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Capital Markets
Accounting Developments
Advisory 2007-7
September 28, 2007

Amendment of FASB Interpretation No. 39

Summary

The Financial Accounting Standards Board ("FASB" or the "Board") Staff Position on FIN 39 (FIN 39-1: Amendment of FASB Interpretation No. 39 (the "FSP")) clarifies that the fair value of receivables and payables recognized upon payment or receipt of cash collateral in connection with derivative master netting arrangements can be offset against the fair value of derivative assets or liabilities subject to the same master netting arrangement. The FSP also amends FIN 39 to no longer permit offsetting of non-derivative conditional contracts.

SFG Observation: The Board provided for an exception to the criteria in paragraph 10 of FIN 39 for **conditional** contracts. The ultimate amounts payable under conditional contracts means that the eventual cash flow consequences cannot be determined solely from the amounts reported in the statement of financial position. FAS 105 requires disclosures of information on financial instruments to fill the information gap and help readers ascertain the potential cash flows from the instruments.

The Board permitted offsetting of the fair value recognized for forwards, interest rate swaps, currency swaps, options, and other conditional or exchange contracts if they are executed with the same counterparty under a master netting arrangement. A master netting arrangement effectively consolidates the

individual contracts into a single agreement between the parties. The failure to make one payment under the master netting arrangement would entitle the other party to terminate the entire arrangement and to demand the net settlement of all contracts.

The exception for derivatives was needed as technically the requirement of paragraph 5(c) ("the reporting party intends to set off") is not met under a master netting arrangement. The Board reasoned that a net presentation discloses the amount of credit risk exposure under the aggregate arrangement. Presentation of the individual contracts does not provide more information about the uncertainty of future cash flows than do the net amounts.

Paragraph 10 applies only to the fair value amounts recognized for conditional or exchange contracts executed with the same counterparty under a master netting arrangement. The exception in paragraph 10 does not apply to other contracts subject to a master netting arrangement.

Derivative counterparties often exchange collateral as part of their master netting arrangements. The collateral can be cash or other securities (generally highly rated, liquid securities). The FSP addresses when collateral can be offset as part of the net presentation for the aggregate fair value of the derivative contracts with the same counterparty.

For more detailed discussion regarding the background of this FSP and reasons for its issuance, please refer to Capital Markets Accounting Developments Advisory 2007-1.

Changes to FIN 39

The FSP allows the fair value of receivables or payables recognized upon payment or receipt of cash collateral in accordance with derivative master netting arrangements to be offset against related net derivative assets or liabilities. If counterparties elect to net their derivative asset and liability positions pursuant to master netting arrangements under FIN 39, the cash collateral recognized in connection with the contracts can be included as part of the netting process.

SFG Observation: Many comment letters to the Board requested guidance on how to determine if cash collateral amounts were recognized at "fair value".

The Board added footnote 5 to the final FSP, which requires cash collateral posted that is recognized at *fair value or an amount that approximates fair value* to be netted against the net derivative asset or liability position. The Board did

not provide a list of factors or other guidance that should be considered in determining if the cash collateral approximates fair value.

The FASB staff commented that a cash collateral receivable or payable does not have a fair value measurement attribute. The fair value option under the Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* may not be available because the collateral terms often make them similar to demand deposits. The fair value option cannot be elected for demand deposits of depository institutions.

The FASB staff noted that the cash collateral receivable or payable may approximate fair value if it is short-term and the interest rate resets frequently, consistent with the Statement of Financial Accounting Standards No. 107, *Disclosures about Fair Value of Financial Instruments*.

Only cash posted as collateral under the master netting arrangement can be offset against derivative fair values. Generally, the agreements call for periodic exchanges of collateral as the aggregate fair value of the contracts changes with market conditions.

The FSP carries forward the guidance under FIN 39 that a reporting entity's decision to offset be consistently applied. A reporting entity is not permitted to offset fair value amounts recognized for derivative instruments without offsetting fair value collateral amounts.

SFG Observation: The consistency application requirement of the FSP applies to contracts in all master netting arrangements. That is, if an entity elects to offset then that decision must be applied consistently to both derivative instruments and collateral amounts recognized under all master netting arrangements. The term master netting arrangement is defined in paragraph 10 of FIN 39 with additional guidance in the basis for conclusions of FIN 39.

Companies will need to determine how to apply the requirements of the FSP consistently to different types of arrangements.

For futures contracts which require daily cash payments, that determination might include an assessment of whether a FIN 39 master netting arrangement exists and whether the cash payments are equivalent to posting collateral or settling the contract.

Disclosures

The FSP requires a reporting entity to disclose in its accounting policies whether it offsets derivative assets and liabilities subject to a master netting arrangement. In addition, the FSP requires that a company disclose cash collateral amounts that have been netted and cash collateral amounts that have not been netted with derivative assets and liabilities. The company should provide explanations for why the cash collateral amounts were not offset such as:

- (1) the amounts are not recognized at fair value, or
- (2) the collateral amounts are not part of master netting arrangements that are eligible for offset.

If a reporting entity makes an accounting policy decision not to offset derivative assets and liabilities subject to master netting arrangements, it must still disclose the amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral.

SFG Observation: Many master netting arrangements including any associated credit support annex include items that are eligible for offsetting and those that are not. The FSP does not give guidance on how to determine whether a collateral amount arose from an instrument that is not eligible for offsetting.

While noting that only cash collateral fair value amounts arising from derivative instruments carried at fair value may be offset, the FSP permits entities to use a reasonably supportable methodology to determine how to allocate the cash collateral.

The disclosures might include presenting the amounts of cash paid or received under futures contracts as discussed above.

Conditional Contracts and Exchange Contracts

The FSP clarifies the term *conditional contracts* and *exchange contracts* used in FIN 39 by replacing them with the term *derivative instruments* as defined in the Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133).

Contracts that (1) meet the definition of a derivative instrument under FAS 133 and related implementation guidance and (2) are carried at fair value are still eligible for offsetting, even if those contracts are scoped out of FAS 133.

The FSP removes paragraph 9 and amends paragraph 10 of FIN 39. Refer to Appendix A for the changes to the language in paragraph 10 of FIN 39.

SFG Observation: The new language eliminates any confusion or uncertainty that might exist as to what contracts qualify for netting under paragraphs 9 and 10 by conforming the language to the definition of a derivative set forth in FAS 133.

The term conditional in FIN 39 was intended to describe the variable nature of the amount ultimately payable or receivable under the contract.

Effective Date

The FSP is effective for fiscal years beginning after November 15, 2007, with early application permitted. The effects of applying the FSP must be recognized as a change in accounting principle through retrospective application for all financial statements presented.

Questions

Questions regarding this Advisory may be directed to Hiroshi Abe (646-471-3898), Jeff Allen (646-471-2937), Shannon Detling (646-471-5619), Neal Dykes (646-471-2359) or David Lukach (646-471-3150).

Appendix A: Amendments to FIN 39

4. Interpretation 39 is amended as follows: [Added text is underlined and deleted text is ~~struck out.~~]

a. Summary:

APB Opinion No. 10, *Omnibus Opinion—1966*, paragraph 7, states that “it is a general principle of accounting that the offsetting of assets and liabilities in the balance sheet is improper except where a right of setoff exists.” This Interpretation defines *right of setoff* and specifies what conditions must be met to have that right. It also addresses the applicability of that general principle to derivative instruments ~~forward, interest rate swap, currency swap, option, and other conditional or exchange contracts~~ and clarifies the circumstances in which it is appropriate to offset amounts recognized for those instruments ~~contracts~~ in the statement of financial position. In addition, it permits offsetting of fair value amounts recognized for multiple derivative instruments ~~forward, swap, option, and other conditional or exchange contracts~~ executed with the same counterparty under a master netting arrangement and fair value amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) arising from the same master netting arrangement as the derivative instruments.

This Interpretation is effective for financial statements issued for periods beginning after December 15, 1993.

b. Paragraph 3:

The contracts described in paragraphs 1 and 2 are often referred to as derivative instruments.^{1a} ~~conditional and exchange contracts. Conditional contracts are those whose obligations or rights depend on the occurrence of some specified future event that is not certain to occur and that could change the timing of the amounts or of the instruments to be received, delivered, or exchanged. Exchange contracts are those that require a future exchange of assets or liabilities rather than a one-way transfer of assets.~~

^{1a}The term *derivative instruments* is defined in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and related implementation guidance. For purposes of this Interpretation, derivative instruments include those that meet the definition of a derivative instrument but are not included in the scope of Statement 133.

c. Paragraphs 8–10, footnote 5, and the related heading:

Applicability to Derivative Instruments ~~Forward, Interest Rate Swap, Currency Swap, Option, and Other Conditional or Exchange Contracts~~

8. Unless the conditions in paragraph 5 are met, the fair value of contracts in a loss position should not be offset against the fair value of contracts in a gain position. Similarly, amounts recognized as accrued receivables should not be offset against amounts recognized as accrued payables unless a right of setoff exists.

9. ~~[This paragraph has been deleted. See Status page.]When fair value or an amount receivable or payable related to conditional or exchange contracts of the reporting entity are recognized in the statement of financial position, the amount recognized represents an asset or a liability. The fair value of a contract in a gain position or an amount accrued as a receivable represents a probable future economic benefit controlled by the reporting entity under the contract. The fair value of a contract in a loss position or an amount accrued as a payable represents a probable future sacrifice of economic benefits arising from the reporting entity's present obligations to transfer assets under the contract.~~

10. Without regard to the condition in paragraph 5(c), a reporting entity may offset fair value amounts⁴ recognized for derivative instruments and fair value amounts⁵ recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) arising from derivative instrument(s) recognized at fair value forward, interest rate swap, currency swap, option, and other conditional or exchange contracts executed with the same counterparty under a master netting arrangement ~~may be offset~~. The fair value recognized for some contracts may include an accrual component for the periodic unconditional receivables and payables that result from the contract; the accrual component included therein may also be offset for contracts executed with the same counterparty under a master netting arrangement. ~~The reporting entity's choice to offset or not must be applied consistently.~~ A master netting arrangement exists if the reporting entity has multiple contracts, whether for the same type of derivative instrument conditional or exchange contract or for different types of derivative instruments contracts, with a single counterparty that are subject to a contractual agreement that provides for the net settlement of all contracts through a single payment in a single currency in the event of default on or termination of any one contract. ~~Offsetting the fair values recognized for forward, interest rate swap, currency swap, option, and other conditional or exchange contracts outstanding with a single counterparty results in the~~

~~net fair value of the position between the two counterparties being reported as an asset or a liability in the statement of financial position.~~

~~⁴The fair value recognized for some contracts may include an accrual component for the periodic unconditional receivables and payables that result from the contract; the accrual component included therein may also be offset for contracts executed with the same counterparty under a master netting arrangement.~~

~~⁵Solely as it relates to the right to reclaim cash collateral or the obligation to return cash collateral, fair value amounts include amounts that approximate fair value. This footnote should not be analogized to for any other asset or liability.~~

d. Paragraphs 10A and 10B are added as follows:

10A. A reporting entity shall make an accounting policy decision to offset fair value amounts pursuant to paragraph 10 of this Interpretation. The reporting entity's choice to offset or not must be applied consistently. A reporting entity shall not offset fair value amounts recognized for derivative instruments without offsetting fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral. A reporting entity that makes an accounting policy decision to offset fair value amounts recognized for derivative instruments pursuant to paragraph 10 but determines that the amount recognized for the right to reclaim cash collateral or the obligation to return cash collateral is not a fair value amount shall continue to offset the derivative instruments.

10B. A reporting entity's accounting policy to offset or not offset in accordance with this Interpretation shall be disclosed. A reporting entity shall disclose the amounts recognized at the end of each reporting period for the right to reclaim cash collateral or the obligation to return cash collateral as follows:

- a. A reporting entity that has made an accounting policy decision to offset fair value amounts shall separately disclose amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral that have been offset against net derivative positions in accordance with this Interpretation. A reporting entity that has made an accounting policy decision to offset fair value amounts is not permitted to offset amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral against net derivative positions if those amounts (1) were not fair value amounts or (2) arose from instruments in a master netting arrangement that are not eligible to be offset. A reporting entity shall separately disclose amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral under master netting arrangements that have not been offset against net derivative positions.

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