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Accounting for derivative instruments and hedging activities by not-for-profit health care organizations, and clarification of the performance indicator; Statement of position 02-2;

American Institute of Certified Public Accountants. Accounting Standards Executive Committee

STATEMENT OF POSITION 02-2

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Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator

Issued Under the Authority of the Accounting Standards Executive Committee

NOTE

Statements of Position on accounting issues present the conclusions of at least two-thirds of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting. Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, identifies AICPA Statements of Position that have been cleared by the Financial Accounting Standards Board as sources of established accounting principles in category *b* of the hierarchy of generally accepted accounting principles that it establishes. AICPA members should consider the accounting principles in this Statement of Position if a different accounting treatment of a transaction or event is not specified by a pronouncement covered by rule 203 of the AICPA Code of Professional Conduct. In such circumstances, the accounting treatment specified by the Statement of Position should be used, or the member should be prepared to justify a conclusion that another treatment better presents the substance of the transaction in the circumstances.

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SUMMARY

This Statement of Position (SOP) amends the AICPA Audit and Accounting Guide *Health Care Organizations* (Guide) to address how nongovernmental not-for-profit health care organizations should report gains or losses on hedging and nonhedging derivative instruments under Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended. This SOP requires the following:

- Not-for-profit health care organizations should apply the provisions of FASB Statement No. 133 (including the provisions pertaining to cash flow hedge accounting) in the same manner as for-profit enterprises.
- Not-for-profit health care organizations should provide all the disclosures required by paragraph 45 of FASB Statement No. 133, including disclosures related to reclassifications into earnings of gains and losses that are reported in accumulated other comprehensive income. Although those organizations are not otherwise required to report changes in the components of comprehensive income pursuant to paragraph 26 of FASB Statement No. 130, *Reporting Comprehensive Income*, such organizations should separately disclose the beginning and ending accumulated derivative gain or loss that has been excluded from the performance indicator (earnings measure), the related net change associated with current period hedging transactions, and the net amount of any reclassifications into the performance indicator in a manner similar to that described in paragraph 47 of FASB Statement No. 133.

The SOP also amends the Guide to clarify that the performance indicator (earnings measure) reported by not-for-profit health care organizations is analogous to income from continuing operations of a for-profit enterprise.

The provisions of the SOP are effective for fiscal years beginning after June 15, 2003. Earlier application of this SOP is encouraged but is permitted only as of the beginning of any fiscal quarter that begins after issuance of this SOP. The provisions of the SOP should be applied prospectively. Not-for-profit health care organizations that reported derivative gains or losses in a manner inconsistent with the conclusions of the SOP in financial statements issued prior to adoption of the SOP are not permitted to reclassify those gains or losses upon adoption.

FOREWORD

The accounting guidance contained in this document has been cleared by the Financial Accounting Standards Board (FASB). The procedure for clearing accounting guidance in documents issued by the Accounting Standards Executive Committee (AcSEC) involves the FASB reviewing and discussing in public board meetings (1) a prospectus for a project to develop a document, (2) a proposed exposure draft that has been approved by at least 10 of AcSEC's 15 members, and (3) a final document that has been approved by at least 10 of AcSEC's 15 members. The document is cleared if at least four of the seven FASB members do not object to AcSEC undertaking the project, issuing the proposed exposure draft or, after considering the input received by AcSEC as a result of the issuance of the exposure draft, issuing the final document.

The criteria applied by the FASB in its review of proposed projects and proposed documents include the following:

1. The proposal does not conflict with current or proposed accounting requirements, unless it is a limited circumstance, usually in specialized industry accounting, and the proposal adequately justifies the departure.

2. The proposal will result in an improvement in practice.

3. The AICPA demonstrates the need for the proposal.

4. The benefits of the proposal are expected to exceed the costs of applying it.

   In many situations, prior to clearance, the FASB will propose suggestions, many of which are included in the document.

Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator

Introduction

1. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, establishes accounting and reporting standards for derivative instruments and hedging activities. If certain conditions are met, a derivative may be specifically designated as a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment (fair value hedge), a hedge of the exposure to variable cash flows of an existing recognized asset or liability or a forecasted transaction (cash flow hedge), or a hedge of foreign currency exposure.[1]

2. The accounting for derivative gains and losses depends on the intended use of the derivative and the resulting designation.

    - For a fair value hedge, the gain or loss on the derivative is recognized in earnings in the period of change together with the offsetting loss or gain on the hedged item attributable to the risk being hedged.
    - For a cash flow hedge, the effective portion of the derivative's gain or loss is initially reported as a component of other comprehensive income (outside earnings) and subsequently reclassified into earnings

1. Not-for-profit health care organizations do not frequently enter into foreign currency hedges. Therefore, this Statement of Position (SOP) focuses on matters pertaining to fair value and cash flow hedges.

when the forecasted transaction affects earnings. Any ineffective portion of the gain or loss is reported in earnings immediately.

For a derivative not designated as a hedging instrument, the gain or loss is recognized in earnings in the period of change.

3. The application of FASB Statement No. 133 to entities that do not report earnings as a separate caption in a statement of financial performance (for example, a not-for-profit organization) is described in paragraph 43 of that Statement. Paragraph 43 indicates that such organizations shall recognize the gain or loss on hedging and nonhedging derivative instruments, and changes in the carrying amount of the hedged item in a fair value hedge, as a change in net assets in the period of change. Paragraph 43 also indicates that cash flow hedge accounting is not available to a not-for-profit or other entity that does not report earnings as a separate caption in a statement of financial performance. Consistent with the provisions of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, FASB Statement No. 133 does not prescribe how a not-for-profit organization should determine the components of an operating measure, if one is presented.

4. Many health care entities are organized as not-for-profit organizations, and thus would appear to be subject to the provisions of paragraph 43 of FASB Statement No. 133. The thrust of the guidance in paragraph 43 appears to be directed at the fact that FASB Statement No. 117 does not require not-for-profit entities to report earnings. However, not-for-profit health care organizations must report a defined measure of earnings (performance indicator) as a separate caption in the statement of operations, based on requirements contained in paragraphs 10.17 and 10.18 of the AICPA Audit and Accounting Guide *Health Care Organizations* (the Guide). Consequently, some not-for-profit health care organizations believed that paragraph 43 of FASB Statement No. 133 (including its provisions related to cash flow hedge accounting) did not affect them. Those entities applied the provisions of FAB Statement No. 133 in the same manner as for-profit enterprises. Other not-for-

profit health care organizations believed they were subject to the guidance in paragraph 43, but interpreted that guidance in different ways. As a result, diversity in practice arose among not-for-profit health care organizations with respect to their accounting for derivatives.

5. This Statement of Position (SOP) addresses how not-for-profit health care organizations should report gains or losses on hedging and nonhedging derivative instruments under FASB Statement No. 133 and clarifies certain matters with respect to the performance indicator (earnings measure) reported by such organizations.

Scope

6. This SOP applies to not-for-profit health care organizations that are within the scope of the Guide. It does not apply to governmental entities that are within the scope of the Guide.

Conclusions

Application of FASB Statement No. 133

7. Except as provided in paragraph 8 of this SOP, not-for-profit health care organizations should apply the provisions of FASB Statement No. 133 (including the provisions pertaining to cash flow hedge accounting) in the same manner as for-profit enterprises. That is, the gain or loss items that affect a for-profit enterprise's income from continuing operations similarly should affect the not-for-profit health care organization's performance indicator, and the gain or loss items that are excluded from a for-profit enterprise's income from continuing operations (such as items reported in other comprehensive income) similarly should be excluded from the performance indicator by the not-for-profit health care organization.

8. Paragraph 47 of FASB Statement No. 133 discusses requirements to report changes in the components of comprehensive income pursuant to paragraph 26 of FASB Statement No. 130, *Reporting Comprehensive Income*.

Although not-for-profit health care organizations are not subject to the requirements of FASB Statement No. 130, this SOP requires those organizations to separately disclose the beginning and ending accumulated derivative gain or loss that has been excluded from the performance indicator (also see paragraph 10 of this SOP), the related net change associated with current period hedging transactions, and the net amount of any reclassifications into the performance indicator in a manner similar to that described in paragraph 47 of FASB Statement No. 133. Similarly, this SOP requires not-for-profit health care organizations to provide disclosures that are analogous to those required by paragraph 45 of FASB Statement No. 133 for for-profit enterprises, including the disclosure of anticipated reclassifications into the performance indicator of gains and losses that have been excluded from that measure and reported in accumulated derivative gain or loss as of the reporting date.

Performance Indicator

9. Paragraphs 10.17 and 10.18 of the Guide are amended as follows. The following text is added after the first sentence of paragraph 10.17:

> This performance indicator and the income from continuing operations reported by for-profit health care enterprises generally are consistent, except for transactions that clearly are not applicable to one kind of entity (for example, for-profit health care enterprises typically would not receive contributions, and not-for-profit health care organizations would not award stock compensation). That is, the performance indicator is analogous to income from continuing operations of a for-profit enterprise.

In paragraph 10.18, item *e* is eliminated, item *f* is renumbered *e*, and item *g* is deleted and replaced with the following two subpoints:

> *f.* Items that are required to be reported in or reclassified from other comprehensive income, such as minimum pension liabilities in accordance with paragraph 37 of FASB Statement No. 87, *Employers' Accounting for Pensions*; foreign currency translation adjustments; and the effective portion of the gain or loss on deriva-

tive instruments designated and qualifying as cash flow hedging instruments.

g. Items that are required to be reported separately under specialized not-for-profit standards. These include extraordinary items, the effect of discontinued operations, and the cumulative effect of accounting changes pursuant to the provisions of FASB Statement No. 117; and unrealized gains and losses on investments not restricted by donors or by law (except for those investments classified as trading securities) and investment returns restricted by donors or by law, as required by paragraphs 4.07 through 4.10 of this Guide.

Effective Date and Transition

10. The provisions of this SOP are effective for fiscal years beginning after June 15, 2003. Earlier application of this SOP is encouraged but is permitted only as of the beginning of any fiscal quarter that begins after issuance of this SOP. This SOP should be applied prospectively for all contracts existing on the initial date of application of this SOP and for transactions after that date. Derivative gains or losses reported in a manner inconsistent with the provisions of this SOP in financial statements for periods prior to the initial date of application of this SOP should not be reclassified upon adoption. Any derivative gains and losses excluded from the performance indicator in the financial statements issued for periods ended before the initial date of application of this SOP that did not meet the cash flow hedging criteria of FASB Statement No. 133 should not be reclassified and included as a component of the performance indicator in any period subsequent to the initial date of application of this SOP. In addition, the derivative gains and losses referred to in the preceding sentence should not be included in the disclosure of the accumulated derivative gain or loss (as described in paragraph 8 of this SOP). However, to the extent that derivative gains or losses on cash flow hedges qualifying under FASB Statement No. 133 had been reported in a manner consistent with the provisions of this SOP in financial statements for periods prior to the initial date of application of this SOP,

such amounts should be included in that disclosure and should be reclassified and included in the performance indicator when the hedged transaction affects the performance indicator. When the financial statements of the year of adoption are presented separately or included in comparative financial statements, the notes to the financial statements should disclose (*a*) the fact that this SOP has been adopted and the effective date of adoption, and (*b*) the nature of any differences in accounting principles or financial statement presentation applicable to the financial statements presented that resulted from adoption of the SOP. Disclosure of pro forma amounts is not required.

11. Entities initially applying hedge accounting upon adoption of this SOP are reminded that all the hedge accounting criteria in FASB Statement No. 133 must be met for the entire period to which hedge accounting is being applied. Derivative instruments should not be retroactively designated as hedges if appropriate contemporaneous documentation of the election and periodic assessment of effectiveness[2] did not occur in conformity with FASB Statement No. 133.

The provisions of this Statement of Position need not be applied to immaterial items.

Background

12. Issues surrounding the reporting of derivatives by not-for-profit health care organizations and the resulting diversity in practice were brought to the attention of the planning subcommittee of the AICPA's Accounting Standards Executive Committee (AcSEC) in December 2000. Specifically, questions had been raised about whether the guidance in paragraph 43 of FASB Statement No. 133, *Accounting for*

2. Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, establishes the general requirement that, to use hedge accounting, an entity should assess a hedge's effectiveness at the time it enters into a hedge and at least every three months thereafter, unless the hedge qualifies for use of the short-cut method. The requirement to assess hedge effectiveness at least every three months applies to entities that issue financial statements only on an annual basis as well as to entities that issue quarterly financial statements.

Derivative Instruments and Hedging Activities, as amended, applied to not-for-profit health care organizations that are required under industry-specific generally accepted accounting principles (GAAP) to report a performance indicator.

13. The planning subcommittee discussed the paragraph 43 issue and concluded that, because not-for-profit health care organizations are required to report a standardized performance indicator that is considered analogous to income from continuing operations reported by for-profit enterprises, they should apply the provisions of FASB Statement No. 133 in the same manner as do for-profit enterprises. Because that conclusion was not considered controversial, the planning subcommittee directed the AICPA staff to draft clarifying guidance in the form of a proposed AICPA Technical Practice Aid (TPA).

14. The planning subcommittee also discussed a footnote that had been added as a conforming change to paragraph 10.18 of the Guide in May 2000. That footnote contained the following statement:

> Not-for-profit health care organizations that have early-adopted FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, should also report unrealized gains and losses on derivatives that do not qualify as a fair value hedge under FASB Statement No. 133, except for the effect of changes in interest accruals, separate from the performance indicator.

In light of the planning subcommittee's conclusion that the provisions of FASB Statement No. 133 should be applied to not-for-profit health care organizations in the same manner as for-profit enterprises, it was decided that the May 2000 conforming change should be deleted from future editions of the Guide.

15. In January 2001, the planning subcommittee discussed a letter received by AcSEC's Chair from The Bond Market Association (TBMA). The letter indicated TBMA's awareness of the planning subcommittee's discussions and expressed concern that the proposed guidance would be issued in the form of a nonauthoritative TPA. TBMA was concerned that not-for-profit health care organizations and their independent auditors would not be aware of such

guidance, resulting in the inconsistent application of derivative accounting among organizations in the sector. TBMA also wanted to ensure that all affected parties would have an opportunity to review and comment on the proposed guidance, because it could represent a significant change in reporting for some not-for-profit health care organizations.

16. In March 2001, after further discussing the draft TPA and considering input received from various sources, the planning subcommittee and AcSEC decided that an SOP should be issued to amend the Guide to address these issues. Although the planning subcommittee and AcSEC did not disagree with the conclusions in the draft TPA, it was concluded that an SOP subject to due process would be the most appropriate vehicle for communicating the guidance. AcSEC issued an exposure draft of a proposed SOP on June 14, 2002 and received four comment letters.

Views on the Issue

17. Some believed that because not-for-profit health care organizations are required by the AICPA Audit and Accounting Guide *Health Care Organizations* to report a performance indicator that is analogous to income from continuing operations of a for-profit enterprise, they should apply the provisions of FASB Statement No. 133 (including the cash flow hedge accounting provisions) in the same manner as for-profit enterprises. That is, the gain or loss items that under FASB Statement No. 133 would affect a for-profit enterprise's earnings similarly should affect the not-for-profit health care organization's performance indicator, and the gain or loss items that under FASB Statement No. 133 are reported in other comprehensive income by the for-profit enterprise similarly should be excluded from the performance indicator by the not-for-profit health care organization. They interpreted paragraph 43 of FASB Statement No. 133 as applying only to organizations that are not required to report an earnings measure.

18. Others believed that paragraph 43 precludes the use of cash flow hedge accounting by not-for-profit health care organizations because the FASB has not defined the performance indicator to be used by those organizations. They

cited the following sentence in paragraph 501 of FASB Statement No. 133 as support for their position:

> For this Statement to permit a not-for-profit entity, for example, to apply cash flow hedge accounting, the Board would first have to define a subcomponent of the total change in net assets during a period that would be analogous to earnings for a business enterprise.

They believed that the definition of *performance indicator* used by not-for-profit health care organizations does not qualify as earnings for FASB Statement No. 133 purposes because it was promulgated by AcSEC, rather than the FASB. Opponents of that view pointed to paragraph 49 of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, which allows AICPA industry Audit and Accounting Guides to provide implementing guidance with respect to that Statement that, if cleared by the FASB, should be adopted by users of those guides. The FASB did not object to the definition of *performance indicator* promulgated in the Guide.

19. Others acknowledged that not-for-profit health care organizations report a performance indicator that is analogous to income from continuing operations of a for-profit enterprise, but believed that the cash flow hedge accounting prohibitions in paragraph 43 should apply because the concept of other comprehensive income is limited to for-profit enterprises that are subject to FASB Statement No. 130, *Reporting Comprehensive Income*. Opponents of that view responded that not-for-profit health care organizations employ other comprehensive income reporting concepts in their statement of operations and their definition of a performance indicator. They pointed to the fact that among the exclusions from the performance indicator listed in paragraph 10.18 of the Guide are the items that for-profit organizations are required to include in other comprehensive income under FASB Statement No. 130 (foreign currency items, minimum pension liability adjustments, and unrealized gains and losses on certain investments in debt and equity securities). Further, they pointed to paragraphs 500 and 501 of FASB Statement No. 133, which indicate that the total change in net assets of a not-for-profit organization is analogous to the total comprehensive income of a for-profit enterprise.

20. Still others believed that, although not-for-profit health care organizations conceptually are capable of applying the mechanics of cash flow hedge accounting in their financial statements, they are precluded from doing so because the list in paragraph 10.18 of the Guide of items to be excluded from the performance indicator does not explicitly include "the effective portion of the gain or loss on derivative instruments designated and qualifying as cash flow hedging instruments." They believed that all transactions except those explicitly listed in paragraph 10.18 should be included in the performance indicator.

21. Among those who believed that paragraph 43 prohibits not-for-profit health care organizations from applying cash flow hedge accounting, some believed that all hedging and nonhedging derivative gains and losses should be included in the performance indicator. Others interpreted paragraph 43 as requiring all hedging and nonhedging derivative gains and losses to be excluded from the performance indicator and reported in "other changes in net assets." Still others employed a hybrid approach to reporting derivative gains and losses based on guidance provided in a conforming change (that subsequently was rescinded[3]) contained in a footnote to paragraph 10.18 of the May 2000 edition of the Guide.

Basis for Conclusions

Scope

Other Not-for-Profit Organizations

22. AcSEC discussed whether the scope of the SOP should extend to other types of not-for-profit organizations (that is, not-for-profit organizations other than health care organizations) in situations in which those organizations voluntarily choose to provide a performance indicator. Those organizations are subject to the AICPA Audit and Accounting Guide *Not-for-Profit Organizations*, rather than the Audit and Accounting Guide *Health Care Organizations*. AcSEC chose not to address similar issues for those organi-

3. See paragraph 14 of this SOP.

zations in the context of this SOP because, unlike health care organizations, other types of not-for-profit organizations are not subject to a standardized or prescribed performance measure.

Governmental Health Care Enterprises

23. Because the concept of reporting "other comprehensive income" conflicts with the reporting requirements of Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, cash flow hedge accounting is not available to governmental health care enterprises that are within the scope of the Guide. Therefore, governmental health care enterprises are excluded from the scope of the SOP. FASB Statement No. 133 applies to governmental enterprises only to the extent that provisions in that Statement do not conflict with the provisions of GASB pronouncements (see paragraph 94 of GASB Statement No. 34).

Reporting a Separate Component of Equity

24. Pursuant to paragraph 26 of FASB Statement No. 130, for-profit entities report *accumulated other comprehensive income* as a component of equity that is displayed separately from retained earnings and additional paid-in capital in a statement of financial position. When FASB Statement No. 130 was issued, the FASB considered whether not-for-profit organizations should also be included within the scope of that Statement. The FASB decided to exclude those organizations, noting that not-for-profit organizations' financial statements already were displaying the equivalent of comprehensive income as a result of the requirements of FASB Statement No. 117. Thus, not-for-profit organizations are not required to report accumulated other comprehensive income as a separate component of equity.

25. AcSEC discussed whether the absence of a requirement to report accumulated other comprehensive income as a separate component of equity was a significant enough difference to preclude not-for-profit health care organizations from being able to use cash flow hedge accounting under

FASB Statement No. 133. AcSEC determined that the concept of reporting accumulated other comprehensive income as a separate component of equity is unique to for-profit enterprises that report retained earnings and additional paid-in capital and that, further, the concept primarily appears to be a carryforward of the reporting practices followed by such entities before the issuance of FASB Statement No. 130. Moreover, AcSEC was concerned that such reporting may conflict with the provisions of FASB Statement No. 117 requiring not-for-profit organizations to report three classes of net assets (unrestricted, temporarily restricted, and permanently restricted). Therefore, AcSEC concluded that the absence of a requirement to report a separate component of equity in the balance sheet of not-for-profit health care organizations should not preclude those organizations from using comprehensive income reporting for qualifying gains and losses on cash flow hedges. Although accumulated other comprehensive income will inherently be carried forward in a not-for-profit health care organization's net assets, there is no compelling need for it to be reported separately in the balance sheet.

Income Statement Classification of Derivative Gains and Losses

26. Although FASB Statement No. 133 provides comprehensive disclosure guidance for derivatives, it does not explicitly address or prescribe the income statement classification for derivative gains and losses that are included in earnings.

27. Paragraph 45 of FASB Statement No. 133 requires an entity to disclose where in the income statement it has chosen to report the net gain or loss on fair value and cash flow hedges (and the related hedged transaction or item), but the paragraph does not specify where or in what captions such gains and losses should be displayed. That allows for flexibility in reporting based on an entity's economic rationale for entering into the hedge. For derivatives that are not designated as hedges, FASB Statement No. 133 does not require disclosure of where gains and losses are reported in the income statement, nor does it specify where within the income statement those gains and losses should be reported. AcSEC decided not to provide more specific

guidance regarding income statement classification in this SOP because it did not want to prescribe more restrictive guidance for not-for-profit health care organizations than that applicable to other organizations subject to FASB Statement No. 133.

Definition of Performance Indicator

28. The term performance indicator was introduced in 1996 when the AICPA issued the Audit and Accounting Guide *Health Care Organizations*.[4] The 1996 revision of the industry Guide was necessitated largely by the issuance of FASB Statements No. 116, *Accounting for Contributions Received and Contributions Made*, and No. 117, which (among other things) changed the financial statement display requirements for not-for-profit organizations. The 1995 exposure draft of the Guide had referred to the earnings measure using terms such as net income and operating income. The FASB subsequently objected to that terminology, deeming it inappropriate for describing an earnings measure of a not-for-profit organization. Accordingly, the final Guide used the generic term *performance indicator* to denote the earnings measure.

29. Paragraph 1.04 of the Guide states, in part:

> The financial reporting for not-for-profit, business-oriented organizations and investor-owned health care enterprises generally is consistent except for transactions that clearly are not applicable. For example, not-for-profit business organizations would have nothing to report for shareholders' equity. On the other hand, investor-owned health care enterprises typically would not have anything to report for contributions.

Consequently, in developing the definition of *performance indicator* (paragraphs 10.17 and 10.18 of the Guide), AcSEC intended that the linkage between the new performance indicator measure and the earnings measure previously reported by not-for-profit health care organizations be preserved to the greatest extent possible, due to its importance

4. Health Care Organizations replaced the AICPA Industry Audit Guide *Audits of Providers of Health Care Services*.

to users of health care organizations' financial statements. The phrase "other items that are required by GAAP to be reported separately" was included in paragraph 10.18(g) of the Guide to enable the performance indicator to remain "evergreen," that is, to permit it to be updated by conforming changes to incorporate the issuance of future accounting standards.

30. Subsequent to issuance of the Guide, AcSEC determined that the provisions of paragraphs 10.17 and 10.18 were not being interpreted by some readers of the Guide in the manner intended by AcSEC. In addition, when new accounting standards have been issued, some readers of the Guide have been uncertain how to apply them with respect to the performance indicator. Consequently, paragraph 9 of this SOP revises the definition of *performance indicator* to state explicitly that the performance indicator should be regarded as the functional equivalent of income from continuing operations of a for-profit enterprise. Additionally, this SOP amends paragraph 10.18 of the Guide to clarify that the reference to "other items that are required by GAAP to be reported separately" refers to GAAP applicable to for-profit enterprises (for example, items that are required under existing accounting standards to be reported in other comprehensive income[5]) as well as GAAP specific to not-for-profit organizations, and that additional items may result from issuance of future accounting standards.

Transition

31. Paragraph 515 of FASB Statement No. 133 states, in part:

> Because hedge accounting is based on an entity's intent at the time a hedging relationship is established, the Board decided that retroactive application of the provisions of this Statement was not appropriate.

Similarly, Derivatives Implementation Group (DIG) Issue No. K5, *Transition Provisions for Applying the Guidance*

5. For example, in June 1997 the phrase "minimum pension liabilities in accordance with paragraph 37 of FASB Statement No. 87, *Employers' Accounting for Pensions*, or foreign currency translation adjustments" was added to paragraph 10.18(g) as a conforming change necessitated by the issuance of FASB Statement No. 130, *Reporting Comprehensive Income*.

in Statement 133 Implementation Issues, indicates that when an entity has applied "the recognition and measurement of derivatives differently than required by subsequently issued cleared implementation guidance, [the entity] should account for the effects of initially complying with that implementation guidance prospectively for all existing contracts and future transactions, as of the effective date for that guidance." Consequently, AcSEC determined that the effects of initially complying with the guidance in this SOP should also be accounted for prospectively.

32. AcSEC also considered whether to allow an alternative for retroactive application of this SOP. Although this SOP does not change the "recognition and measurement of derivatives," it may change an entity's accounting policy and thus may affect certain actions taken by an entity. For example, based on their interpretation of authoritative literature, certain health care entities may have had economic hedges that they did not designate as cash flow hedges because they did not believe that cash flow hedging derivatives were accounted for differently from non-hedging derivatives. AcSEC recognized that the historical actions undertaken to document, designate, or assess effectiveness by entities that, in prior periods, had adopted accounting policies inconsistent with those set forth in this SOP may have differed had this SOP been effective during those prior periods. In recognition of this fact, and because hedging relationships cannot be documented retroactively under FASB Statement No. 133, AcSEC decided that retroactive application of the provisions of this SOP was not appropriate.

33. Because the effect of an entity's hedging activities on its financial statements in the initial year of adoption of this SOP may not be comparable to the preceding year, AcSEC discussed whether pro forma disclosures in the year of adoption would address concerns related to consistency and comparability of financial information. Disclosure of the pro forma effects of retroactive application of hedge accounting for prior periods (in a manner similar to the requirements of paragraph 19(d) of Accounting Principles Board Opinion No. 20, *Accounting Changes*) was considered and rejected for the same reasons that AcSEC rejected retroactive restatement as a transition option, as

described in paragraph 32. The exposure draft solicited comments on an alternative pro forma measure that would require entities to disclose the effect on their performance indicator for the year of adoption of continuing to apply their prior year's reporting practices, if such practices differed from those required by the SOP. One commenter stated that such a requirement was inappropriate and would not provide users of the financial statements with meaningful comparative information. For example, for an entity that prior to adoption of the SOP believed that paragraph 43 of Statement No. 133 prohibited cash flow hedge accounting but that upon adoption of the SOP adopted cash flow hedge accounting, the information derived from disclosing what the performance indicator would have been had the entity continued to not take advantage of hedge accounting has little (if any) meaning for users of financial statements. Similarly, for an entity that prior to adoption of the SOP was excluding gains and losses from the performance indicator in a manner other than that allowed by this SOP, disclosing what the performance indicator would have been had the entity continued to exclude those derivative gains/losses from the performance indicator subsequent to its adoption of the SOP does not provide meaningful information and, further, results in comparing a performance indicator derived in accordance with GAAP with a measure that is no longer considered to be in accordance with GAAP. Therefore, although acknowledging that the usefulness of financial information about an entity increases if that information can be compared with similar information in prior periods, AcSEC concluded that the potential usefulness of that information is diminished or eliminated if the information has no comparative value. Additionally, AcSEC considered this SOP's guidance as similar in nature to the guidance provided in Statement No. 133 and DIG Issue No. K5. Neither Statement No. 133 nor Issue No. K5 requires disclosure of any pro forma information. Consequently, AcSEC concluded that pro forma disclosures of any type would not be appropriate for the year of adoption of this SOP. However, when the financial statements of the year of adoption are presented separately or included in comparative financial statements, the entity should disclose in the notes to the financial statements (*a*) the fact that the SOP has been adopted and the effective date of adoption (for example, beginning of a year or beginning of a quarter), and (*b*) the nature of any differences in accounting principles or financial statement presentation applicable to the financial statements presented that resulted from adoption of the SOP (for example, "The effective portion of unrealized gains and losses on cash flow hedges, which prior to adoption of SOP 02-2 were included in the performance indicator, are now reported below the performance indicator").

34. The exposure draft would have required entities to adopt the SOP as of the beginning of a fiscal year. Several respondents to the exposure draft objected to precluding entities from early adopting this SOP, based on their understanding that a number of entities had already been applying the provisions of FASB Statement No. 133 pertaining to cash flow hedge accounting prior to issuance of the exposure draft. They also were concerned about allowing diversity in practice to continue over the extended period that would result from requiring adoption as of the beginning of a fiscal year. AcSEC concluded that in the interest of remedying diversity in practice as quickly as possible, entities should be allowed to early adopt the SOP.

35. AcSEC observed that some not-for-profit health care organizations may have employed a methodology that excluded derivative gains and losses from the performance indicator until those gains or losses were realized. Upon realization, those organizations would have recognized the derivative's gain or loss in the performance indicator. Consistent with its decision to require prospective application of this SOP, AcSEC decided that upon initial application of this SOP, any prior gains or losses on derivative instruments recognized by those not-for-profit health care organizations that had been excluded from the performance indicator in years before adoption and that did not meet the hedging criteria of FASB Statement No. 133 (including the requirements of contemporaneous documentation and testing of effectiveness) should not subsequently be reclassified and included as a component of the performance indicator.

Rather, any such derivative gains and losses should be permanently excluded from the performance indicator.

36. AcSEC did agree, however, that to the extent that a not-for-profit health care organization had reported derivative gains or losses in a manner consistent with the provisions of this SOP (including compliance with the documentation and designation requirements of FASB Statement No. 133) in financial statements for periods prior to the initial application of this SOP, such amounts should be reclassified and included in the performance indicator when the hedged item affects the performance indicator.

37. For entities that initially apply hedge accounting upon adoption of this SOP or thereafter, paragraph 11 states that all the hedge accounting criteria in FASB Statement No. 133 must be met for the entire period to which hedge accounting is being applied in order for hedge accounting to be used. AcSEC noted that when an organization designates an existing derivative as a hedging instrument upon adoption of the SOP or thereafter, the fair value of the derivative instrument typically will not be zero at the inception of the hedging relationship. Because paragraph 68(b) of FASB Statement No. 133 requires that the fair value of the hedging instrument at the inception of the hedging relationship be zero in order for the short-cut method to be used, application of the short-cut method will not be possible and hedge ineffectiveness for cash flow hedges must be measured under either the hypothetical derivative method or the change in fair value method as described in DIG Issue No. G7, *Cash Flow Hedges: Measuring the Ineffectiveness of a Cash Flow Hedge under Paragraph 30(b) When the Shortcut Method is Not Applied*. For cash flow hedging relationships that were designated and accounted for pursuant to the hedge accounting criteria in FASB Statement No. 133 prior to the adoption of this SOP, the adoption of this SOP will not affect how hedge effectiveness is assessed or hedge ineffectiveness is measured for such relationships.

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