PROPOSED FASB STAFF POSITION

No. FIN 39-a

Title: Amendment of FASB Interpretation No. 39

Comment Deadline: January 31, 2007

Introduction

1. This FASB Staff Position (FSP) addresses:

    a. Certain modifications to FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*

    b. Whether a reporting entity that is party to a master netting arrangement[1] can offset the receivable or payable recognized upon payment or receipt of cash collateral[2] against fair value amounts recognized for derivative instruments that have been offset under the same master netting arrangement in accordance with paragraph 10 of Interpretation 39.

Specifically, this FSP amends paragraph 3 to replace the terms *conditional contracts* and *exchange contracts* with the term *derivative instruments* as defined in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and paragraph 10 to permit a reporting entity to offset fair value amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) against fair value amounts recognized for derivative instruments executed with the same counterparty under the same master netting arrangement that have been offset in accordance with paragraph 10 of Interpretation 39.

[1]The characteristics of a master netting arrangement for purposes of this FSP are described in paragraph 10 of Interpretation 39.
[2]In accordance with footnote 4 of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, the payer would recognize a receivable representing the right to receive a return of the cash collateral, and the payee would recognize a liability representing the obligation to return the cash collateral.

Background

2. Paragraph 3 of Interpretation 39 defines conditional contracts as "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." Questions have been raised about whether a contract whose obligations or rights depend solely on the occurrence of a default or termination would meet the definition of a conditional contract.

3. Paragraph 10 of Interpretation 39 permits a reporting entity to offset fair value amounts recognized for derivative instruments executed with the same counterparty under a master netting arrangement without applying the condition in paragraph 5(c) of Interpretation 39 that a reporting entity intends to set-off. The FASB staff has received inquiries on whether a reporting entity can offset the receivable or payable recognized upon payment or receipt of cash collateral against the fair value amounts recognized for derivative instruments that have been offset under the same master netting arrangement in accordance with paragraph 10. In those inquiries, the reporting entity met the conditions in subparagraphs 5(a), 5(b), and 5(d) of Interpretation 39 and made an accounting policy decision to offset the fair value amounts recognized for derivative instruments executed with the same counterparty under a master netting arrangement in accordance with paragraph 10. Further, the terms of the master netting arrangement granted the entity in a net asset position the right to require the counterparty to provide collateral in the form of cash. The entity in the net asset position recognized the cash collateral received as an asset and recognized a payable for the obligation to return the cash collateral. The entity that posts cash collateral derecognized the cash collateral paid and recognized a receivable for the right to reclaim the cash collateral.

FASB Staff Position

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

a. Summary of Interpretation 39:

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 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* ~~*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.~~ A *derivative instrument*, as defined in FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, is a financial instrument or other contract with all three of the following characteristics: [1a]

a. It has (1) one or more underlyings and (2) one or more notional amounts or payment provisions or both. Those terms determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required.
b. It 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.

[1a] Statement 133 Implementation Issues provide additional guidance relating to the application of this definition.

c. Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement (paragraph 6; footnotes 3 and 4 omitted).

c. Paragraphs 8–10 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), *fair value amounts*[4] recognized for derivative instruments ~~forward, interest rate swap, currency 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 may be offset. A reporting entity that determines that the amount recognized upon payment or receipt of cash collateral is not a fair value amount shall not be precluded from offsetting the derivative instruments. The reporting entity's choice to offset or not must be applied consistently.[5] 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 derivative instruments

~~forward, interest rate swap, currency swap, option, and other conditional or exchange contracts~~ outstanding with a single counterparty <u>and fair value amounts recognized upon payment or receipt of cash collateral</u> 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.

[4]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.

[5]<u>A reporting entity shall not offset fair value amounts recognized for derivative instruments without offsetting fair value amounts recognized upon payment or receipt of cash collateral against that net amount.</u>

d. Paragraph 10A is added as follows:

<u>A reporting entity's accounting policy to offset or not offset in accordance with this Interpretation shall be disclosed. A reporting entity shall disclose amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral, separately, regardless of whether the reporting entity has offset those amounts in accordance with paragraph 10 for each period in which a statement of financial position is presented. The reporting entity shall separately disclose amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral that have not been offset in accordance with paragraph 10 because those amounts are not fair value amounts for each period for which a statement of financial position is presented.</u>

e. Appendix A is added as follows:

<u>Appendix A</u>

<u>IMPLEMENTATION GUIDANCE</u>

<u>A1. This appendix is an integral part of this Interpretation and provides implementation guidance that illustrates the application of paragraphs 10 and 10A. The illustrations assume that the reporting entity met the conditions in paragraphs 5(a), 5(b), and 5(d) of this Interpretation.</u>

<u>Illustration 1</u>

<u>A2. Entity A, the reporting entity, enters into a master netting arrangement with Entity B. Entity A makes an accounting policy decision to offset fair value amounts recognized for derivative instruments executed with the same counterparty under a master netting arrangement.</u>

Entity A is in a net asset position under its master netting arrangement with Entity B. The terms of the master netting arrangement grant Entity A the right to require Entity B to provide cash collateral. Upon receipt of the cash collateral, Entity A recognizes a payable for its obligation to return the cash collateral to Entity B. Entity A determines that, based on the terms of the master netting arrangement (including the collateral agreement) with Entity B, the payable for its obligation to return the cash collateral to Entity B is recognized at fair value.

A3. Because Entity A has made an accounting policy decision to offset fair value amounts recognized for derivative instruments executed with the same counterparty under a master netting arrangement, Entity A will offset the payable for its obligation to return the cash collateral to Entity B against fair value amounts recognized for the derivative instruments executed with Entity B under the master netting arrangement that have been offset. Entity A will disclose (a) its accounting policy decision to offset and (b) the amount recognized for its obligation to return cash collateral to Entity B for each period for which a statement of financial position is presented.

Illustration 2

A4. As a continuation of Example 1, Entity A enters into a master netting arrangement with Entity Z. Entity A is in a net liability position under its master netting arrangement with Entity Z. The terms of the master netting arrangement grant Entity Z the right to require Entity A to provide cash collateral. Upon payment of the cash collateral, Entity A recognizes a receivable for its right to receive a return of the cash collateral from Entity Z. Entity A determines that, based on the terms of the master netting arrangement (including the collateral agreement) with Entity Z, the receivable for Entity A's right to reclaim the cash collateral from Entity Z is **not** recognized at fair value.

A5. Because the receivable recognized for Entity A's right to reclaim cash collateral is not a fair value amount, Entity A may not offset the receivable against fair value amounts recognized for derivative instruments executed with Entity Z under the master netting arrangement that have been offset. Due to its accounting policy decision, Entity A will offset fair value amounts recognized for derivative instruments executed with Entity Z under the master netting arrangement. Entity A will disclose its accounting policy decision to offset and disclose separately (a) the amount recognized for its obligation to return cash collateral to Entity B and (b) the amount recognized for its right to reclaim cash collateral from Entity Z for each period for which a statement of financial position is presented.

Effective Date and Transition

5. The guidance in this FSP is effective for fiscal years beginning after December 15, 2006. A reporting entity shall recognize the effects of applying this FSP as a change in accounting principle through retrospective application for all financial statements presented unless it is impracticable to do so. If a reporting entity determines it is impracticable to retrospectively apply the guidance in this FSP for all financial statements presented, the reporting entity shall disclose why it is impracticable and apply the guidance in this FSP retrospectively for as many consecutive prior financial statements as practicable. Upon adoption of this FSP, a reporting entity shall be permitted to change its accounting policy to offset or not offset fair value amounts recognized for derivative instruments under master netting arrangements.

Appendix

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

A1. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this FSP. It includes reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than to others.

Background Information and Basis for Conclusions

A2. The original scope of this FSP was to address whether a receivable or payable recognized upon payment or receipt of cash collateral could be offset against derivative instruments that have been offset under the same master netting arrangement in accordance with paragraph 10 of Interpretation 39. The Board decided to permit offsetting fair value amounts recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) against fair value amounts recognized for derivative instruments that have been offset in accordance with Interpretation 39 if the receivable or payable arises from the same master netting arrangement as the derivative instruments. The Board believes that when a master netting arrangement exists, offsetting fair value amounts recognized for the derivative instruments and fair value amounts recognized for the receivable or payable recognized upon payment or receipt of cash collateral fairly portrays the amount of credit risk exposure under the entire arrangement.

A3. The Board later discussed whether its decision to permit offsetting the receivable or payable associated with cash collateral would have implications on other receivables or payables that are reported at fair value. The Board acknowledges that some constituents believe that the receivable or payable associated with cash collateral is conditional (as that term was originally used in Interpretation 39) because the right to reclaim cash collateral or the obligation to return cash collateral is conditional upon the occurrence of a default or termination. However, the Board believes that the receivable or payable associated with cash collateral is conditional because the amount of the receivable or payable varies based on changes in the net fair value of the related derivative instruments subject to the same master netting arrangement. The Board concluded that its decision that the receivable or payable recognized upon payment or receipt of cash collateral is conditional should not affect the presentation of other types of receivables or payables that are carried at fair value, such as loans or notes payable (especially after the final Statement on the fair value option for financial assets and financial liabilities becomes effective).

A4. During its deliberations, the Board discussed whether Interpretation 39 should be amended to clarify the intended meaning of conditional contracts. Interpretation 39 was issued in March 1992 when no authoritative accounting literature existed that defined a derivative instrument and when there was diversity in the accounting for derivative instruments. The Board believes that the terms *conditional contracts* and *exchange contracts* were used to ensure that contracts having similar characteristics as options, forwards, interest rate swaps, and so forth, were appropriately included in the exception in paragraph 10 of Interpretation 39. Therefore, the Board agreed that the exception in paragraph 10 was intended to apply only to derivative instruments.

A5. Statement 133, was issued in June 1998 to define derivative instruments and address the accounting for derivative instruments. The Board decided that Interpretation 39 should be amended to replace the terms *conditional contracts* and *exchange contracts* with the term *derivative instruments,* as defined in Statement 133. The Board acknowledges that certain contracts that may have met the definition of a conditional contract, as previously defined in Interpretation 39, may not meet the definition of a derivative instrument (for example, certain contracts requiring physical settlement of a commodity that is not readily convertible to cash). The Board concluded that limiting the exception in paragraph 10 of Interpretation 39 to derivative instruments is an acceptable solution.

A6. Paragraph 9 of Interpretation 39 provided guidance on the recognition of conditional and exchange contracts in the statement of financial position. The Board does not believe that paragraph 9 is still relevant since Statement 133 addresses the recognition of derivative instruments as assets or liabilities in the statement of financial position at fair value. The Board agreed that paragraph 9 of Interpretation 39 should be deleted.