

# FASB Interpretation No. 39

[FIN 39 Status Page](#)  
[FIN 39 Summary](#)

## Offsetting of Amounts Related to Certain Contracts

an interpretation of APB Opinion No. 10  
and FASB Statement No. 105

March 1992



Financial Accounting Standards Board  
of the Financial Accounting Foundation  
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**CONTENTS**

	Paragraph Numbers
Introduction.....	1-4
Interpretation:	
General Principle .....	5-6
Special Applications .....	7
Applicability to Forward, Interest Rate Swap, Currency Swap, Option, and Other Conditional or Exchange Contracts .....	8-10
Effective Date and Transition .....	11
Appendix: Background Information and Basis for Conclusions .....	12-50

## FIN 39: Offsetting of Amounts Related to Certain Contracts

### an interpretation of APB Opinion No. 10 and FASB Statement No. 105

#### FIN 39 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 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 forward, swap, option, and other conditional or exchange contracts executed with the same counterparty under a master netting arrangement.

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

#### INTRODUCTION

1. The FASB has been asked to clarify footnote i to the illustration in Appendix B of FASB Statement No. 105, Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk. That footnote addresses the applicability of APB Opinion No. 10, *Omnibus Opinion—1966*, paragraph 7, and FASB Technical Bulletin No. 88-2, Definition of a Right of Setoff, to forward contracts, interest rate swaps, and currency swaps and discusses the circumstances in which amounts recognized for individual contracts may be offset against amounts recognized for other contracts and reported as a net amount in the statement of financial position. The fair value of those contracts or an accrued receivable or payable arising from those contracts, rather than the notional amounts or the amounts to be exchanged, is recognized in the statement of financial

position.<sup>1</sup> Examples of other types of contracts for which the notional amounts or the amounts to be exchanged are not recognized in the statement of financial position include, but are not limited to, futures contracts and forward purchase-sale contracts.

2. Questions have also been raised about offsetting amounts recognized for contracts for which the fair value of those contracts, rather than the notional amounts or the items to be received or delivered in a conditional exchange, is recognized in the statement of financial position. Examples of those contracts include, but are not limited to, financial options, interest rate caps, collars and floors, and swaptions.

3. The contracts described in paragraphs 1 and 2 are often referred to as *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.

4. This Interpretation supersedes Technical Bulletin 88-2 as of the effective date of this Interpretation or its earlier application. The guidance in that Technical Bulletin is incorporated substantially unchanged in paragraphs 5-7 of this Interpretation primarily as a matter of convenience.

## INTERPRETATION

### General Principle

5. Opinion 10, 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." A *right of setoff* is a debtor's legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor.<sup>2</sup> A right of setoff exists when all of the following conditions are met:

- a. Each of *two* parties owes the other determinable amounts.
- b. The reporting party has the right to set off the amount owed with the amount owed by the other party.
- c. The reporting party intends to set off.
- d. The right of setoff is enforceable at law.

A debtor having a valid right of setoff may offset the related asset and liability and report the net amount.<sup>3</sup>

6. Generally, debts may be set off if they exist between mutual debtors each acting in its capacity as both debtor and creditor. In particular cases, however, state laws about the right of setoff may provide results different from those normally provided by contract or as a matter of common law. Similarly, the U.S. Bankruptcy Code imposes restrictions on or prohibitions against the right of setoff in bankruptcy under certain circumstances. Legal constraints should be considered to determine whether the right of setoff is enforceable.

### **Special Applications**

7. Various accounting pronouncements specify accounting treatments in circumstances that result in offsetting or in a presentation in a statement of financial position that is similar to the effect of offsetting. This Interpretation does not modify the accounting treatment in the particular circumstances prescribed by any of the following pronouncements:

FASB Statements and Interpretations

APB Opinions

Accounting Research Bulletins

FASB Technical Bulletins

AICPA Accounting Interpretations

AICPA Audit and Accounting Guides

AICPA Industry Audit Guides

AICPA Statements of Position

Examples of those pronouncements are:

FASB Statement No. 13, *Accounting for Leases* (leveraged leases, paragraphs 42-47)

FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises* (reinsurance, paragraphs 38-40)

FASB Statement No. 87, *Employers' Accounting for Pensions* (accounting for pension plan assets and liabilities)

FASB Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (accounting for plan assets and liabilities)

FASB Statement No. 109, *Accounting for Income Taxes* (net tax asset or liability amounts reported)

APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions* (reporting of discontinued operations)

AICPA Audit and Accounting Guides, *Audits of Brokers and Dealers in Securities* (trade date accounting for trading portfolio positions), and *Construction Contractors* and *Audits of Federal Government Contractors* (advances received on construction contracts)

AICPA Industry Audit Guide, *Audits of Banks* (reciprocal balances with other banks)

## **Applicability to 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. 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* <sup>4</sup> recognized for 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 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 conditional or exchange contract or for different types of 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.

## **EFFECTIVE DATE AND TRANSITION**

11. The provisions of this Interpretation are effective for financial statements issued for periods beginning after December 15, 1993. Earlier application is encouraged. Financial statements for fiscal years before the effective date may be restated to conform to the provisions of this Interpretation.

*This Interpretation was adopted by the affirmative votes of five members of the Financial Accounting Standards Board. Mr. Swieringa dissented. Mr. Northcutt did not vote.*

Mr. Swieringa disagrees with the exception in paragraph 10 that fair value amounts for

certain contracts executed with the same counterparty under a master netting arrangement may be offset. The conditions in paragraph 5 specify that a right of setoff is necessary but not sufficient for offsetting assets and liabilities in a statement of financial position. To qualify for offsetting, that right must be unconditional and the reporting party must intend to set off.

Under a master netting arrangement, both the ability and intent to set off are conditional. That arrangement typically provides for the net settlement of cash flows that are payable at the same date and in the same currency, but it does not provide for the net settlement of cash flows that are payable at different dates and in different currencies. Moreover, that arrangement provides for the net settlement of gains and losses only in the event of default. The Board previously concluded that offsetting assets and liabilities in the statement of financial position is not representationally faithful if a party does not intend to set off (paragraph 45) and is inappropriate if a party has the legal right to set off only in the event of default (paragraph 49). Mr. Swieringa agrees with those conclusions and would not permit the exception in paragraph 10.

Mr. Northcutt joined the Board just before this Interpretation was issued and did not vote on it.

*Members of the Financial Accounting Standards Board:*

Dennis R. Beresford, *Chairman*

Joseph V. Anania

Victor H. Brown

James J. Leisenring

Robert H. Northcutt, Jr.

A. Clarence Sampson

Robert J. Swieringa

**Appendix**

**BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS**

**CONTENTS**

	Paragraph Numbers
Introduction.....	12
Background Information.....	13–16
Basis for Conclusions .....	17–37
Comments on Exposure Draft.....	26–37
Background Information Incorporated from Technical Bulletin 88-2.....	38–39
Consideration of Comments Received Incorporated from Technical Bulletin 88-2 .....	40–50

## **Appendix: BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS**

### **Introduction**

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

### **Background Information**

13. Many financial instruments and other contracts have been developed to manage risks, and their use has increased dramatically in recent years. Those instruments and contracts, sometimes referred to as off-balance-sheet instruments or derivative instruments, include forward contracts, interest rate swap contracts, currency swap contracts, and option contracts, among others. In the absence of definitive accounting standards for reporting assets and liabilities arising from those instruments and contracts, various financial reporting practices have developed. Certain amounts arising from the potential benefits of the rights and the potential sacrifices from the obligations under those contracts are sometimes recognized.

14. For example, for an interest rate swap contract, the fair value of the contract, or the net amounts receivable or payable as a result of the contract, may be recognized as an asset or a liability. Similarly, the premium paid or received, or the fair value of an option contract, may be recognized as an asset or a liability. Also, the fair value of a forward contract to exchange one item for another may be recognized in the statement of financial position.

15. The general principle that the offsetting of assets and liabilities is improper except where a right of setoff exists is usually thought of in the context of unconditional receivables from and payables to another party. That general principle also applies to conditional amounts recognized for contracts under which the amounts to be received or paid or items to be exchanged in the future depend on future interest rates, future exchange rates, future commodity prices, or other factors.

16. Footnote i to the illustration in Appendix B of Statement 105 addresses forward contracts, interest rate swaps, and currency swaps and states, "Netting of receivable and payable amounts when right of setoff does not exist is in contravention of APB Opinion No. 10, *Omnibus Opinion—1966*, paragraph 7, and FASB Technical Bulletin No. 88-2, *Definition of a Right of Setoff*." Dealers in these contracts commonly report their holdings in trading accounts measured

at their fair values. Some dealers in those contracts have reported the fair value of contracts with different parties as a net increase in or reduction of a trading account or other assets, arguing that the recognized fair values are valuation accounts rather than separate assets and liabilities.

### **Basis for Conclusions**

17. Amounts recognized for forward, interest rate swap, currency swap, option, and other conditional or exchange contracts are not valuation accounts. The fair values recognized in the financial statements are measurements of the rights and obligations associated with the contracts already executed and, therefore, are assets and liabilities in their own right. FASB Concepts Statement No. 6, *Elements of Financial Statements*, paragraphs 34 and 43, states the following about valuation accounts:

A separate item that reduces or increases the carrying amount of an asset is sometimes found in financial statements. For example, an estimate of uncollectible amounts reduces receivables to the amount expected to be collected, or a premium on a bond receivable increases the receivable to its cost or present value. Those "valuation accounts" are part of the related assets and are neither assets in their own right nor liabilities.

A separate item that reduces or increases the carrying amount of a liability is sometimes found in financial statements. For example, a bond premium or discount increases or decreases the face value of a bond payable to its proceeds or present value. Those "valuation accounts" are part of the related liability and are neither liabilities in their own right nor assets.

The fair values recognized for conditional or exchange contracts are not valuation accounts because valuation accounts exist only as part of a measurement of an asset or a liability, not as a complete measurement of an asset or a liability.

18. Paragraph 40 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, states:

Fair values of financial instruments depict the market's assessment of the present value of net future cash flows directly or indirectly embodied in them, discounted to reflect both current interest rates and the market's assessment of the risk that the cash flows will not occur. Investors and creditors are interested in predicting the amount, timing, and uncertainty of future net cash inflows to an entity, as those are the primary sources of future cash flows from the entity to them. Periodic information about the fair value of an entity's financial instruments under current conditions and expectations should help those users both in making their own predictions and in confirming or correcting their earlier expectations.

19. While the fair value amount is a representation of the current market assessment of future events that will have cash flow consequences, the conditional nature of the contracts discussed in paragraph 10 means that the eventual cash flow consequences are often not discernible from the amounts reported in the statement of financial position. Statement 105 requires that additional information about the financial instruments that result from those contracts, even if they are recognized at fair value, be disclosed in the financial statements because of the practical limits on the information that is conveyed by the amounts reported in the body of the financial statements.

20. FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, paragraph 37, states that ". . . financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise" (footnote reference omitted). The amount of credit risk exposure—the amount of accounting loss the entity would incur if the counterparties to forward, interest rate swap, currency swap, option, or other conditional or exchange contracts failed to perform in accordance with the terms of those contracts—is one indicator of the uncertainty of future cash flows from those instruments.

21. The Board decided to permit offsetting of the fair value recognized for forward, interest rate swap, currency swap, option, and other conditional or exchange contracts if they are executed with the same counterparty under a master netting arrangement. That arrangement effectively consolidates 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 Board believes that an exception to the requirement of paragraph 5(c) of this Interpretation, which states that "the reporting party intends to set off" is justified when a master netting arrangement exists because the net presentation discloses the amount of credit risk exposure under that arrangement. The Board decided that, given a master netting arrangement, presentation of the aggregate fair values of the individual contracts executed under that arrangement would not provide more information about the uncertainty of future cash flows from those contracts than net amounts would.

22. Paragraph 10 of this Interpretation applies only to *fair value amounts* recognized for conditional or exchange contracts executed with the same counterparty under a master netting arrangement. Paragraph 10 does not apply to other amounts recognized for other types of contracts executed under a master netting arrangement; however, those amounts could otherwise meet the conditions of paragraph 5 for a right of setoff. For example, unless the conditions in paragraph 5 are met, the amount recognized under a repurchase agreement may not be offset against the amount recognized under a reverse repurchase agreement solely because the agreements are executed with the same counterparty under a master netting arrangement, nor may an accrued receivable be offset against an accrued payable on interest rate swaps that are not recognized at fair value solely because the swaps are executed with the same counterparty under a master netting arrangement. The Board concluded that the gross unconditional

receivables and payables recognized in the statement of financial position for these types of assets and liabilities provide useful information about the timing and amount of future cash flows that would be lost if those amounts were offset.

23. The Board recognizes that under the existing mixed attribute measurement system, some amounts recognized in the statement of financial position provide more information about the uncertainties of future cash flows than other amounts do. Where information about the uncertainties of future cash flows is readily discernible from an unconditional receivable or payable recognized in the statement of financial position, the Board believes that information is useful to financial statement users and should not be offset unless the conditions in paragraph 5 for the right of setoff are satisfied.

24. This Interpretation permits, but does not require, offsetting of fair value amounts recognized for conditional or exchange contracts executed with the same counterparty under a master netting arrangement. The Board recognizes that optional accounting treatment of similar contracts adversely affects the comparability of financial statements. However, the Board is concerned that requiring offsetting may be costly for entities that do not have systems that separately identify the contracts that have been executed under each arrangement.

25. The Board decided to use the term *fair value* rather than *market value* in the final Interpretation. The concept of fair value is the same as that of market value as it was used in the Exposure Draft of a proposed Interpretation. The change was made to be consistent with the terminology used in Statement 107.

#### **Comments on Exposure Draft**

26. The Board issued a proposed Interpretation, *Offsetting of Amounts Related to Certain Contracts*, for comment on June 11, 1991 and received 59 letters of comment. Certain of the comments received and consideration of them are discussed in the following paragraphs.

27. Some respondents noted that the subject of offsetting is currently part of the Board's project on financial instruments and off-balance-sheet financing and should be addressed there rather than in this Interpretation. This Interpretation is intended to provide interim guidance on the application of the general principle of a right of setoff and does not anticipate the conclusions to be reached in the financial instruments and off-balance-sheet financing project.

28. Some respondents asserted that the fair value of forward, interest rate swap, currency swap, option, and other conditional or exchange contracts are valuation accounts, not assets and liabilities, because they do not satisfy the definitions in Concepts Statement 6. The Board's reasons for concluding that the fair values recognized are assets and liabilities are discussed in paragraph 17.

29. Some respondents asserted that paragraph 253 of Concepts Statement 6, which addresses an estimated loss on a purchase commitment, seems to indicate that a valuation account may

exist as a complete measurement of an asset or a liability. However, paragraphs 251-253 of Concepts Statement 6 acknowledge that the current accounting for estimated losses on purchase commitments is an expedient with no conceptual support. In concept, a valuation account decreases or increases the value of an asset or liability and has no existence apart from that asset or liability. Paragraph 251 differentiates between concept and expedient: "It [the estimated loss on a purchase commitment] is at best part of a liability and is not *by itself* an obligation to pay cash or otherwise sacrifice assets in the future. There is no asset from which it may be a deduction in present practice. . . . That predicament results, however, because estimated loss on purchase commitments is the recorded part of a series of transactions and events that are mostly unrecorded."

30. Some respondents reported that there has been a significant effort recently to develop *cross-product* master netting arrangements. A cross-product master netting arrangement consolidates a variety of types of contracts with a single counterparty and, in the event of default, entitles the nondefaulting party to terminate the entire arrangement and to demand net settlement of all contracts. The Board intended for the provisions of paragraph 10 to apply to conditional or exchange contracts executed with the same counterparty under a cross-product master netting arrangement. Thus, the Board revised the definition of master netting arrangement to clarify that a master netting arrangement exists when the reporting entity has multiple contracts, *whether for the same type of conditional or exchange contract or for different types of 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.

31. Some respondents commented that the proposed Interpretation seemed inconsistent in the list of financial instruments to which it applies. In particular, respondents cited the difference in the list of instruments included in paragraphs 1 and 2 and paragraph 10. Although paragraphs 1 and 2 were intended to be a more detailed list of financial instruments that raise the question of how to apply the conditions for right of setoff, they were not intended to be exhaustive. The Board believes that specifying an exhaustive list of instruments that are addressed by the Interpretation is not desirable and therefore has included *other conditional or exchange contracts* in paragraph 10 in the list of items to which this Interpretation applies so that the Interpretation will address not only those financial instruments that exist today but instruments that will result from future innovation.

32. Some respondents indicated that the provisions of paragraph 10 also should apply to repurchase and reverse repurchase agreements executed with the same counterparty under a master netting arrangement and to all interest rate swaps executed with the same counterparty under a master netting arrangement. For the reasons discussed in paragraph 22, the Board concluded that offsetting of these assets and liabilities is inappropriate unless those contracts otherwise satisfy the conditions in paragraph 5 for right of setoff.

33. Some respondents asserted that comparability will be adversely affected unless offsetting of fair value amounts for contracts executed under a master netting arrangement is mandatory. The Board acknowledges that respondents have valid concerns about comparability. However, the Board believes that the cost-benefit considerations, discussed in paragraph 24, that led the Board to permit, but not require, offsetting are valid.

34. Some respondents stated that an entity should be required to disclose whether it is offsetting fair value amounts so that financial statement users would be able to assess comparability between entities. This Interpretation does not affect the requirements of Statement 105 to disclose the extent, nature, and terms of financial instruments with off-balance-sheet risk and credit risk of financial instruments with off-balance-sheet credit risk. The Board believes that disclosure about whether an entity is offsetting fair value amounts under the provisions of paragraph 10 is not meaningful without also quantifying the effect of gross versus net presentation. Presumably an entity that reports gross amounts has determined that the cost-benefit of reporting net amounts is not justified; therefore, the Board concluded that the entity should not have to incur that same cost to make meaningful disclosures about the effect of choosing to report gross amounts.

35. Some respondents commented that having to apply the provisions of the proposed Interpretation would place U.S. financial institutions at a competitive disadvantage, thereby potentially reducing liquidity in the market. Other standard-setting organizations have issued guidance similar to the guidance in this Interpretation. For example, a joint Statement of Recommended Accounting Practice (SORP), *Off-Balance-Sheet Instruments and Other Commitments and Contingent Liabilities*, issued in November 1991 by the British Bankers' Association and the Irish Bankers' Federation, indicates that the value of interest rate, exchange rate, and market-price-related contracts should not be offset unless they are with the same counterparty and there is a legal right of setoff.

36. Some respondents indicated that paragraph 10 of this Interpretation seems inconsistent with the requirement in paragraph 5(c) that the reporting party intends to set off. Some respondents indicated that the requirement in paragraph 5(c) should be eliminated because intent is not relevant if the right and the ability to set off exist and because the requirement leads to noncomparability among financial statements. The Board concluded that a fundamental reconsideration of the requirements of paragraph 5 is beyond the scope of this Interpretation. The Board acknowledges the inconsistency between paragraph 10 and paragraph 5(c) and concluded, for the reasons stated in paragraph 21, that even if the reporting entity intends to set off only in the event of default or termination, it is appropriate to offset fair value amounts recognized for conditional or exchange contracts executed with the same counterparty under a master netting arrangement.

37. Some respondents commented that the effective date of this Interpretation should be delayed. In particular, banks requested a delay in the effective date to provide time to develop systems that can accumulate unrealized gains and losses on a counterparty basis and, thereby,

permit offsetting of unrealized gains and losses for contracts executed under a master netting arrangement; to execute additional master netting arrangements; and to address capital adequacy concerns. Although the data required to implement the proposed Interpretation, gross unrealized gains and losses, are available and are currently disclosed under the requirements of Statement 105, the Board decided for practical reasons to delay the effective date of the Interpretation to provide adequate time for entities to resolve other implementation issues.

## **Background Information Incorporated from Technical Bulletin 88-2**

38. This Interpretation supersedes FASB Technical Bulletin No. 88-2, *Definition of a Right of Setoff*, as of the effective date of this Interpretation or its earlier application. The guidance in that Technical Bulletin is incorporated substantially unchanged in paragraphs 5-7 of this Interpretation primarily as a matter of convenience. Some respondents to the proposed Interpretation suggested that the Background Information and Consideration of Comments Received on the Proposed Technical Bulletin section of Technical Bulletin 88-2 also be incorporated in this Interpretation. Respondents indicated that that information has been helpful in answering questions in practice and has provided preparers of financial statements with additional information to better understand the criteria needed for a right of setoff. Those sections of Technical Bulletin 88-2 have been reviewed and to the extent they are still relevant they have been incorporated as part of the basis for conclusions of this Interpretation in paragraphs 39-50. Those sections of this Interpretation have been brought forward from Technical Bulletin 88-2 essentially unchanged except for paragraph numbers; where applicable the word *Interpretation* has been substituted for the words *Technical Bulletin* and references to specific paragraphs of this Interpretation have been added.

39. FASB Statements No. 76, *Extinguishment of Debt*, and No. 77, *Reporting by Transferors for Transfers of Receivables with Recourse*, and FASB Technical Bulletin No. 85-2, *Accounting for Collateralized Mortgage Obligations (CMOs)*, address extinguishment of recognized liabilities and derecognition of recognized assets. This Interpretation is based on the explanation in Statement 76 that offsetting is a display issue that does not presume the derecognition of recognized liabilities. Paragraph 40 of that Statement states:

Several respondents to the revised Exposure Draft commented about offsetting assets against liabilities, though it was apparent that some respondents had confused *offsetting* with *extinguishment*. In the Board's view, *offsetting* is a display issue—how recognized assets and recognized liabilities should be presented in a balance sheet (or how other recognized elements should be displayed in a basic financial statement). In contrast, *extinguishment* is a recognition issue—whether an asset or a liability exists and whether continued recognition is warranted in the basic financial statements. This Statement addresses when debt ceases to be a liability that warrants continued recognition in the balance sheet.

## Consideration of Comments Received Incorporated from Technical Bulletin 88-2

40. Some respondents to the proposed Interpretation suggested that the Consideration of Comments Received on the Proposed Technical Bulletin section of Technical Bulletin 88-2 also be incorporated in this Interpretation. Relevant portions of that section are contained herein in paragraphs 41-50.

41. A proposed Technical Bulletin, *Definition of a Right of Setoff*, was released for comment on April 14, 1988. Sixty letters of comment were received on the proposed Technical Bulletin. Certain of the comments received and consideration of them are discussed in the following paragraphs.

42. Some respondents questioned whether the proposed Technical Bulletin was intended to prohibit offsetting in circumstances in which offsetting is prescribed or permitted by various existing accounting pronouncements. They noted that such an objective would exceed the guidelines for a Technical Bulletin established in FASB Technical Bulletin No. 79-1 (Revised), *Purpose and Scope of FASB Technical Bulletins and Procedures for Issuance*. Paragraph 7 of this Interpretation clarifies that such a change is not intended.

43. Paragraph 2(a) of the proposed Technical Bulletin stated that the right of setoff "exists when each of *two* parties owes the other determinable amounts." Some respondents indicated that the number of entities involved in the transaction is not relevant to the decision to offset. The general principle of a right of setoff involves only two parties, and exceptions to that general principle should be limited to practices specifically permitted by the pronouncements indicated in paragraph 7 of this Interpretation.

44. Some respondents requested clarification of the requirement that each party owes the other determinable amounts. They specifically questioned whether those amounts need to be in the same currency, have the same maturities, and, if applicable, bear the same interest rate. If the parties meet the other criteria specified in the definition, specifying currency or interest rate requirements is unnecessary. However, if maturities differ, only the party with the nearer maturity could offset because the party with the longer term maturity must settle in the manner that the other party selects at the earlier maturity date.

45. Some respondents disagreed with the requirement that each party intend to set off and proposed that ability to set off should be sufficient. Those respondents further stated that the decision for net or gross settlement often is a matter of convenience or is tax motivated, would not be made until shortly before settlement, and should not determine the presentation in a statement of financial position. Others indicated that intent is not a condition specified by Opinion 10 and that a new requirement should not be imposed. They also stated that intent is subjective, can exist in various degrees, and is difficult to substantiate, and that such a requirement will be applied inconsistently in practice. If a party does not intend to set off even

though the ability to set off exists, an offsetting presentation in the statement of financial position is not representationally faithful. Acknowledgment of the intent to set off by the reporting party and, if applicable, demonstration of the execution of the setoff in similar situations meet the criterion of intent.

46. Other respondents supported requiring an intent to set off if the condition is limited to the party intending to set off. They observed that a reliable assessment of the other party's intent is impractical and that the lack of that intent is irrelevant if a unilateral legal right of setoff exists for one party. This Interpretation requires that only the reporting entity need have the intent to set off.

47. As used in the proposed Technical Bulletin, *enforceable by law* meant enforceable in a court proceeding by reason of statute or otherwise and demonstrable through examination of a contract. However, some respondents interpreted the requirement to mean the existence of a statute, and they cited situations in which the right of setoff is not specifically included in contractual agreements but was enforceable because of regulatory procedures or as part of normal business practice. The wording of the requirement in paragraph 5(d) of this Interpretation was revised to state *enforceable at law* in order to include those situations.

48. Some respondents opposed the bankruptcy protection requirement in paragraph 2(d) of the proposed Technical Bulletin as inconsistent with the going-concern concept. Commentators indicated that, as a general rule, accounting should reflect what is expected to occur in the normal course of business and protection in bankruptcy is not pertinent when the probability of bankruptcy is remote. Some respondents were concerned also about the difficulty of determining protection in bankruptcy. They noted that the lack of a uniform bankruptcy law and the broad discretion provided to bankruptcy judges would make predicting the outcome of isolated transactions involved in a setoff situation extremely difficult. Those respondents also noted that legal opinions are costly, if obtainable at all, but would likely be required for management and auditors to determine if a right of setoff exists. Also, some banks pointed out that bankruptcy law generally is inapplicable to certain regulated industries due to regulatory intervention in insolvency. In light of these comments, the requirement of legal enforceability was deemed to be sufficient evidence of the right of setoff. This Interpretation does not include a separate requirement for protection in bankruptcy.

49. Some respondents questioned whether transactions involving a lender, a parent company, and its subsidiary could qualify under the proposed definition if all parties agree to the lender's unilateral right of setoff under a contractual arrangement. An example of that transaction is a loan by the foreign branch of a U.S. bank to a foreign subsidiary of a U.S. parent with the parent simultaneously depositing an amount equal to the loan in the U.S. bank for the same term. The deposit is collateral for the loan, and the bank has the legal right of setoff only in the event of default by the foreign subsidiary. Offsetting the collateral with the debt in that situation is inappropriate either in the bank's financial statements or in the consolidated financial statements of the parent and the foreign subsidiary.

50. Some respondents identified Statement 87 as an example in which plan assets are offset against the plan liabilities without meeting the criteria of the proposed Technical Bulletin. They indicated that other assets held in trust should be offset against the related liabilities in a manner similar to the reporting prescribed in Statement 87. Pension trusts are significantly different from most trusts and trustee assets supporting other liabilities. The accounting and reporting for pensions was specifically considered by the Board in Statement 87. However, trusts established for other specified purposes, such as for decommissioning of a nuclear generating plant, would have to meet the conditions for setoff specified in paragraph 5.

## Footnotes

FIN39, Footnote 1--For example, a forward foreign exchange contract may call for a party to deliver one million U.S. dollars in exchange for two million German marks at a specified future date. Under current reporting practice, the party would not record a receivable for the German marks or a payable for the U.S. dollars. Rather, a net amount reflecting the fair value of the position may be reported in the statement of financial position.

FIN39, Footnote 2--For purposes of this Interpretation, cash on deposit at a financial institution is to be considered by the depositor as cash rather than as an amount owed to the depositor.

FIN39, Footnote 3--This Interpretation does not address derecognition or nonrecognition of assets and liabilities. Derecognition by sale of an asset or extinguishment of a liability results in removal of a recognized asset or liability and generally results in the recognition of gain or loss. Although conceptually different, offsetting that results in a net amount of zero and derecognition with no gain or loss are indistinguishable in their effects on the statement of financial position. Likewise, not recognizing assets and liabilities of the same amount in financial statements achieves similar reported results.

FIN39, Footnote 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.