward contract is indexed in part to something other than that entity's own stock (namely, currency exchange rates).

15-75A

Pending Content

Transition Date: (P) December 16, 2018; (N) December 16, 2019 | **Transition Guidance:** 260-10-65-4 : .


For purposes of evaluating whether a financial instrument meets the scope exception in paragraph

815-10-15-74(a)(1) : , a [down round feature](#) shall be excluded from the consideration of whether the instrument is indexed to the entity's own stock.



15-76 Temporary equity is considered stockholders' equity for purposes of the scope exception in paragraph 815-10-15-74(a) : even if it is required to be displayed outside of the permanent equity section.

15-77 For guidance on determining whether a freestanding financial instrument or embedded feature is not precluded from qualifying for the first part of the scope exception in paragraph 815-10-15-74(a) : , see the guidance beginning in paragraph 815-40-15-5 : .

15-78 Paragraph 815-40-25-39 : explains that, for purposes of evaluating under this Subtopic whether an embedded derivative indexed to an entity's own stock would be classified in stockholders' equity if freestanding,



the additional considerations necessary for equity classifications beginning in paragraph 815-40-25-7 :  do not apply if the hybrid contract is a conventional convertible debt instrument in which the holder may only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash (at the discretion of the issuer).

> > > Leases


15-79 Leases that are within the scope of Topic 840 :  are not derivative instruments subject to this Subtopic, although a derivative instrument embedded in a lease may be subject to the requirements of paragraph 815-15-25-1 : .

Pending Content

Transition Date: (P) December 16, 2018; (N) December 16, 2019 | **Transition Guidance:** 842-10-65-1 : 


Leases that are within the scope of Topic 842 :  are not derivative instruments subject to this Subtopic, although a derivative instrument embedded in a lease may be subject to the requirements of paragraph 815-15-25-1 : .





> > > Residual Value Guarantees

15-80 Residual value guarantees that are subject to the requirements of Topic 840 :  are not subject to the requirements of this Subtopic.

Pending Content





Transition Date: (P) December 16, 2018; (N) December 16, 2019 | **Transition Guidance:** 842-10-65-1 : 

Residual value guarantees that are subject to the requirements of Topic 842 :  on leases are not subject to the requirements of this Subtopic.


15-81 A third-party residual value guarantor shall consider the guidance in this Subtopic for all residual value guarantees that it provides to determine whether they are derivative instruments and whether they qualify for any of the scope exceptions in this Subtopic. The guarantees described in paragraph 840-10-15-20 :  for which the exceptions of paragraphs 460-10-15-7(b) :  and 460-10-25-1(a) :  do not apply are subject to the initial recognition, initial measurement, and disclosure requirements of Topic 460 : .

Pending Content

Transition Date: (P) December 16, 2018; (N) December 16, 2019 | **Transition Guidance:** 842-10-65-1 : 

A third-party residual value guarantor shall consider the guidance in this Subtopic for all residual value guarantees that it provides to determine whether they are derivative instruments and whether they qualify for any of the scope exceptions in this Subtopic. The guarantees described in paragraph 842-10-15-43 :  for which the exceptions of paragraphs 460-10-15-7(b) :  and 460-10-25-1(a) :  do not apply are subject to the initial recognition, initial measurement, and disclosure requirements of Topic 460 : .


> > > Registration Payment Arrangements



15-82 Registration payment arrangements within the scope of Subtopic 825-20 :  are not subject to the requirements of this Subtopic. The exception in this paragraph applies to both the issuer that accounts for the arrangement pursuant to that Subtopic and the counterparty.

> > > Certain Fixed-Odds Wagering Contracts

15-82A


Pending Content

Transition Date: (P) December 16, 2017; (N) December 16, 2018 | **Transition Guidance:** 606-10-65-1 : 

Fixed-odds wagering contracts for an entity operating as a casino and for the casino operations of other entities are within the scope of Topic 606 :  on revenue from contracts with customers. See paragraph 924-815-15-1 : .

> Definition of Derivative Instrument

15-83A A derivative instrument is a financial instrument or other contract with all of the following characteristics:

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


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

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

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

1. Its terms implicitly or explicitly require or permit net settlement.
2. It can readily be settled net by a means outside the contract.
3. It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

15-84 In this Topic, both of the following are collectively referred to as derivative instruments:

- a. A derivative instrument included within the scope of this Subtopic by this Subsection
- b. An embedded derivative that has been separated from a host contract as required by paragraph 815-15-25-1 : .

15-85 The terms *underlying*, *notional amount*, *payment provision*, and *settlement* are intended to include the plural forms in the remainder of this Topic. Including both the singular and plural forms is more accurate but much more awkward and impairs the readability.

15-86 Following is further discussion of each of the three characteristics of a derivative instrument:

- a. Underlying, notional amount, payment provision
- b. Initial net investment
- c. Net settlement.

> > Underlying, Notional Amount, Payment Provision

15-87 Following is further discussion of the features that relate to the settlement amount(s) of a derivative instrument:

- a. Underlying
- b. Notional amount
- c. Payment provision.


> > > Underlying

15-88 An underlying is a variable that, along with either a notional amount or a payment provision, determines the settlement of a derivative instrument. An underlying usually is one or a combination of the following:





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

15-89 However, an underlying may be any variable whose changes are observable or otherwise objectively verifiable. An underlying may be a price or rate of an asset or liability but is not the asset or liability itself.

15-90 Reference to either a notional amount or a payment provision is needed in relation to an underlying to compute the contract's periodic settlements and resulting changes in fair value.

15-91 Example 3 (see paragraph 815-10-55-77 : ) illustrates the determination of an underlying if a commodity contract includes a fixed element and a variable element.

> > > Notional Amount

15-92 A notional amount is a number of currency units, shares, bushels, pounds, or other units specified in the contract. Other names are used, for example, the notional amount is called a **face amount**  in some contracts. The settlement of a derivative instrument with a notional amount is determined by interaction of that notional amount with the underlying. The interaction may be simple multiplication, or it may involve a formula with leverage factors or other constants. As defined in the glossary, the **effective notional amount**  is the stated notional amount adjusted for any leverage factor. If a requirements contract contains explicit provisions that support the calculation of a determinable amount reflecting the buyer's needs, then that contract has a notional amount. See paragraphs 815-10-55-5 through 55-7 :  for related implementation guidance. For implementation guidance on identifying a commodity contract's notional amount, see paragraph 815-10-55-5 : .

> > > Payment Provision

15-93As defined in the glossary, a payment provision specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner. For example, a derivative instrument might require a specified payment if a referenced interest rate increases by 300 basis points.

> > Initial Net Investment


15-94Many derivative instruments require no initial net investment. Some require an initial net investment as compensation for one or both of the following:


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

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

15-95A derivative instrument does not require an initial net investment in the contract that is equal to the notional amount (or the notional amount plus a premium or minus a discount) or that is determined by applying the notional amount to the underlying. For example:

- a. A commodity futures contract generally requires no net investment, while purchasing the same commodity requires an initial net investment equal to its market price. However, both contracts reflect changes in the price of the commodity in the same way (that is, similar gains or losses will be incurred).
- b. A swap or forward contract generally does not require an initial net investment unless the terms favor one party over the other.
- c. An option generally requires that one party make an initial net investment (a premium) because that party has the rights under the contract and the other party has the obligations.

15-96 If the initial net investment in the contract (after adjustment for the time value of money) is less, by more than a nominal amount, than the initial net investment that would be commensurate with the amount that would be exchanged either to acquire the asset related to the underlying or to incur the obligation related to the underlying, the characteristic in paragraph 815-10-15-83(b) : is met. The amount of that asset acquired or liability incurred should be comparable to the effective notional amount of the contract. This does not imply that a slightly off-market contract cannot be a derivative instrument in its entirety. That determination is a matter of facts and circumstances and shall be evaluated on a case-by-case basis. Example 16, Case C (see paragraph 815-10-55-166 : ) illustrates the guidance in this paragraph.

15-97 A contract that requires an initial net investment in the contract that is in excess of the amount determined by applying the effective notional amount to the underlying is not a derivative instrument in its entirety. Example 16, Case A (see paragraph 815-10-55-150 : ) illustrates such a contract.

15-98 The phrase *initial net investment* is stated from the perspective of only one party to the contract, but it determines the application of this Subtopic for both parties. Even though a contract may be a derivative instrument as described in paragraphs 815-10-15-13 through 15-139 : for both parties, the scope exceptions in paragraphs 815-10-15-74 through 15-75 : apply only to the issuer of the contract and will result in different reporting by the two parties. The normal purchases and sales scope exception (beginning in paragraph 815-10-15-22 :) also may apply to one of the parties but not the other.

> > Net Settlement

15-99A contract fits the description in paragraph 815-10-15-83(c) : if its settlement provisions meet criteria for any of the following:

- a. Net settlement under contract terms

- b. Net settlement through a market mechanism
- c. Net settlement by delivery of derivative instrument or asset readily convertible to cash.



> > > Net Settlement Under Contract Terms

15-100 In this form of net settlement, neither party is required to deliver an asset that is associated with the underlying and that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (or the notional amount plus a premium or minus a discount). (For example, most interest rate swaps do not require that either party deliver interest-bearing assets with a principal amount equal to the notional amount of the contract.) Net settlement may be made in cash or by delivery of any other asset (such as the right to receive future payments—see the discussion beginning in paragraph 815-10-15-104 :), whether or not that asset is readily convertible to cash.

15-101 Further considerations in the application of this form of net settlement are addressed as follows:

- a. Net share settlement
- b. Net settlement in the event of nonperformance or default
- c. Structured settlement as net settlement
- d. Net settlement of a debt instrument through exercise of an embedded put option or call option.

> > > > Net Share Settlement

15-102 The net settlement criterion as described in paragraph 815-10-15-83(c) : and related paragraphs in this Subsection is met if a contract provides for [net share settlement](#)  at the election of either party. Therefore, if either counterparty could net share settle a contract, then it would be considered to have the net settlement characteristic of a derivative instrument regardless of whether the net shares received were readily convertible to cash as described in paragraph 815-10-15-119 : or were restricted for more than 31 days as discussed beginning in paragraph 815-10-15-130 : . While this conclusion applies to both investors and issuers of contracts, issuers of those net share settled contracts shall consider whether such contracts qualify for the scope exception in paragraph 815-10-15-74(a) : . See Example 5 (paragraph 815-10-55-90 : ).

> > > > Net Settlement in the Event of Nonperformance or Default

15-103 Penalties for nonperformance may give a contract the characteristic of net settlement. For example:

- a. A penalty for nonperformance in a purchase order is a net settlement provision if the amount of the penalty is based on changes in the price of the items that are the subject of the contract.
- b. A fixed penalty for nonperformance is not a net settlement provision.
- c. A contract that contains a variable penalty for nonperformance based on changes in the price of the items that are the subject of the contract does not contain a net settlement provision as discussed beginning in paragraph 815-10-15-100 : if it also contains an incremental penalty of a fixed amount (or fixed amount per unit) that would be expected to be significant enough at all dates during the remaining term of the contract to make the possibility of nonperformance remote. If a contract includes such a provision, it effectively requires performance, that is, requires the party to deliver an asset that is associated with the underlying. The assessment of the fixed incremental penalty shall be performed only at the contract's inception. The magnitude of the fixed incremental penalty shall be assessed on a standalone basis as a disincentive for nonperformance, not in relation to the overall penalty.

d. An **asymmetrical default provision** does not give a commodity forward contract the characteristic described as net settlement beginning in paragraph 815-10-15-100 : .For related implementation guidance, see the discussion beginning in paragraph 815-10-55-10 :

> > > Structured Settlement as Net Settlement

15-104 Upon settlement of a contract, in lieu of immediate net cash settlement of the gain or loss under the contract, the holder may receive a financial instrument involving terms that would provide for the gain or loss under the contract to be received or paid over a specified time period. A contract that provides for such a structured payout of the gain (or loss) resulting from that contract meets the characteristic of net settlement in paragraphs 815-10-15-100 through 15-109 : if the fair value of the cash flows to be received (or paid) by the holder under the structured payout are approximately equal to the amount that would have been received (or paid) if the contract had provided for an immediate payout related to settlement of the gain (or loss) under the contract. The fact that a contract accomplishes settlement by requiring the party in a loss position under the contract to make cash payments over a specified timeframe to the party in a gain position (in lieu of immediate cash settlement of the gain) does not preclude the contract from meeting the characteristic of net settlement in those paragraphs.

15-105A A contract that requires additional investing or borrowing to obtain the benefits of the contract's gain only over time as a traditional adjustment of the yield on the amount invested or the interest element on the amount borrowed does not meet the characteristic of net settlement.

15-106 Contracts that require one party to the contract to invest funds in or borrow funds from the other party so that the party in a gain position under the contract can obtain the value of that gain over time as a nontraditional adjustment of the yield on the amount invested or the interest element on the amount borrowed may meet the characteristic of net settlement. See related implementation guidance beginning in paragraph 815-10-55-19 :

> > > Net Settlement of a Debt Instrument Through Exercise of an Embedded Put Option or Call Option

15-107 The potential settlement of the debtor's obligation to the creditor that would occur upon exercise of a put option or call option embedded in a debt instrument meets the net settlement criterion as discussed beginning in paragraph 815-10-15-100 : because neither party is required to deliver an asset that is associated with the underlying. Specifically:

- a. The debtor does not receive an asset when it settles the debt obligation in conjunction with exercise of the put option or call option.
- b. The creditor does not receive an asset associated with the underlying.

15-108 The guidance in the preceding paragraph shall be applied under both of the following circumstances:

- a. When applying paragraph 815-15-25-1(c) : to a put option or call option (including a prepayment option) embedded in a debt instrument
- b. When analyzing the net settlement criterion (see guidance beginning in paragraph 815-10-15-100 :) for a freestanding call option held by the debtor on its own debt instrument and for a freestanding put option issued by the debtor on its own debt instrument.

15-109 The guidance in paragraph 815-10-15-107 : shall not be applied under either of the following circumstances:

- a. To put or call options that are added to a debt instrument by a third party contemporaneously with or after the issuance of a debt instrument. (In that circumstance, see paragraph 815-10-15-6 : .)

b. By analogy to an embedded put or call option in a hybrid instrument that does not contain a debt host contract.

> > > Net Settlement Through a Market Mechanism


15-109A Further considerations are addressed as follows:

- a. Primary characteristics of market mechanism
- b. Indicators of primary characteristics of market mechanism
- c. Effects of an assignment clause on market mechanism
- d. Ongoing evaluation of market mechanism.

> > > > Primary Characteristics of Market Mechanism

15-110 In this form of net settlement, one of the parties is required to deliver an asset of the type described in paragraph 815-10-15-100, but there is an established market mechanism that facilitates net settlement outside the contract. (For example, an exchange that offers a ready opportunity to sell the contract or to enter into an offsetting contract.) Market mechanisms may have different forms. Many derivative instruments are actively traded and can be closed or settled before the contract's expiration or maturity by net settlement in active markets.

15-111 The term *market mechanism* is to be interpreted broadly and includes any institutional arrangement or other agreement having the requisite characteristics. Regardless of its form, an established market mechanism must have all of the following primary characteristics:

- a. It is a means to settle a contract that enables one party to readily liquidate its net position under the contract. A market mechanism is a means to realize the net gain or loss under a particular contract through a net payment. Net settlement may occur in cash or any other asset. A method of settling a contract that results only in a gross exchange or delivery of an asset for cash (or other payment in kind) does not satisfy the requirement that the mechanism facilitate net settlement.
- b. It results in one party to the contract becoming fully relieved of its rights and obligations under the contract. A market mechanism enables one party to the contract to surrender all future rights or avoid all future performance obligations under the contract. Contracts that do not permit assignment of the contract from the original issuer to another party do not meet the characteristic of net settlement through a market mechanism. The ability to enter into an offsetting contract, in and of itself, does not constitute a market mechanism because the rights and obligations from the original contract survive. The fact that an entity has offset its rights and obligations under an original contract with a new contract does not by itself indicate that its rights and obligations under the original contract have been relieved. This applies to contracts regardless of whether either of the following conditions exists:
 - 1. The asset associated with the underlying is financial or nonfinancial.
 - 2. The offsetting contract is entered into with the same counterparty as the original contract or a different counterparty (unless an offsetting contract with the same counterparty relieves the entity of its rights and obligations under the original contract, in which case the arrangement does constitute a market mechanism). (Example 6 [see paragraph 815-10-55-91 : ] illustrates this guidance.)
- c. Liquidation of the net position does not require significant transaction costs. For purposes of assessing whether a market mechanism exists, an entity shall consider transaction costs to be significant if they are 10 percent or more of the fair value of the contract. Whether assets deliverable under a group of futures contracts exceeds the amount of assets that could rapidly be absorbed by the market without significantly affecting the price is not relevant to this characteristic. The lack of a liquid market for a group of contracts does not affect the determination of whether there is a market mechanism that facilitates net settlement because the test focuses on a singular contract. An exchange offers a ready opportunity to sell each contract,

thereby providing relief of the rights and obligations under each contract. The possible reduction in price due to selling a large futures position is not considered to be a transaction cost.

d. Liquidation of the net position under the contract occurs without significant negotiation and due diligence and occurs within a time frame that is customary for settlement of the type of contract. A market mechanism facilitates easy and expedient settlement of the contract. As discussed under the primary characteristic in (a), those qualities of a market mechanism do not preclude net settlement in assets other than cash.

15-112 Paragraph Not Used : 


> > > Indicators of Primary Characteristics of Market Mechanism

15-113 Entities shall consider the indicators in the following paragraph for each of the primary characteristics in determining whether a method of settling a contract qualifies as an established market mechanism. All of the indicators need not be present for an entity to conclude that a market mechanism exists for a particular contract.

15-114 The following are indicators that the primary characteristic in paragraph 815-10-15-111(a) : is met:

- a. Access to potential counterparties is available regardless of the seller's size or market position.
- b. Risks assumed by a market maker as a result of acquiring a contract can be transferred by a means other than by repackaging the original contract into a different form.

15-115 The following are indicators that the primary characteristic in paragraph 815-10-15-111(b) : is met:


- a. There are multiple market participants willing and able to enter into a transaction at market prices to assume the seller's rights and obligations under a contract.
- b. There is sufficient liquidity in the market for the contract, as indicated by the transaction volume as well as a relatively narrow observable [bid-ask spread](#) .

15-116 The following are indicators that primary characteristic in paragraph 815-10-15-111(d) : is met:

- a. Binding prices for the contract are readily obtainable.
- b. Transfers of the instrument involve standardized documentation (rather than contracts with entity-specific modifications) and standardized settlement procedures.
- c. Individual contract sales do not require significant negotiation and unique structuring.
- d. The closing period is not extensive because of the need to permit legal consultation and document review.


> > > Effects of an Assignment Clause on Market Mechanism

15-117 As noted in the primary characteristic in paragraph 815-10-15-111(b) : , an assessment of the substance of any assignment clause is required to determine whether that assignment clause precludes a party from being relieved of all rights and obligations under the contract. Although permission to assign a contract shall not be unreasonably withheld by the counterparty in accordance with the terms of a contract, an assignment feature cannot be viewed simply as a formality because it may be invoked at any time to prevent the nonassigning party from being exposed to unacceptable credit or performance risk. Accordingly, the existence of an assignment clause may or may not permit a party from being relieved of its rights and obligations under the contract. If it is remote that the counterparty will withhold permission to assign the contract, the mere existence of the clause shall not preclude the contract from possessing the net settlement characteristic described in paragraph 815-10-15-110 : as a market mechanism. Such a determination requires assessing whether a sufficient number of acceptable potential assignees exist in the marketplace such that assignment of the contract would not result

in imposing unacceptable [credit risk](#)  or performance risk on the nonassigning party. Consideration shall be given to past counterparty and industry practices regarding whether permission to be relieved of all rights and obligations under similar contracts has previously been withheld. However, if it is reasonably possible or probable

that the counterparty will withhold permission to assign the contract, the contract does not possess the net settlement characteristic described in paragraph 815-10-15-110 : as a market mechanism.

> > > Ongoing Evaluation of Market Mechanism

15-118 The evaluation of whether a market mechanism exists shall be performed at inception and on an ongoing basis throughout a contract's life. Example 4, Case A (see paragraph 815-10-55-86 : ) illustrates this guidance.


> > > Net Settlement by Delivery of Derivative Instrument or Asset Readily Convertible to Cash

15-119 In this form of net settlement, one of the parties is required to deliver an asset of the type described in paragraph 815-10-15-100 : , but that asset is readily convertible to cash or is itself a derivative instrument.

15-120 An example of a contract with this form of net settlement is a forward contract that requires delivery of an exchange-traded equity security. Even though the number of shares to be delivered is the same as the notional amount of the contract and the price of the shares is the underlying, an exchange-traded security is readily convertible to cash. Another example is a swaption—an option to require delivery of a swap contract, which is a derivative instrument.

15-121 Examples of assets that are readily convertible to cash include a security or commodity traded in an active market and a unit of foreign currency that is readily convertible into the functional currency of the reporting entity.

15-122 An asset (whether financial or nonfinancial) shall be considered to be readily convertible to cash only if the net amount of cash that would be received from a sale of the asset in an active market is either equal to or not significantly less than the amount an entity would typically have received under a net settlement provision. The net amount that would be received upon sale need not be equal to the amount typically received under a net settlement provision. Parties generally should be indifferent as to whether they exchange cash or the assets associated with the underlying, although the term *indifferent* is not intended to imply an approximate equivalence between net settlement and proceeds from sale in an active market.

15-123 The form of a financial instrument is important; individual instruments cannot be combined for evaluation purposes to circumvent compliance with the criteria beginning in paragraph 815-10-15-119 : . Example 8 (see paragraph 815-10-55-111 : ) illustrates this guidance.

15-124 Discussion of additional matters relevant to this form of net settlement is organized as follows:

- a. Effect of conversion costs
- b. Contracts involving multiple deliveries
- c. Asset's suitability as collateral does not equate to asset being readily convertible to cash
- d. Determining whether shares of stock are readily convertible to cash
- e. Ongoing evaluation of readily convertible to cash.

> > > Effect of Conversion Costs

15-125 If an entity determines that the estimated costs that would be incurred to immediately convert the asset to cash are not significant, then receipt of that asset puts the entity in a position not substantially different from net settlement. Therefore, an entity shall evaluate, in part, the significance of the estimated costs of converting the asset to cash in determining whether those assets are readily convertible to cash.

15-126 For purposes of assessing significance of such costs, an entity shall consider those estimated conversion costs to be significant only if they are 10 percent or more of the gross sales proceeds (based on the spot price

at the inception of the contract) that would be received from the sale of those assets in the closest or most economical active market.

15-127The assessment of the significance of those conversion costs shall be performed only at inception of the contract.

> > > Contracts Involving Multiple Deliveries

15-128 For contracts that involve multiple deliveries of the asset, the phrase *in an active market that can rapidly absorb the quantity held by the entity* in the definition of *readily convertible to cash* shall be applied separately to the expected quantity in each delivery.

> > > Asset's Suitability as Collateral Does Not Equate to Asset Being Readily Convertible to Cash

15-129The ability to use a security that is not publicly traded or an agricultural or mineral product without an active market as collateral in a borrowing does not, in and of itself, mean that the security or the commodity is readily convertible to cash.

> > > Determining Whether Shares of Stock Are Readily Convertible to Cash

15-130A security that is publicly traded but for which the market is not very active is readily convertible to cash if the number of shares or other units of the security to be exchanged is small relative to the daily transaction volume. That same security would not be readily convertible if the number of shares to be exchanged is large relative to the daily transaction volume.

15-131Shares of stock in a publicly traded entity to be received upon the exercise of a stock purchase warrant do not meet the characteristic of being readily convertible to cash if both of the following conditions exist:

- a. The stock purchase warrant is issued by an entity for only its own stock (or stock of its consolidated subsidiaries).
- b. The sale or transfer of the issued shares is restricted (other than in connection with being pledged as collateral) for a period of 32 days or more from the date the stock purchase warrant is exercised.

15-132Restrictions imposed by a stock purchase warrant on the sale or transfer of shares of stock that are received from the exercise of that warrant issued by an entity for other than its own stock (whether those restrictions are for more or less than 32 days) do not affect the determination of whether those shares are readily convertible to cash. The accounting for restricted stock to be received upon exercise of a stock purchase warrant shall not be analogized to any other type of contract.

15-133Newly outstanding shares of common stock in a publicly traded company to be received upon exercise of a stock purchase warrant cannot be considered readily convertible to cash if, upon issuance of the shares, the sale or transfer of the shares is restricted (other than in connection with being pledged as collateral) for more than 31 days from the date the stock purchase warrant is exercised (not the date the warrant is issued), unless the holder has the power by contract or otherwise to cause the requirement to be met within 31 days of the date the stock purchase warrant is exercised.

15-134In contrast, if the sale of an actively traded security is restricted for 31 days or less from the date the stock purchase warrants are exercised, that limitation is not considered sufficiently significant to serve as an impediment to considering the shares to be received upon exercise of those stock purchase warrants as readily convertible to cash.

15-135The guidance that a restriction for more than 31 days prevents the shares from being considered readily convertible to cash applies only to stock purchase warrants issued by an entity for its own shares of stock, in which case the shares being issued upon exercise are newly outstanding (including issuance of treasury shares)

and are restricted with respect to their sale or transfer for a specified period of time beginning on the date the stock purchase warrant is exercised.

15-136 However, even if the sale or transfer of the shares is restricted for 31 days or less after the stock purchase warrant is exercised, an entity still must evaluate both of the following criteria:

- a. Whether an active market can rapidly absorb the quantity of stock to be received upon exercise of the warrant without significantly affecting the price
- b. Whether the other estimated costs to convert the stock to cash are expected to be not significant. (The assessment of the significance of those conversion costs shall be performed only at inception of the contract.)

Thus, the guidance in paragraph 815-10-15-122 : shall be applied to those stock purchase warrants with sale or transfer restrictions of 31 days or less on the shares of stock.

15-137 If the shares of an actively traded common stock to be received upon exercise of the stock purchase warrant can be reasonably expected to qualify for sale within 31 days of their receipt, such as may be the case under SEC Rule 144, Selling Restricted and Control Securities, or similar rules of the SEC, any initial sales restriction is not an impediment to considering those shares as *readily convertible to cash*, as that phrase is used in paragraph 815-10-15-119 : . (However, a restriction on the sale or transfer of shares of stock that are received from an entity other than the issuer of that stock through the exercise of another option or the settlement of a forward contract is not an impediment to considering those shares readily convertible to cash, regardless of whether the restriction is for a period that is more or less than 32 days from the date of exercise or settlement.)

15-138 Paragraph 815-10-15-141 : explains that the guidance in the Certain Contracts on Debt and Equity Securities Subsections applies to those warrants that are not derivative instruments subject to this Topic but that involve the acquisition of securities that will be accounted for under Topic 320 : . However, such warrants are not eligible to be hedging instruments.

Pending Content

Transition Date: (P) December 16, 2017; (N) December 16, 2018 | **Transition Guidance:** 825-10-65-2 :

Paragraph 815-10-15-141 : explains that the guidance in the Certain Contracts on Debt and Equity Securities Subsections applies to those warrants that are not derivative instruments subject to this Topic but that involve the acquisition of securities that will be accounted for under either Topic 320 : or Topic 321 : . However, such warrants are not eligible to be hedging instruments.

> > > Ongoing Evaluation of Readily Convertible to Cash

15-139 The evaluation of whether items to be delivered under a contract are readily convertible to cash shall be performed at inception and on an ongoing basis throughout a contract's life (except that, as stated in paragraph 815-10-15-127 : , the assessment of the significance of those conversion costs shall be performed only at inception of the contract). Example 4, Cases B, C, and D (see paragraphs 815-10-55-87 through 55-89 :) illustrate this guidance.

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From: [Michelle Herrman](#)
To: [John Hill](#); [Lee Ann Watters](#)
Subject: RE: Financial Capacity Clarification
Date: Thursday, January 18, 2018 3:35:00 PM
Attachments: [image001.png](#)
[image002.png](#)

John,

I have read the sections you have cited and I concur with your conclusion. I will work on preparing a disclosure to be used for our financial statements.

I greatly appreciate your help.

Michelle D. Herrman, CPA, PHR
Vice President of Finance
Office: 606-451-4337



From: John Hill [mailto:John.Hill@mcmcpa.com]
Sent: Thursday, January 18, 2018 12:15 PM
To: Michelle Herrman <michelleh@skrecc.com>; Lee Ann Watters <LeeAnn.Watters@mcmcpa.com>
Subject: RE: Financial Capacity Clarification

Michelle

See attached. I believe paragraph 15-45 attached is directly on point for both contracts that would state that you meet the normal purchase exception (which is referred to in section 15-13b – the 10b exception in the old guidance).

Take a look at 15-45 – specifically a and c – I believe based on the contracts and our discussions you meet all the criteria. If you would confirm that then I believe both are excluded out of derivative accounting and treated as disclosure items as a commitment.

John

John Hill, CPA
Assurance Partner
Phone: 502.882.4381

From: Michelle Herrman [mailto:michelleh@skrecc.com]
Sent: Thursday, January 18, 2018 9:48 AM
To: Lee Ann Watters; John Hill
Subject: Financial Capacity Clarification

Lee Ann and John,

I wanted to forward some additional information regarding the way that the financial capacity pricing of our contract will be handled. Below are a few examples that were provided to us that will assist in clarifying.

I also wanted to mention, that the auction years take place three years in advance. For instance, in 2017 they held the pricing auctions for 2020. (As are the 2019 prices) Those prices are now known and firm. We are told that this is the pattern that will be followed in future years.

In our conversation yesterday it was mentioned that the energy piece of our contract is not considered a derivative because of the “10b Exception.” Could you please let me know the full reference for that exception? Where can I find that guidance?

I appreciate your assistance in helping me work through this.

Thank you.

Michelle D. Herrman, CPA, PHR
Vice President of Finance
Office: 606-451-4337



Here are examples to illustrate settlements where one example has capacity prices below the assumed contract price and one example has capacity prices above the assumed contract price. The examples show total dollars settled for the complete Planning Year, however settlements occur monthly during the actual Planning Year. The examples should illustrate that SKRECC will effectively pay the Contract price plus any difference between the Final Zonal Capacity Price and the BRA Resource Clearing Price, assuming the Daily UCAP Obligation is the same as the quantity in the MSCG-SKRECC hedge.

For settlement illustration purposes only; prices are fictitious

Zonal Capacity Price breakdown

Planning Year	BRA Resource Clearing Price-(CP)	BRA Resource Clearing Price (Base)	BRA Zonal Capacity Price	1st IA	2nd IA	CP Transition	3IA	Zonal Capacity Price (\$/MW-Day)
PY X	59.37		59.37	0.01	0.75	0	1.63	61.76
PY Y	140.00		139.81	0.78	1.62	0	1.43	143.64

Assumptions

Daily UCAP Obligation =	68 MWs
Contract Price between MSCG and SKRECC	██████████ \$/MW Day
Contract Quantity in MSCG/SKRECC Hedge	68
Number of Days in Planning Year	365 Days

PY X	SKRECC pays PJM	(=61.76*68*365)	1,532,883	\$/PY
	SKRECC pays MSCG	██████████		\$/PY
	MSCG pays SKRECC	██████████		\$/PY
	SKRECC Total Payment	██████████		\$/PY

Effective Capacity Rate (=3,161820/(68*365))	██████████	\$/MW-day
Contract Price	██████████	\$/MW-day
Difference	██████████	\$/MW-day
Final Zonal Capacity Price - BRA RCP	██████████	\$/MW-day

PY Y	SKRECC pays PJM	(=143.64*68*365)	3,565,145	\$/PY
	SKRECC pays MSCG	██████████		\$/PY
	MSCG pays SKRECC	██████████		\$/PY
	SKRECC Total Payment	██████████		\$/PY

Effective Capacity Rate (=3,192,845/(68*365))	██████████	\$/MW-day
Contract Price	██████████	\$/MW-day
Difference	██████████	\$/MW-day
Final Zonal Capacity Price - BRA RCP	██████████	\$/MW-day

From: [Michelle Herrman](#)
To: [Lee Ann Watters](#)
Cc: [John Hill](#)
Subject: RE: Contract
Date: Friday, January 12, 2018 11:12:00 AM
Attachments: [Master Purchase Power and sale agreement EEI version.pdf](#)
[image001.png](#)
[SKRECC MSCG EEI Cover Sheet \(Executed\).pdf](#)
[SKRECC MSCG IECA August 2012 \(Executed\).pdf](#)
[SKRECC MSCG IECA March 2013.pdf](#)
[SKRECC MSCG EEI Collateral Annex \(Executed\).pdf](#)
[MSCG-SKRECC Energy Confirm \(Executed\).pdf](#)
[MSCG-SKRECC Capacity Confirm \(Executed\).pdf](#)

The attachments are included in our application

Lee Ann,

I am forwarding the components of the contract. They are composed of the following:

1. Master Power Purchase and Sale Agreement
2. Collateral Annex (including Paragraph 10)
3. IECA August 2012 Dodd-Frank Agreement
4. IECA March 2013 Dodd-Frank Agreement
5. Financial Capacity Confirmation
6. Firm Physical Energy Confirmation

Items 5 and 6 contain the details of the purchase of the 58MW of Energy and 68 MW of Capacity. To summarize, we have agreed to purchase a consistent block of energy (7x24x365) from Morgan Stanley. They will provide this energy through a PJM Market Interconnection that will pass to us through East Kentucky Power. The 58 MW consist of about 40% of our kWh energy requirements on an annual basis. The cost of the energy is a firm fixed cost that will not change during the life of the contract. The Capacity Charge is a fixed price, but with a modification. There is incremental pricing for the capacity charge. There is an initial auction price, then the initial auction price may change during two incremental auctions. We have an agreed upon price for the initial auction, but may have exposure in pricing due to the incremental auctions. (Exposure up or down).

We still are under contract with East Kentucky power, but our wholesale purchase agreement with them allows us to purchase a portion of our energy needs from alternate sources.

This agreement is highly confidential and we ask that you maintain the confidentiality. Please let me know if you have any questions.

Thank you.

Michelle D. Herrman, CPA, PHR

Vice President of Finance

Office: 606-451-4337



From: Lee Ann Watters [mailto:LeeAnn.Watters@mcmcpa.com]
Sent: Friday, January 12, 2018 9:54 AM
To: Michelle Herrman <michelleh@skrecc.com>
Cc: John Hill <John.Hill@mcmcpa.com>
Subject: Contract

Michelle – I discussed the energy contract with John Hill and from the preliminary information he believes we have a derivative that may or may not qualify as a hedge. Would it be possible for you to send us the contract so that we can review it?

Lee Ann Watters, CPA, CGFM

Assurance Principal
Phone: 502.783.2528



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