

APPENDIX B

Criteria for Shortcut Method

The following is FASB's guidance for the shortcut method, as explained in SFAS 133, *Accounting for Derivative Instruments and Hedging Activities* (June 1998):

Assuming No Ineffectiveness in a Hedge with an Interest Rate Swap

68. An assumption of no ineffectiveness is especially important in a hedging relationship involving an interest-bearing financial instrument and an interest rate swap because it significantly simplifies the computations necessary to make the accounting entries. An entity may assume no ineffectiveness in a hedging relationship of interest rate risk involving a recognized interest-bearing asset or liability and an interest rate swap (or a compound hedging instrument composed of an interest rate swap and a mirror-image call or put option as discussed in paragraph 68(d) below) if all of the applicable conditions in the following list are met:

Conditions applicable to both fair value hedges and cash flow hedges

- a. The notional amount of the swap matches the principal amount of the interest-bearing asset or liability being hedged.
- b. If the hedging instrument is solely an interest rate swap, the fair value of that swap at the inception of the hedging relationship is zero. If the hedging instrument is a compound derivative composed of an interest rate swap and mirror-image call or put option as discussed in paragraph 68(d), the premium for the mirror-image call or put option must be paid or received in the same manner as the premium on the call or put option embedded in the hedged item. That is, the reporting entity must determine whether the implicit premium for the purchased call or written put option embedded in the hedged item was principally paid at inception-acquisition (through an original issue discount or premium) or is being paid over the life of the hedged item (through an adjustment of the interest rate). If the implicit premium for the call or put option embedded in the hedged item was principally paid at inception-acquisition, the fair value of the hedging instrument at the inception of the hedging relationship must be equal to the fair value of the mirror-image call or put option. In contrast, if the implicit premium for the call or put option embedded in the hedged item is principally being paid over the life of the hedged item, fair value of the hedging instrument at the inception of the hedging relationship must be zero.
- c. The formula for computing net settlements under the interest rate swap is the same for each net settlement. (That is, the fixed rate is the same throughout the term, and the variable rate is based on the same index and includes the same constant adjustment or no adjustment.)
- d. The interest-bearing asset or liability is not prepayable (that is, able to be settled by either party prior to its scheduled maturity) except as indicated in the following sentences. This criterion does not apply to an interest-bearing asset or liability that is prepayable solely due to an embed-

ded call option provided that the hedging instrument is a compound derivative composed of an interest rate swap and a mirror-image call option. The call option is considered a mirror image of the call option embedded in the hedged item if (1) the terms of the two call options match (including matching maturities, strike price, related notional amounts, timing and frequency of payments, and dates on which the instruments may be called) and (2) the entity is the writer of one call option and the holder (or purchaser) of the other call option. Similarly, this criterion does not apply to an interest-bearing asset or liability that is prepayable solely due to an embedded put option provided that the hedging instrument is a compound derivative composed of an interest rate swap and a mirror-image put option.

dd. The index on which the variable leg of the swap is based matches the benchmark interest rate designated as the interest rate risk being hedged for that hedging relationship.^{18c}

^{18c} For cash flow hedge situations in which the cash flows of the hedged item and the hedging instrument are based on the same index but that index is not the benchmark interest rate, the shortcut method is not permitted. However, the entity may obtain results similar to results obtained if the shortcut method was permitted.

e. Any other terms in the interest-bearing financial instruments or interest rate swaps are typical of those instruments and do not invalidate the assumption of no ineffectiveness.

Conditions applicable to fair value hedges only

- f. The expiration date of the swap matches the maturity date of the interest-bearing asset or liability.
- g. There is no floor or cap on the variable interest rate of the swap.
- h. The interval between repricings of the variable interest rate in the swap is frequent enough to justify an assumption that the variable payment or receipt is at a market rate (generally three to six months or less).

Conditions applicable to cash flow hedges only

- i. All interest receipts or payments on the variable-rate asset or liability during the term of the swap are designated as hedged, and no interest payments beyond the term of the swap are designated as hedged.
- j. There is no floor or cap on the variable interest rate of the swap unless the variable-rate asset or liability has a floor or cap. In that case, the swap must have a floor or cap on the variable interest rate that is comparable to the floor or cap on the variable-rate asset or liability. (For this purpose, comparable does not necessarily mean equal. For example, if a swap's variable rate is Libor and an asset's variable rate is Libor plus 2 percent, a 10 percent cap on the swap would be comparable to a 12 percent cap on the asset.)
- k. The repricing dates match those of the variable-rate asset or liability.