

CHAPTER 2

INVESTMENTS IN DEBT AND EQUITY SECURITIES

CONTENTS

Overview	2001
Background	2002
Accounting for Securities by For-Profit Enterprises	2009
Accounting for Equity Method Investments and Nonmarketable Equity Securities	2031
Accounting for Securities Held by Not-for-Profit Organizations	2032
Impairment of Investment Securities	2034
Miscellaneous Topics Relating to Securities	2047
Regulatory Considerations	2052
Auditing Considerations	2053
International Financial Reporting Standards (IFRS)	2055
Illustrations	2056

OVERVIEW

Accounting for securities varies, depending on several factors: the type and marketability of the security, management's intended holding period for the security, the nature of the transaction, and the type of entity holding the security. The major accounting issue for securities is how they are measured in the financial statements.

An entity may elect to carry any security at fair value with changes in fair value being recorded in net income. If the "fair value option" is not used, an investor that has the intent and ability to hold a debt security to maturity may classify the security as "held-to-maturity" and carry it at amortized cost. All other debt securities and investments in marketable equity securities that do not convey significant influence or control over the investee must be carried at fair value. Investments in securities that are bought to generate profits on short-term price changes are called "trading." Changes in fair value of trading securities are recorded in net income. Investments in securities that an investor intends to hold for indefinite periods of time are called "available-for-sale." Changes in fair value of available-for-sale securities are recorded in other comprehensive income. There are restrictions against certain transfers between the classifications of securities.

Nonmarketable equity securities that do not convey significant interest are generally carried at cost, unless the fair value option is used.

Impairment is recognized in earnings when a decline in value has occurred that is deemed to be other than temporary, and the current fair value becomes the new cost basis for the security. Numerous disclosures are required about

securities, including the net carrying amounts, fair values, and maturities. Not for profit organizations follow different rules.

AUTHOR'S NOTE: Readers should refer to the Important Notice in the Preface of this book for a discussion of the current status of the FASB's project on the accounting for financial instruments. After exploring various approaches, the FASB decided to principally retain existing accounting guidance for classifying and measuring investments in debt securities, resulting in very limited changes to current GAAP, except with regards to impairment of held-to-maturity and available-for-sale securities. On the other hand, the FASB decided that all investments in equity securities, except those accounted for under the equity method of accounting, should be measured at fair value with changes in fair value recognized in net income, with a practical expedient that would allow investments in equity securities that are not publicly traded to be carried at cost with adjustments for impairment and observable changes in value. Readers should be alert to the issuance of a final standard, which is expected in late 2015.

BACKGROUND

Accounting for investments in securities is addressed primarily by ASC 320, *Investments in Debt and Equity Securities*; ASC 323, *Equity Method and Joint Ventures*; and ASC 810-10, *Consolidation/Overall*. Accounting for securities held by not-for-profit organizations is covered by ASC 958-320, *Not-for-Profit Entities/Investments/Debt and Equity Securities*.

ASC 320 addresses the accounting for debt securities and investments in equity securities with readily determinable market values where the investor does not have significant influence or control over the investee company (so-called "passive" investments). When an investor has significant influence over another entity, the investor does not account for the securities as financial instruments—rather, the investor applies the "equity method," a specialized accounting model that reflects the level of participation in the operating and financial decisions of the company. ASC 323 discusses the "equity method" of accounting for equity securities. Investments in equity securities that do not have readily determinable market values and do not convey significant influence or control to the investor are accounted for under the "cost method," as described in ASC 325. ASC 810-10 discusses consolidation of majority-owned subsidiaries. ASC 810-10 also addresses consolidation of thinly capitalized entities, also known as "variable interest entities."

Exhibit 2-1 provides an overview of the applicable literature to decide whether an investment in stock should be accounted for under the cost method, the equity method, or consolidation. Consolidation and the equity method are robust accounting topics that are covered in depth in Wolters Kluwer's *GAAP Guide*, Chapters 47 and 20, respectively.

Definition of a Security

Whether a financial instrument is a security or not is important, because investments are accounted for differently, depending in part on their legal form. (The

ASC glossary term, "Security" was modeled after the definition of a security in the Uniform Commercial Code that existed when the guidance that underpins the accounting for investments in securities was originally issued.) For accounting purposes, a security is:

A share, participation, or other interest in property or in an enterprise of the issuer or an obligation of the issuer that (a) either is represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer, (b) is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment, and (c) either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations.

Each instrument must be tested against the accounting definition to determine whether it is a security. The FASB resolved the question for a few common instruments:

- Accounts receivable, leases, and loans, including conforming mortgage loans and insured loans, do not meet the definition of a security unless legally they have been converted into securities (in a securitization or through a debt restructuring). (ASC glossary term, "Security"); (ASC 320-10-55-2 and 55-3)
- Most options to buy and sell securities are derivatives that should be accounted for under ASC 815, *Derivatives and Hedging*, not as securities. (ASC 320-10-55-5) Whether an instrument is considered a derivative for accounting purposes is discussed in detail in Chapter 12, "Derivatives Accounting."
- Some securities have embedded derivatives that must be accounted for separately under ASC 815-15, *Derivatives/Embedded Derivatives*. For example, investments in convertible debt securities that involve publicly traded stocks are considered to represent a debt instrument (the host contract) and an embedded equity derivative (an option). (ASC 815-15-55-220)
- If an embedded derivative is separated from a host contract that is a security, the remaining security-host component is accounted for as a security that does not contain an embedded derivative. (ASC 320-10-15-7(a)) Embedded derivatives are discussed in detail in Chapter 13, "Embedded Derivatives."

In addition, the SEC staff believes that *beneficial interests* that are in the form of certificates generally meet the definition of a security. (December 10, 1997, speech by Robert Uhl, then a Professional Accounting Fellow at the SEC)

PRACTICE POINTER: It is not advisable to generalize about whether certain types of instruments are securities. For example, most Certificates of Deposit (CDs) would not meet the definition, but a negotiable CD might. If questions arise about whether a particular instrument is a security, it may be necessary to engage legal counsel.

OBSERVATION: Under current GAAP, securities and nonsecurities, such as loans, are accounted for differently. Practitioners should be cognizant of "accounting arbitrage," that is, the ability to select between different accounting models that exist between securities and other forms of investment and ensure that the instruments are properly categorized for accounting purposes.

Debt Securities

A debt security is a security that represents a creditor relationship (i.e., one party owes another party a specified or determinable amount of money). For example, according to the ASC glossary term, "Debt Security", the following types of instruments are considered debt securities:

- U.S. Treasury bonds, notes, and bills and government agency securities
- Municipal bonds
- Corporate bonds and commercial paper
- Convertible debt
- Securitized debt instruments, including collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICs)
- Interest-only and principal-only strips
- Preferred stock that is mandatorily redeemable by the issuer or that is redeemable at the option of the investor
- Securitized financial assets issued in equity form that nonetheless represent a creditor relationship (see ASC 325-40, *Investments—Other/Beneficial Interests in Securitized Financial Assets*).

Similar instruments issued by foreign entities are also debt securities.

Applicability of ASC 320 All debt securities are accounted for under ASC 320, whether marketable or not.

PRACTICE POINTER: After the securitization of a mortgage loan held for sale, any retained mortgage-backed security must be classified in accordance with ASC 320.

Equity Securities

An equity security is a security representing an ownership interest in an enterprise or the right to acquire or dispose of an ownership interest in an entity at a fixed or determinable cost. Examples of equity securities include:

- Common, preferred, and other capital stock.
- Warrants and options that do not meet the definition of a derivative (see Chapter 12, "Derivatives Accounting").

Investments in convertible debt and preferred stock that is either mandatorily redeemable by the issuer or redeemable at the option of the investor are considered debt securities for accounting purposes, *not* equity securities.

PRACTICE POINTER: Chapter 16, "Issuer's Accounting for Equity Instruments and Related Contracts," addresses the characteristics of equity securities from the issuer's perspective.

The accounting for equity securities generally depends on whether the security has a readily determinable fair value, that is, whether it is marketable. As described in the ASC glossary term, equity securities are considered to have a "Readily Determinable Fair Value" in the following circumstances:

- A U.S. equity security: Bid/asked quotations or sales prices are currently available on a securities exchange registered with the Securities and Exchange Commission or in the over-the-counter (OTC) market, provided that the quotations or prices are reported by NASDAQ or by OTC Markets Group Inc.
- An equity security traded only in a foreign market: The foreign market has a breadth and scope comparable to one of the U.S. markets described above.
- A mutual fund share: The fund determines and publishes fair value per share data and those amounts are the basis for current transactions. An investment in a mutual fund that invests only in debt securities is an equity security. (ASC 320-10-50-4 and 55-9)

Restricted stock Restricted stock is considered not to have a readily determinable fair value if governmental or contractual restrictions limit the sale of the stock for one year or more from the date of acquisition. (ASC glossary term, "Readily Determinable Fair Value") A security that can be expected to qualify for sale within one year (e.g., under Rule 144 or similar rules of the SEC), is deemed to have a readily determinable fair value.

PRACTICE POINTER: Stock of the Federal Reserve Bank or Federal Home Loan Bank held by member banks is considered restricted stock. (ASC 942-325-25-1)

Applicability of ASC 320 If an equity security has a readily determinable fair value and does not convey control or significant influence, it must be accounted for under ASC 320. If an equity security does not have a readily determinable fair value and does not convey control or significant influence to the investor, it is accounted for using the cost method under ASC 325, unless the investor has elected the fair value option in ASC 825-10, *Financial Instruments/Overall/Fair Value Option Subsections* (see Chapter 19, "The Fair Value Option for Financial Instruments") or if the investor is an insurance enterprise (see below).

PRACTICE POINTER: If a nonmarketable equity security is convertible into a marketable equity security, or vice versa, the investor should evaluate the marketability of the security that he or she currently holds. For example, a nonmarketable preferred stock that is convertible into marketable common stock is considered nonmarketable, and therefore is outside the scope of ASC 320. It is not appropriate to "look through" the current investment to the nature of the potential or underlying asset. If the convertible instrument is a debt security, the security must be accounted for under ASC 320, regardless of its marketability. (ASC 320-10-55-2) Such instruments may contain embedded derivatives that require separate accounting. See Chapter 13, "Embedded Derivatives."

Insurance company exception Investments in nonmarketable equity securities that are held by a for-profit insurance enterprise are reported at fair value. Changes in fair value are reported as unrealized gains and losses, net of applicable income taxes, in other comprehensive income. (ASC 944-325-30-1, 944-325-35-1, and 944-325-45-1, *Financial Services—Insurance/Investments—Other*)

OBSERVATION: It is unclear why insurance companies are required to carry nonmarketable equity securities at fair value, but not other types of entities investing in private equities.

OBSERVATION: Under current GAAP, there are "special" models for investments in securities that afford the investor significant influence (the equity method) or control (consolidation). However, the form of the investment—common stock—is indisputably a financial instrument. The FASB consistently has excluded consolidated investments from standards that account for financial instruments at fair value but has permitted the fair value option in ASC 825-10 for equity method investments.

EXHIBIT 2-1 DECIDING WHICH LITERATURE APPLIES TO EQUITY SECURITIES

Level and Type of Ownership	Relevant GAAP	Eligible for ASC 825-10, Fair Value Option Subsections Election	General Principle, if Fair Value Election Is Not Made
Stock of a corporation held in its own treasury	ASC 505-30		Report as treasury stock, not as an asset.
< 20% ownership of voting common stock leads to the presumption that the investor does not have significant influence, absent evidence to the contrary	ASC 323-10-15-8	✓	If not marketable, cost method applies, as discussed in ASC 325-20. If marketable, apply ASC 320.

Level and Type of Ownership	Relevant GAAP	Eligible for ASC 825-10, Fair Value Option Subsections Election	General Principle, if Fair Value Election Is Not Made
≥ 20% investment in voting common stock, absent evidence to the contrary, leads to the presumption that the investor has significant influence	ASC 323-10-15-8	✓	Equity method applies.
Presumptions of significant influence in ASC 323 stand until overcome by evidence to the contrary	ASC 323-10-15-10		Examples of "evidence to the contrary" include inability to obtain information, side agreements, and exclusive control by majority owner.
Corporate joint ventures	ASC 323, ASC 810-10-25-1	✓	Equity method applies.
Real estate investment trusts (REIT's) investment in a service corporation	If not a VIE under ASC 810-10, ASC 974-323-25-1		Provides examples of factors that suggest the ability to influence or control notwithstanding the ownership level.
Partnership interests and ventures	ASC 323-30, ASC 970-835, ASC 810-10-25-1	✓	Equity method would generally be appropriate.
Limited partnership interests	ASC 323-30-S99	✓	SEC registrants must account for investments > 3 to 5% under the equity method, even if they do not have significant influence.
Investments in LLCs	ASC 323-30-35-3	✓	Equity method would generally be appropriate.
> 50% ownership of outstanding voting shares	ASC 810-10-15-10		Consolidation applies.

Level and Type of Ownership	Relevant GAAP	Eligible for ASC 825-10, Fair Value Option Subsections Election	General Principle, if Fair Value Election Is Not Made
Effect of veto rights held by minority shareholders	ASC 810-10-25-2 through 25-14	(if consolidation presumption is overcome)	Certain types of veto rights can overturn consolidation presumption for majority owner.
>50% investment in voting common stock generally results in consolidation, but other methods apply if control does not rest with the majority owner	ASC 810-10-15-10(a)(1))	✓	Equity method applies if majority owner has significant influence. If not, cost method applies. If marketable, apply ASC 320.

Other Instruments That Must Be Accounted for Like Securities

ASC 815 provides a scope exception for interest-only and principal-only strips with specific characteristics. A security that qualifies for the scope exception should be accounted for like a debt security, as discussed in this section. An interest-only strip or principal-only strip is outside the scope of ASC 815 if it meets both of the following conditions:

- It represents only the rights to receive only a specified proportion of the contractual interest or principal cash flows of a specific debt instrument, and
- It does not incorporate any terms that are *not* present in the original debt instrument.

Except for instruments that are within the scope of ASC 815, financial assets (such as interest-only strips, other beneficial interests issued in securitization transactions, loans, or other receivables) that can contractually be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment must be subsequently measured like investments in debt securities under ASC 320—*whether or not they are actually securities*. (ASC 860-20-35-2 and 310-10-35-45) All of the measurement provisions of ASC 320, including impairment and transfers, and the related interpretive guidance apply to instruments with these characteristics. (ASC 860-20-35-3) However, the disclosure requirements of ASC 320 need only be applied to instruments that are actually securities. (ASC 860-20-35-3)

PRACTICE POINTER: This provision applies primarily to prepayable debt instruments purchased at a significant premium over the amount at which they can be prepaid and prepayable instruments with no "principal" balance, such as interest-only strips. ASC 320 requires that instruments with significant prepayment risk be carried at fair value, not amortized cost. (See restrictions under "Held-to-Maturity Securities" section.)

All other instruments that have contractual terms that allow the instrument to be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its recorded investment must be evaluated in accordance with ASC 815 to determine if they are freestanding instruments or hybrid instruments containing an embedded derivative that must be accounted for separately.

PRACTICE POINTER: Chapter 12, "Derivatives Accounting," discusses the types of instruments discussed above that would be considered derivatives in their own right; Chapter 13, "Embedded Derivatives," discusses which of these instruments contain embedded derivatives that require separate accounting.

ACCOUNTING FOR SECURITIES BY FOR-PROFIT ENTERPRISES

Trade Date Accounting

Under trade date accounting, purchases of securities are recognized in the balance sheet at the trade date, not the date the security is actually received and paid for.

Security	XXX,XXX	XXX,XXX
Trade date payable		
Gains and losses on sales or disposals of securities also are recognized in the statement of operations on the trade date.		
Trade date receivable	XXX,XXX	XXX,XXX
Security		X,XXX
Gain (or loss) on sale		

The following GAAP requires trade date accounting for regular-way securities transactions:

- ASC 960, *Plan Accounting—Defined Benefit Pension Plans*
- ASC 942-325-25-2, *Financial Instruments—Depository and Lending/Investments—Other/Recognition*
- AICPA Audit and Accounting Guide, *Brokers and Dealers in Securities*
- AICPA Audit and Accounting Guide, *Employee Benefit Plans*
- AICPA Audit and Accounting Guide, *Investment Companies*
- AICPA Audit and Accounting Guide, *Property and Liability Insurance Companies*
- AICPA Audit and Accounting Guide, *Life and Health Insurance Entities*

Under ASC 815, a commitment to buy or sell a security in the future meets the definition of a derivative (a forward contract) if the underlying security is

Computation of net proceeds

	Fair Value of Proceeds
<i>Gain on sale calculation</i>	
Net proceeds	800,000
Carrying amount of loans sold	(725,000)
Gain on sale	75,000
<i>Journal entries</i>	
Cash	728,000
Servicing asset	32,000
I-O strip	40,000
Loans	725,000
Gain on sale	75,000

To record the transfer of receivables and recognize the I-O strip and servicing asset obtained. Subsequently, the servicing asset would be measured at either fair value with changes in value recognized in earnings or amortized and tested for impairment, based on the election made under ASC 860-50-35.

CHAPTER 5

TRANSFERS OF FINANCIAL ASSETS

CONTENTS

Overview	5001
Background	5002
Scope	5003
Accounting for Transfers of Financial Assets	5005
Disclosures	5023
Regulatory Considerations	5024
Audit Considerations	5024
International Financial Reporting Standards (IFRS)	5026
Illustrations	5026

OVERVIEW

The phrase "transfer of financial assets" can refer to many types of common transactions, including sales, exchanges, securitizations, and pledges of collateral. This chapter discusses provisions of GAAP that apply to all transfers of financial assets and discusses the application of those provisions in general. Other chapters of this book further discuss certain types of transfers, including securitizations (Chapter 6, "Securitizations") and repurchase agreements and securities lending transactions (Chapter 9, "Repurchase Agreements, Securities Lending Arrangements and Other Pledges of Collateral").

Accounting for a transfer of financial assets is straightforward when the transferor has no continuing involvement with the transferred asset or with the transferee. However, when the transferor retains an interest in the transferred assets or is involved with the transferee in some way, questions arise about whether the transfer should be accounted for as a sale or a secured borrowing. Where the transfer meets the requirements to be treated as a sale, the transaction is said to achieve "off-balance-sheet accounting." Achieving off-balance accounting in a transfer of financial assets is very important for many companies, particularly those concerned about capital requirements, debt ratios, and the pattern of earnings.

Accounting for transfers of financial assets is more complicated than accounting for transfers of other types of assets in part because the underlying transactions tend to be more complicated. For example, the cash flows of a financial asset can be divided and "owned" simultaneously by different parties. The accounting for transfers of financial assets is built on a "control" framework, under which assets are treated as sold (and therefore are removed (derecognized) from the books of the transferor) when control of those assets is surrendered. To conclude that control has been surrendered, the transferor must conclude that the assets in question are legally out of its control, even in the event of bankruptcy,

and the transferor must also conclude that it does not effectively retain control through contractual provisions or other arrangements.

When derecognition of a financial asset occurs, the transferring entity records any proceeds it receives or obligations it incurs at fair value. Subsequently, those interests are accounted for under other GAAP, depending on the instrument type. When control has not been surrendered, the transaction is accounted for by both parties as a secured borrowing.

BACKGROUND

ASC 860 provides guidance on the accounting for transfers of financial assets. ASC 860 uses terminology that may not be familiar to some accountants and market participants. Exhibit 5-1 provides a translation between ASC 860 and common usage.

EXHIBIT 5-1
TERMINOLOGY FOR TRANSFERS OF FINANCIAL ASSETS
Common Usage

ASC 860	Sale	Borrowing
"Transferor"	Seller of asset	Borrower of cash; collateral provider
"Transferee"	Buyer of asset	Lender of cash

Accounting for transfers of financial assets where the transferor has no continuing involvement with the transferred assets or with the transferee generally raise no accounting questions. Such transactions are treated the same way the sale of any other asset would be treated, and there is little need for guidance on those transfers.

Of course, transfers of financial assets often do involve various types of continuing involvement, raising questions about whether the transfers should be accounted for as a sale, with the transferred assets derecognized, or as a borrowing. The answers to these questions are often extremely important to transferors. In some cases, this is because the transferor is subject to regulatory requirements or debt covenants that begin with assets or liabilities as reported under GAAP. In other cases, the transferor is simply concerned with market reaction to reported levels of assets or debt.

Examples of transfers of financial assets that often involve continuing involvement include:

- Securitizations, in which assets are transferred to a special-purpose entity, which issues beneficial interests (debt or equity securities) to investors to finance the purchase of the transferred assets.
- Factoring arrangements, in which an entity sells accounts receivable, often with some form of recourse.

- Securities lending transactions, in which broker-dealers "borrow" securities needed to cover open positions, using cash or other securities as collateral.
- Repurchase agreements, in which securities are sold for cash in a transaction that also involves an agreement that the seller will repurchase the securities at a later date.
- Loan participations, which involve the sale by a lender of portions of its interests in a loan.

Common examples of continuing involvement that may occur in these or other transfers of financial assets include:

- Continuing to service a financial asset that has been transferred.
- Providing recourse to the buyer of the transferred asset.
- Sharing in the revenues from the transferred asset (e.g., obtaining an interest-only strip or residual interest).
- Providing collateral to a lender.
- Converting the interest rate or currency of the transferred asset.
- Holding a forward contract or an option contract to repurchase the transferred asset.

SCOPE

ASC 860 has a wide-ranging effect on financial institutions and the treasury function at other types of companies. For example, the following types of transactions are all considered transfers of financial assets:

- Sales of receivables, either with or without recourse
- Securitizations
- Loan participations
- Factoring arrangements
- Secured borrowings
- Bond swaps
- Repurchase agreements
- Dollar rolls
- Securities lending transactions

ASC 860 addresses transfers of financial assets that are recognized in the balance sheet. For example, ASC 860 applies to transfers involving the following instruments:

- Receivables and loans
- Investments in debt and equity securities, except for investments that are in-substance real estate
- Minimum lease payments relating to sales-type and direct financing leases and guaranteed residual values (ASC 860-20-55-26)

- Derivatives, including derivatives accounted for under ASC 815 that are not financial instruments (ASC 815-10-40-2 and 40-3, *Derivatives and Hedging/Overall/Derecognition*) (Note: Derivatives that could become liabilities would be subject to the extinguishment of liabilities provisions of ASC 405 in addition to the transfer of assets provisions of ASC 860. (ASC 860-10-40-40) See Chapter 11, "Extinguishments of Debt.")
- Beneficial interests in securitization trusts that hold nonfinancial assets (unless the interests are held by a related party or the holder must consolidate the trust) (ASC 860-10-55-9).

Although the scope of ASC 860 is quite broad, there are a number of transactions that are very similar to transfers of recognized financial assets that are not within the scope of the guidance, and there are also a small number of transfers of recognized financial assets that are the subject of scope exceptions.

EXHIBIT 5-2
TRANSACTIONS EXCLUDED FROM THE SCOPE OF ASC 860
(ASC 860-10-15-4)

Transfer of ...	Reason for Exclusion	Applicable GAAP, if Any
Real estate and equity method investments that are in substance real estate	Not a financial asset	ASC 360-20, ASC 815-10-40-2 and 40-3, and ASC 610
Equipment under lease	Not a financial asset	ASC 360-20, ASC 976 and ASC 610
Future revenues (e.g., as royalties, income from a business line)	Not a recognized financial asset (such as an accounts receivable)	ASC 470-10-25-1, 25-2 and 35-3, Debt/Overall
Securitized stranded costs by utility companies	Not a financial asset (ASC 860-10-55-7 and 55-8)	ASC 470-10-18
Judgment from litigation (unless it represents a contract for fixed payments)	Not a financial asset (ASC 860-10-55-10 and 55-11)	—
Minimum lease payments on an operating lease	Not recognized in the balance sheet	ASC 840, Leases
Unguaranteed residual values on a lease	Not a financial asset (ASC 860-10-55-6)	ASC 840 and ASC 360-10 and ASC 840
Leveraged leases, money-over-money and wrap lease transactions	Specific scope exception	ASC 840
Bad debt recovery rights	Not recognized in the balance sheet (previously written off)	See Chapter 3
Stock of consolidated subsidiary that holds more than just financial instruments	Special model for controlled entity (ASC 860-10-55-13)	See Chapter 16

Transfer of ...	Reason for Exclusion	Applicable GAAP, if Any
A company's own equity	Equity, not an asset to the company (ASC 860-10-55-15)	See Chapter 16
Loan syndication	Not a transfer (each lender funds its own loan; the lead lender is acting as servicer) (ASC 860-10-55-4)	See Chapter 3
Origination, settlement, or restructuring of receivables	Not a transfer (ASC 860-10-55-4)	See Chapter 3 (restructuring) and Chapter 6 (origination fees)
Charitable contributions	Not a transfer (ASC 860-10-15-4(d))	ASC 958

PRACTICE POINTER: Some companies, in an attempt to get around the requirements of ASC 860, have considered selling preferred interests in a subsidiary that holds only financial assets rather than selling interests in the financial assets themselves. As selling equity in a consolidated subsidiary is not subject to the provisions of ASC 860, the hope is that any such sales will result in recognition of a non-controlling interest (equity), rather than debt (liability). The SEC staff has indicated that it views such transactions as transfers of financial assets, despite their form, and has concluded that ASC 860 should be applied. To the extent the transaction does not meet the requirements for sale accounting, it should be reflected as a secured borrowing, not the sale of a non-controlling interest in a subsidiary.

ACCOUNTING FOR TRANSFERS OF FINANCIAL ASSETS

Unit of Account

In large part to address concern about whether components of financial assets could be consistently identified, the FASB decided that derecognition should only occur if control of an entire financial asset or a pro rata portion of a financial asset is surrendered. Therefore, giving up control of certain cash flows (e.g., principal or interest payments) from a financial asset no longer results in derecognition.

The discussion of transfers of financial assets relates to transfers of:

- Entire financial assets;
- Groups of entire financial assets;
- Participating interests of (i.e., pro rata portions of) an entire financial asset.

For a transfer of less than an entire financial asset to qualify for sale accounting, the interest being sold must qualify as a "participating interest," as defined. A participating interest in a financial asset has all of the following characteristics (ASC 860-10-40-6A):

- (1) **Proportionate ownership interest**—From the date of the transfer, interest represents a proportionate (pro-rata) interest in an entire financial asset. The percentage of ownership interests held by the transferor may change (e.g., if the transferor later sells another interest in the entire financial asset) as long as the resulting portions held by the transferor (including any participating interest retained) and transferred meet the other characteristics of a participating interest.
- (2) **Proportionate cash flows**—All cash flows from the entire transferred asset must be divided among holders (including interests retained by the transferor) in proportion to their ownership share. Cash flows may be allocated only if each cash flow is proportionately allocated to all holders. Allocation of specific cash flows, such as all interest cash flows and all principal cash flows, does not meet this characteristic. Fees and services performed deemed to be fair compensation are not considered. Proceeds received by the transferor are also not considered unless the transferor receives an ownership interest in the financial asset that results in it receiving disproportionate cash flows.
- (3) **No subordination**—The rights of each participating interest holder (including the transferor if an interest is retained) have the same priority and there is no subordination of participating interests. Also, priority cannot change in the event of bankruptcy or other receivership.
- (4) **No recourse**—Participating interest holders have no recourse to the transferor (or its consolidated affiliates or agents) or to each other. The transfer does not include standard representations and warranties and contractual servicing obligations. Also, this does not include contractual obligations to share in benefits from "set-off rights" received ("set-off rights" result in a party that has a payable and receivable from the same counterparty offsetting the two if the counterparty fails to pay its obligation). In addition, this provision focuses only on recourse amongst parties to the participation. Recourse provided by a third party guarantor does not preclude an interest from being a participating interest. (ASC 860-10-55-17M)
- (5) **Cannot pledge or exchange individually**—No party has the right to pledge or exchange the entire financial asset unless all participating interest holders agree to pledge or exchange the entire financial asset.

If a transferor transfers a portion of a financial asset and that portion does not meet the definition of a participating interest, the transfer cannot be accounted for as a sale and instead would be accounted for as a secured borrowing. For example, if a transfer of a participating interest involves the participating interest holder having recourse to the transferor (other than standard representations and warranties, ongoing contractual obligations to service the entire financial asset and administer the transfer contract, and contractual obligations to share in any set-off benefits received by any participating interest holder), the transfer must be accounted for as a secured borrowing.

PRACTICE POINTER: Prior to FAS-166, which was issued in 2009 and amended the previous guidance in FAS-140, sale accounting could be applied to any "portion" or "component" of a financial asset, under the theory that the cash flows from a financial asset could each be controlled by different parties, and that a transferor should therefore derecognize the portions of a financial asset that represented cash flows it no longer controlled following a transfer. However, there was no guidance on what constituted a portion or component of a financial asset. Regulators and others quickly began to become concerned about transactions that were being accounted for as sales of components of financial assets despite structuring that appeared to ensure continued control of the underlying financial asset by the transferor. (FAS-166, par. A14-A15)

ASC 860 now permits sale accounting only for transfers of "portions" of financial instruments that exactly mirror the characteristics of the original financial asset. However, in a securitization transaction, a transferor can transfer an entire financial asset and the securitization entity can divide the cash flows of those assets into beneficial interests representing specific cash flows, such as principal and interest cash flows, some of which can be issued to the transferor. While this might allow a transferor to achieve something akin to a sale of a non-pro-rata portion of a financial asset, the beneficial interests held by the transferor after the securitization would be recognized at their fair value, not at a portion of the historical carrying value of the transferred assets. In addition, many securitization entities must be consolidated. Chapter 6, "Securitizations" discusses the accounting for securitization transactions.

Criteria for Sale Accounting

Determining whether control is surrendered includes consideration of a transferor's continuing involvement in the transferred financial assets considering all agreements made contemporaneously or in contemplation of the transfer, even if they are not made at the same time as the transfer. (ASC 860-10-40-4(c))

The transferor has surrendered control over transferred assets (i.e., an entire transferred asset, a group of transferred assets, or a participating interest) only if all of the following conditions are met:

- **Isolation:** The transferred financial assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. Transferred financial assets are isolated in bankruptcy or other receivership only if the transferred financial assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its consolidated affiliates. (Bankruptcy-remote entities used in multiple step transfers are not considered consolidated affiliates for this purpose.) Notwithstanding the isolation analysis, each entity involved in the transfer must be evaluated under consolidation guidance. (ASC 860-10-40-5(a))
- **Transferee can pledge or exchange:** Each transferee has the right to pledge or exchange the assets it received, and no condition both (1) constrains the transferee from taking advantage of its right to pledge or

CHAPTER 9

REPURCHASE AGREEMENTS, SECURITIES LENDING ARRANGEMENTS AND OTHER PLEDGES OF COLLATERAL

CONTENTS

Overview	9001
Background	9002
Accounting for Collateral	9005
Accounting for Securities Lending Arrangements	9009
Accounting for Repurchase Financings	9019
Disclosure Requirements	9020
Regulatory Considerations	9023
Audit Considerations	9023
International Financial Reporting Standards (IFRS)	9024
Illustrations	9024

OVERVIEW

Accounting for collateral in a transaction accounted for as a secured borrowing depends primarily on the extent of the secured party's rights to use the asset. A secured party generally should not record collateral received in a lending transaction as its own asset unless it is cash. However, if the borrower defaults under the terms of the agreement and is no longer entitled to retrieve it, the lender should record the collateral as its own asset. A borrower should continue to report on its balance sheet an asset it pledges as collateral but, if the secured party has the right to freely use the collateral, the assets should be reclassified into a category that indicates their restricted status. Borrowers and lenders must disclose certain information about assets pledged and received as collateral.

Securities lending arrangements involve temporary exchanges of securities for cash, other securities, or guarantees with an obligation to return the same (or very similar) securities at a future date. Some securities lending transactions are driven by the need for cash, and the securities function as collateral for the lender. Some securities lending transactions are driven by the need for a specific security, and the cash or other securities exchanged function as collateral. Regardless of the participants' motivation, the economics of these arrangements are similar.

Accounting for securities lending arrangements depends on whether the transferor has surrendered control over the assets, using the same criteria discussed in Chapter 5, "Transfers of Financial Assets." At first glance, the transferor

in most securities lending transactions appears to maintain effective control because he has committed to repurchase the security. However, several additional conditions must be evaluated to conclude definitively on the matter.

When a securities lending transaction meets all the conditions for sale accounting, the transferor derecognizes the transferred asset, recognizes the proceeds as its own asset, and records a gain or loss. The transferee records the purchase of the transferred asset at fair value. Accounting for the forward (re)purchase contract depends on whether the contract meets the definition of a derivative.

When a securities lending transaction must be accounted for as a secured borrowing, the proceeds are reported as a payable by the transferor and a receivable by the transferee. The difference between the selling price and the repurchase price is recognized as interest expense and interest income by the transferor and transferee, respectively. The security being loaned is considered a pledge of collateral.

Receivables and payables from securities lending arrangements should not be netted (offset) in the balance sheet unless the legal right of setoff exists. However, payables and receivables that represent repurchase agreements and reverse repurchase agreements may be offset if several specific conditions are met.

BACKGROUND

FASB Accounting Standards Codification® (ASC) Subtopic 860-10, *Transfers and Servicing/Overall* provides guidance on whether securities lending arrangements, including repurchase agreements, dollar rolls, and security sell/buyback transactions, should be accounted for as secured borrowings or sales. ASC 860-30, *Transfers and Servicing/Secured Borrowing and Collateral* addresses the accounting for transfers of collateral in transactions accounted for as secured borrowings. The sale criteria in ASC 860-10-40-4 and 40-5, which were discussed in Chapter 5, "Transfers of Financial Assets," also apply to securities lending transactions. Because the transfer of securities is accompanied by an agreement to repurchase them, the criteria in ASC 860-10-40-24, regarding conditions which, if met, indicate that a transferor maintains effective control of a transferred asset when there is also a repurchase agreement covering that asset, are particularly relevant.

ASC 210-20-45, *Balance Sheet/Offsetting/Other Presentation Matters* provides an exception to the general offsetting rules for payables and receivables from repurchase agreements and reverse repurchase agreements that meet several specific criteria.

Terminology—Types of Securities Lending Transactions

Repurchase Agreement (Repo) An agreement whereby one party agrees to sell financial assets (usually securities) to another for cash, with a simultaneous agreement to repurchase the same or equivalent financial assets at a specific price at a later date.

Many repurchase agreements are for short terms, often overnight. Some repurchase agreements do not have explicit settlement dates—that is, they remain outstanding until one of the parties terminates the arrangement (called "till further notice" or TFN). The repurchase price is generally equal to the original selling price plus interest, typically at current money market yields. Economically, the "seller" is borrowing cash. A reverse repurchase agreement ("reverse repo" or "resale") is the flipside of a repo—a reverse repo is the purchase of a security for cash, with a simultaneous agreement to resell the same or equivalent securities at a later date for a specified price. Economically, the "purchaser" is lending cash. There are several kinds of custodial arrangements relating to repo transactions, including tri-party repos, deliver-out repos, and hold-in-custody repos. These custody arrangements can be relevant in determining whether the transferor has surrendered control of the securities.

PRACTICE POINTER: Banks, broker-dealers, insurance companies, and other financial institutions use the term "repo" to refer to sales/repurchases and the term "reverse repo" to refer to purchases/resales. Investment companies (e.g., mutual funds) use the same terminology to refer to the opposite transactions.

Repurchase-to-Maturity Transaction A repo in which the settlement date of the agreement is at the maturity date of the financial asset and the transferor therefore does not actually reacquire the financial asset.

Dollar Rolls Repurchase and reverse repurchase agreements that involve similar, but not the same, securities.

Dollar rolls typically involve mortgage-backed securities.

Federal Funds Purchased and Sold Funds that commercial banks borrow (purchase) or deposit (sell) from Federal Reserve Banks for a term of one day (although the transactions may be rolled over).

In a collateralized transaction, the purchaser of federal funds places U.S. Treasury securities in an account for the seller until the funds are repaid. Collateralized federal funds transactions are essentially a specific form of repurchase (resale) agreements.

Securities Lending Agreements A loan of specific securities to a party who agrees to return a like quantity of the same security.

The securities borrower typically obtains full title to the securities so that they can be delivered to another party, such as to cover a short sale or a customer's failure to deliver securities sold. The lender typically receives collateral, including cash, other securities, or a bank letter of credit, to secure the

return of their securities. The lender receives a fee that is negotiated at the time of the transaction, often called a rebate. The length of the transaction can be overnight, open (cancelable on demand), or for a specified term. Typically, each security loan is initially collateralized at a predetermined margin that exceeds the value of the securities loaned; the collateral is adjusted as the market value of the security rises and falls.

Sell-Buybacks Two transactions entered into at the same time whereby (1) a security is sold and (2) the same security is purchased for settlement at a future date.

The forward price is derived using an interest rate such as the repo rate. Historically, these transactions were documented separately and not linked legally. Increasingly, however, the contracts are executed under fully documented, legally enforceable agreements.

PRACTICE POINTER: These descriptions are primarily based on a July 1999 report of the Technical Committee of the International Organization of Securities Commissions (IOSCO), Committee on Payment and Settlement Systems, called, "Securities Lending Transactions: Market Development and Implications." The report provides an overview of securities lending markets, typical transaction terms and a robust discussion of legal and regulatory issues.

Terminology for Transaction Elements

Sometimes it is difficult to identify for accounting purposes which element of a secured borrowing is collateral and which element is proceeds (e.g., in certain securities lending transactions). The confusion is caused partly by differences between the terminology used by market participants and ASC 860-30. It is helpful to remember that a secured borrowing has only one pledge of collateral—the other upfront flow represents the exchange of proceeds from the lender to the borrower.

Exhibit 9-1 summarizes the accounting terminology for three common transactions, assuming they are accounted for as secured borrowings.

EXHIBIT 9-1 ACCOUNTING TERMINOLOGY IN SECURED BORROWINGS*

1. Repurchase agreement (or a bank loan secured by marketable securities)

	Bank	Broker/dealer (initiator)
Cash (proceeds)	Lender	Borrower
Security posted as collateral	Transferee (secured party)	Transferor

2. Securities Lending (e.g., equity securities for cash "collateral")

	Bank	Broker/dealer (initiator)
Cash (proceeds)	Borrower	Lender
Security lent (considered collateral)	Transferor	Transferee (secured party)

3. Borrow versus Pledge Securities Lending (e.g., equity securities for Treasury bills as "collateral")

	Bank	Broker/dealer (initiator)
T-bills (proceeds)	Borrower	Lender
Security lent (considered collateral)	Transferor	Transferee (secured party)

* If, instead, the transactions were accounted for as sales, the transferor would be the seller of the security (lent) and the transferee would be the purchaser of the security (lent).

ACCOUNTING FOR COLLATERAL

Pledges of Collateral

A borrower may grant a security interest in certain assets to a lender (the secured party) to serve as collateral for its obligation under a borrowing, or under other kinds of contracts that could become obligations, such as interest rate swaps. When the collateral is transferred to the secured party, the arrangement is commonly referred to as a pledge. Secured parties sometimes are permitted to sell or repledge collateral held under a pledge.

Noncash Collateral

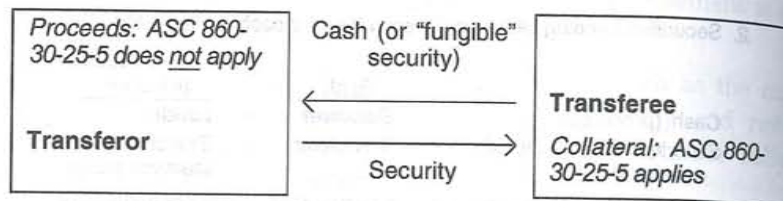
ASC 860-30-25-5 addresses the accounting for pledges of noncash financial assets as collateral in all transactions that are accounted for as secured borrowings, including standard bank loans, corporate debt, and many securities lending transactions. Whether a securities lending transaction should be accounted for as a secured borrowing is addressed later in this chapter.

Generally, when a specific security is being loaned, and the transaction is accounted for as a secured borrowing, it represents the collateral in the transaction for accounting purposes, and ASC 860-30-25-5 applies. The cash or "fungible" securities provided by the securities borrower represents the proceeds of the

borrowing for accounting purposes—ASC 860-30-25-5 does not apply to that leg of the transaction.

Exhibit 9-2 illustrates the distinction between collateral and proceeds in a securities lending transaction that is accounted for as a secured borrowing.

EXHIBIT 9-2
DISTINGUISHING COLLATERAL FROM PROCEEDS IN A SECURED BORROWING



The accounting for pledges of other financial assets as collateral under ASC 860-30-25-5 depends on whether the secured party has the right to sell or repledge the collateral and on whether the debtor has defaulted.

- If the secured party (transferee) has the right by contract or custom to sell or repledge the collateral, then the debtor (transferor) should reclassify that asset and report it separately in its balance sheet (e.g., as a security pledged to creditors) from other assets not so encumbered.
- If the secured party (transferee) sells collateral pledged to it, it should recognize the proceeds from the sale and its obligation to return the collateral. The sale of the collateral is a transfer subject to ASC 860.
- The debtor (transferor) should continue to carry the collateral as its asset, and the secured party (transferee) should not recognize the pledged asset, unless the debtor defaults under the contract.
- If the debtor (transferor) defaults under the terms of the secured contract and is no longer entitled to redeem the pledged asset, it should derecognize the pledged asset. The secured party (transferee) should recognize the collateral as its asset, initially measured at fair value or, if it has already sold the collateral, derecognize its obligation to return the collateral.

PRACTICE POINTER: When an asset pledged as collateral is required to be reclassified as an encumbered asset, the transferor should continue to follow the same measurement principles as before the transfer. For example, securities reclassified from the available-for-sale category to securities pledged to creditors should continue to be measured at fair value, with changes in fair value reported in other comprehensive income, while debt securities reclassified from the held-to-maturity category to securities pledged to creditors should continue to be measured at amortized cost. (ASC 860-30-35-2)

REGULATORY ALERT: Under statutory accounting principles, insurance companies need only *disclose* assets that the secured party has the right to sell or pledge. Under GAAP, they must be reclassified in the balance sheet. (SSAP No. 33)

OBSERVATION: Under ASC 310-40, *Receivables/Troubled Debt Restructurings by Creditors* (troubled debt restructurings) and ASC 310, *Receivables* (loan impairment), a creditor does not recognize the debtor's assets in a repossession or in-substance foreclosure until it receives physical possession of them. However, in some cases, a loss is recognized at an earlier point based on the fair value of the collateral (adjusted for any costs to sell, if applicable). Refer to Chapter 3, "Loans and the Allowance for Credit Losses," for more information.

EXHIBIT 9-3
ACCOUNTING FOR PLEDGES OF NONCASH COLLATERAL*

		Transferor of Collateral/ Borrower of Cash	Secured Party/ Lender of Cash
Does the recipient have the right to sell or repledge the noncash collateral?	→ No →	Continue to report asset as its own, no reclass required	No entry
↓ Yes		Reclassify the asset to a separate category for encumbered assets	No entry
Has the recipient sold or pledged the collateral?	→ Yes →	No entry	Recognize proceeds and obligation to return collateral
↓ No		No entry	No entry
Has the debtor defaulted and can no longer redeem pledged asset?	→ Yes →	Remove asset from balance sheet	Recognize asset as its own (or if the asset has been sold, derecognize the obligation to return collateral)
↓ No			
Continue to report as above.			

* Note: For accounting purposes, cash collateral is considered "proceeds" under ASC 860-30, not a pledge of collateral. See Exhibit 9-32.

Cash Collateral

Cash "collateral" is not subject to the guidance for collateral in ASC 860-30-25-3. Rather, all cash collateral should be recorded as an asset by the party receiving it, together with a liability for the obligation to return it to the payer. (ASC 860-30-25-3) The payer of cash collateral should derecognize the cash and record a receivable from the borrower. (ASC 860-30-25-4)

OBSERVATION: Cash "collateral" received is treated as proceeds of either a sale or a borrowing, rather than as collateral held to secure a loan.

Interaction with ASC 320

A debt security classified as held-to-maturity under ASC 320 may be pledged as collateral provided that the transaction is not accounted for as a sale and the entity intends and expects to be able to satisfy the obligation and recover access to its collateral. (ASC 320-10-25-18(e)(1))

A debt security or marketable equity security received by a transferor as proceeds in a securities lending transaction should be accounted for under ASC 320. Given the nature of a securities lending transaction, it seems inconsistent with ASC 320 to classify debt securities received as proceeds as held-to-maturity.

Sales of Collateral Received (Short Sales)

A bank or other financial institution that, as transferee, sells transferred collateral should subsequently measure that liability like a short sale. (ASC 860-30-35-3) ASC 942-405, *Financial Services—Depository and Lending/Liabilities* states that obligations incurred in short sales should be reported as liabilities and carried at fair value in the statement of position. Changes in fair value are recognized in earnings currently and in the same caption as gains and losses on securities. Interest on short positions should be accrued periodically and reported as interest expense. (ASC 942-405-25-1, 35-1, and 45-1)

Safekeeping and Custody Arrangements

Financial assets transferred to another party simply for safekeeping or custody continue to be carried as assets by the transferor. The custodian does not control the assets but must follow the transferor's instructions. The only consideration exchanged in those transfers is, perhaps, payment of a fee by the transferor to the custodian for the custodial services. (FAS-140, par. 260) [Content Not Codified—basis for conclusions]

ACCOUNTING FOR SECURITIES LENDING ARRANGEMENTS

Applying the Sale Criteria

Securities lending transactions involve transfers of financial assets and therefore they are subject to ASC 860. To be considered a sale, a securities lending transaction must meet all of the following conditions (presented in summary here, but discussed in detail in Chapter 5, "Transfers of Financial Assets"):

- The transferred assets have been isolated from the transferor. (ASC 860-10-40-5(a))
- The transferee has the right to pledge or exchange the assets it receives, without a constraint that benefits the transferor. (ASC 860-10-40-5(b))
- The transferor does not maintain effective control over the transferred assets or third-party beneficial interests related to those transferred assets. (ASC 860-10-40-5(c))

Securities lending transactions include an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (ASC 860-10-40-5(c)(1)). Therefore, they must be analyzed further under ASC

CHAPTER 14

HEDGE ACCOUNTING

CONTENTS

Overview	14,001
Background	14,002
Fair Value Hedge Accounting	14,021
Cash Flow Hedges	14,036
Foreign Currency Hedges	14,061
Entities That Do Not Report Earnings Separately	14,075
Reporting Elements of Hedge Accounting	14,076
Regulatory Considerations	14,079
Audit Considerations	14,079
International Financial Reporting Standards (IFRS)	14,082
Illustrations	14,083

OVERVIEW

All derivatives must be carried at fair value in the balance sheet. However, for qualifying hedge transactions, gains and losses on derivatives may be recognized in earnings in a pattern that matches the hedged item. The mechanics of hedge accounting vary, depending on whether the risk being hedged is price risk, cash flow risk, or foreign currency risk. To qualify for hedge accounting, numerous criteria must be met, involving both the derivative and the hedged item. Hedge accounting is prohibited for several types of transactions. In order for hedge accounting to be used, hedging transactions must be designated and documented at the inception of the transaction and the entity must expect the derivative to be highly effective in offsetting the fluctuations in price or cash flow of the hedged item. Generally, ineffectiveness in a hedging relationship is recognized in earnings currently. Hedge accounting is elective for transactions that meet all of the necessary criteria.

AUTHOR'S NOTE: As part of the project on accounting for financial instruments, the FASB has been exploring possible changes to the hedge accounting model. In early 2015, the FASB began to discuss the hedging portion of the project, after it had been on hold for several years. Rather than a significant reconsideration of hedge accounting, the FASB decided to pursue several targeted topics. The more significant changes pursuant to the FASB's tentative decisions include: (1) allowing components of nonfinancial items to be hedged; (2) reducing the requirements for ongoing effectiveness testing; (3) allowing the specified index rate in a variable-rate instrument to be the hedged risk, instead of requiring a benchmark rate to the hedged risk; and (4) eliminating requirements to separately compute and present hedge ineffectiveness for qualifying hedge relationships. An exposure draft of potential changes to the hedge accounting guidance is expected to be issued in late 2015 or early 2016. Readers should monitor the progress of this important project.

BACKGROUND

ASC 815, *Derivatives and Hedging* is the primary source of literature for hedge accounting. The original guidance, which was published in FAS-133, was heavily interpreted and modified by several additional FASB standards, numerous EITF consensuses, and over 40 DIG issues addressing various aspects of hedge accounting. The guidance for hedge accounting is extensive, in part because of the detailed requirements for an item or transaction to qualify for hedge accounting initially and on an ongoing basis. This chapter discusses the three types of hedging relationships that have specific methods of hedge accounting, the required criteria for hedge accounting, and reporting the results of hedge accounting in the financial statements.

Disclosures about derivatives and hedge accounting are discussed in Chapter 15, "Disclosures about Derivatives."

Description of Hedge Accounting

Hedge accounting is a special accounting practice that reflects certain situations when derivatives are used as part of a strategy in combination with other instruments. Rather than applying the applicable GAAP to each component of the strategy, hedge accounting permits, but does not require, the reporting entity to override GAAP for one or both components and allows the entity to recognize the gains or losses on the derivative in the same period as the income statement effect of the hedged item.

Because hedge accounting defers the recognition of gains and losses in earnings, numerous conditions must be met both upfront and over the life of the hedging relationship; these are referred to as hedge criteria. The criteria differ depending on the nature of the risk being hedged, but are cumbersome in any event. Despite the many criteria to qualify for hedge accounting and the complexity of actually determining the accounting entries in some instances, many entities elect to apply hedge accounting even though it is entirely optional—that is, even in a situation in which a company could qualify for hedge accounting, it may elect not to do so. Entities engaged in risk management strategies often desire hedge accounting, and therefore are willing to undertake the tasks necessary to achieve it, so that their reported net income reflects the effect of their derivative transactions in the same period as the item being hedged.

Different Types of Hedges

ASC 815 prescribes different methods of hedge accounting, depending on the type of risk being hedged. The FASB created three categories of hedging relationships. The categories share some common criteria, but each also has its own unique criteria and different mechanics for achieving matching in the income statement. The three categories are:

1. **Fair Value Hedges** Hedges of changes in price or fair value of an existing asset, liability, or a firm commitment that has a fixed price. For example, the fair value of a fixed-rate bond changes as the general level of interest rates changes. That risk can be hedged with a receive-variable, pay-fixed interest swap. Another example is a firm commitment to buy grain at a fixed price (so long as the contract is not a derivative because it qualifies for the normal purchase exception (ASC 815-20-25-7 through 25-9)), which becomes more or less valuable as the market price of grain rises and falls. That risk can be hedged with an option to sell grain. Fair value hedges essentially convert a fixed price item to a floating rate (then current price) item—the combined position now has cash flow risk (see below).
2. **Cash Flow Hedges** Hedges of variable cash flows from an existing asset or liability, or from a transaction expected to occur in the future whose price has not yet been set (known as a forecasted transaction). For example, a floating-rate debt could require increased cash flows if interest rates rise. That risk can be hedged with a receive-floating, pay-fixed interest rate swap. Another example is a projected sale of a commodity (so long as the contract is not a derivative because it qualifies for the normal sale exception (ASC 815-20-25-7 through 25-9)) whose terms have not yet been agreed upon, which could result in less cash if the market price of that commodity falls by the time a contract is struck. That risk can be hedged by selling a futures contract for settlement on approximately the same date as the commodity sale. Cash flow hedges essentially fix the cash flows for a transaction that previously had an uncertain amount of cash flow—the combined position now has price risk.
3. **Hedge of a Net Investment in a Foreign Operation** Hedges of the translation adjustment arising from remeasuring a company's net investment in the assets, liabilities, revenues, and expenses of a foreign subsidiary into the reporting currency of the investor under ASC 830. That risk can be hedged with a pay foreign currency, receive functional currency swap.

OBSERVATION: Fair value exposures and cash flow exposures are often mutually exclusive. By allowing hedges of both types of exposure, the FASB is permitting hedge accounting when one type of risk has been reduced in a transaction, even though hedging one risk creates (or increases) another.

Exhibit 14-1 summarizes how several common hedging transactions would be characterized under ASC 815.

EXHIBIT 14-1
CHARACTERIZATION OF HEDGING STRATEGIES UNDER ASC 815

Strategy	Hedge Type under ASC 815	Bottom-Line Effect on Income if Perfectly Effective
1. Swap interest rate from fixed to floating (same currency)	Fair value	Creates floating interest rate in interest income or expense
2. Swap interest rate from floating to fixed (same currency)	Cash flow	Creates fixed interest rate in interest income or expense
3. Lock in fixed interest rate on anticipated debt-offering with a futures contract	Cash flow	When debt is issued, creates desired fixed rate
4. Lock in price of raw materials with a forward purchase contract (no purchase order exists). Assume same currency.	Cash flow	Cost of goods sold will reflect the locked in price of materials (ignoring any complications of inventory accounting).
5. Lock in minimum selling price of finished goods with an option (no sale contract with a customer exists). Assume same currency.	Cash flow	Sales revenue will reflect a minimum selling price of inventory, less cost of option
6. Lock in US\$ equivalent of a purchase of machinery from a foreign supplier (currency amount per contract)	Cash flow or fair value hedge	No effect until machine is depreciated, using the locked-in US\$-equivalent cost as the basis
7. Monetizing a call option in a debt instrument (hedging an embedded option with an offsetting option)	Fair value	Creates effective interest rate for noncallable debt
8. Swap interest rate from fixed to floating and swap currency from foreign currency to functional currency (say US\$)	Fair value	Creates floating US\$ interest rate in interest income or expense
9. Swap interest rate from floating to fixed and swap currency from foreign currency to functional currency (say US\$)	Cash flow	Creates fixed US\$ interest rate in interest income or expense
10. Lock in US\$ equivalent of a forecasted sale of goods by a foreign subsidiary	Cash flow	Sales revenue will reflect the US\$ equivalent of today's selling price of inventory

The mechanics of hedge accounting vary for the three major categories of hedges. To provide context for this long and detailed chapter, Exhibit 14-2 provides an overview of the way hedge accounting works for the three categories. Then, each type of hedge is analyzed in detail, including the documentation requirements, the qualifications for hedging instruments and hedged items, and a detailed discussion of each type of hedge accounting.

EXHIBIT 14-2
SUMMARY OF DERIVATIVES AND HEDGE ACCOUNTING

	No Hedge Accounting	Qualifying Fair Value Hedges	Qualifying Cash Flow Hedges	Qualifying Hedges of Net Investment In Foreign Subsidiary
Derivative:				
Balance sheet	Fair value	Fair value	Fair value	Fair value
Treatment of gain or loss	Earnings	Earnings	First OCI to the extent effective, then earnings timed to match hedged item	CTA (part of other comprehensive income), to the extent effective
Treatment of hedged item:				
Treatment of loss or gain	Not applicable	Earnings	Earnings (follow GAAP for hedged item)	CTA (other comprehensive income)
Balance sheet	Not applicable	Adjust for changes in fair value of hedged risk(s)	Follow GAAP for hedged item	Translate into reporting currency under ASC 830
Bottom-line effect on income	Entire gain or loss on derivative	—Only ineffectiveness on derivative—		

Common Hedge Criteria

To qualify for hedge accounting, all hedges must meet all of the following threshold criteria:

- Derivatives used as hedges must be linked to a specific transaction that affects earnings and that relationship must be documented at inception.
- Throughout the term of the hedge, the entity must expect the hedging instrument to be highly effective in offsetting changes in the fair value or cash flow of the hedged item, using reasonable methods that are appropriate in the circumstances.
- Ineffectiveness from mismatches in terms and other factors must be recognized currently in earnings.

These key qualifying conditions are described below. Additional criteria that must be met for fair value hedges and cash flow hedges are discussed later in this chapter under those section headings.

Documentation of the Hedging Relationship

At the inception of every hedging transaction, the entity must document the following information (ASC 815-20-25-3):

- Which instrument is the hedging instrument and which specific item it is hedging. Generally, long and short positions may not be hedged on a net basis. For example, an entity may not hedge its net interest rate gap position or net income for a period. It must dig deeper and identify specific transactions to hedge.
- The nature of the risk being hedged (e.g., overall changes in fair value, interest rate risk, or foreign currency risk).
- The entity's risk management objective or strategy (e.g., to convert a floating-rate instrument to a fixed rate, or to hedge corn inventory from declines in the price of corn).
- The method the entity will use to assess and measure effectiveness (prospectively and retrospectively).
- The method the entity will use to measure hedge ineffectiveness.

PRACTICE POINTER: Documenting hedging relationships after the fact is not in accordance with GAAP and will disqualify a transaction for hedge accounting for the period prior to the designation.

REGULATORY ALERT: The SEC staff expects vigilant compliance with the documentation requirements of ASC 815, and the documentation should be contemporaneous with the designations of hedging relationships. For example, the SEC staff expects the documentation of the methods that will be used to measure ineffectiveness to be sufficiently detailed such that a third party could follow the documentation and compute the same amount. Refer to the Current Accounting and Disclosure portion of the SEC website for additional information. The SEC has required registrants to restate their financial statements for failure to comply with the documentation requirements of ASC 815. (December 7, 1999, speech by Pascal Desroches, then a Professional Accounting Fellow at the SEC.)

In addition, in the March 2005 update of Current Accounting and Disclosure Issues in the Division of Corporate Finance, the SEC staff reiterated that it will challenge the application of hedge accounting in situations where a registrant has not contemporaneously complied with ASC 815-20's documentation requirements upon designation of a hedge. The SEC staff stresses that, for hedges of forecasted transactions, the documentation must include the estimated date, nature, and hedged amount of the forecasted transaction. The methodology used to assess hedge effectiveness must be reasonable and must be documented at inception.

At the December 2006 National Conference on Current SEC and PCAOB Developments, the SEC staff again addressed hedge documentation. The SEC staff reiterated that if a company fails to document its approach for assessing hedge effectiveness, then the hedge documentation is insufficient and hedge accounting would be inappropriate. The SEC staff also cited a recent issue involving cash flow hedges where a group of individual transactions are part of one hedging relationship. In that case, the documentation must be sufficiently clear that the group of hedged items share the same risk exposure. If the transactions have different characteristics (e.g., a group of forecasted sales of

commodities that have different delivery locations) additional analysis may need to be done to support the assertion that the group of hedged items share the same risk exposure. If there are changes in the composition of the group of transactions, the company may be required to update this analysis periodically throughout the life of the relationship. (Speech by Joseph D. McGrath, then a Professional Accounting Fellow, Office of the Chief Accountant of the SEC, at the December 2006 National Conference on Current SEC and PCAOB Developments)

Hedging Instruments

All or a proportion of a contract that meets the definition of a derivative in ASC 815 and is accounted for separately may be designated as a hedging instrument if the transaction qualifies for hedge accounting. Thus, both freestanding derivatives and embedded derivatives that are bifurcated from their host contract are eligible hedging instruments. In addition, two or more derivatives may be considered in combination and be jointly designated as a hedging instrument. (ASC 815-20-25-45) Common hedging instruments are options, forwards, swaps, and similar instruments.

Cash instruments, such as debt instruments, equity securities, short sale facilities, and other contracts that do not meet the definition of a derivative, may not be designated as the hedging instrument, except for two specific types of foreign currency hedges involving unrecognized firm commitments and the net investment in a foreign operation. (ASC 815-20-25-71) This prohibition applies also to the hybrid instruments that are accounted for on a combined basis at fair value. (ASC 815-15-35-1 and 35-2) (Refer to Chapter 13, "Embedded Derivatives," for more information.)

To enhance readability, this chapter uses the term "derivative" instead of hedging instrument, except in narrow circumstances where other types of instruments may be designated as hedging instruments. Those circumstances are specifically noted later in this chapter in the section on "Foreign Currency Hedges."

Written options When a company writes an option, it takes on a potential obligation and gives the counterparty a potential right if the option goes in the money. The option writer's potential for gain is limited to the amount of premium received, but his potential for loss is much greater. Writing options is primarily a risk-taking activity and, as such, hedge accounting is allowed only in very narrow circumstances. A combination of a written option and a swap or forward contract (such as a swaption) should be considered a written option for purposes of applying the hedge accounting criteria. (ASC 815-20-25-88)

A written option may be designated as a hedging instrument of a recognized asset or liability or an unrecognized firm commitment only if the combination of instruments has at least as much potential for gains as exposure to loss (the symmetrical gain and loss test). For example, the following strategies could, on a combined basis, provide symmetrical opportunities for gain and loss, depending on the facts and circumstances:

- A written option that hedges a callable debt.
- A collar (that is considered a net written option) that hedges an equity security. (ASC 815-20-25-94)

However, a *covered call strategy* (i.e., a call option written against an asset held) would generally not meet the symmetrical gain and loss test, because the asset alone has upside and downside potential, but in the combined scenario, it only has downside potential.

The symmetrical gain and loss test should be applied only at the inception of the hedging relationship. (ASC 815-20-25-95) The time value of the written option may be excluded for the purpose of performing the symmetrical gain and loss test as long as that method is documented and consistent with the entity's risk management strategy. (ASC 815-20-25-96)

Collars A combination of options (e.g., a collar) in which the strike price and the notional amount of both the written option component and the purchased option component remain constant would be considered a net written option unless all of the following three conditions are met (ASC 815-20-25-89):

1. No net premium is received, either in cash or as a favorable term, either at inception or over the life of the contract.
2. Each option is based on the same underlying and has the same maturity date.
3. The notional amount of the written option component is no greater than the notional amount of the purchased option component.

If the combination of options does not meet all of those conditions, it is subject to the symmetrical gain and loss test in ASC 815-20-25-95 for fair value hedges and in ASC 815-20-25-95 for cash flow hedges. For example, under this guidance, a combination of options having different underlying indices, such as a collar containing a written floor based on three-month Treasury rates and a purchased cap based on three-month LIBOR, must be considered a net written option even though those rates may be highly correlated. (ASC 815-20-25-90)

If either the written option component or the purchased option component has a strike price or notional amount that could fluctuate over the life of the contract, these conditions must be applied on each date that either the strike prices or the notional amounts change. (ASC 815-20-25-91)

If a collar is made up of a purchased option and a written option that have different notional amounts (but the notional amount of the written option is less than that of the purchased option), the hedged item may be specified as two different proportions of the same asset referenced in the collar, based on the upper and lower price ranges specified in the put and call options. That is, the quantities of the asset designated as being hedged may be different based on those price ranges in which the collar goes in the money. (ASC 815-20-25-10)

AUTHOR'S NOTE: The Chicago Board Options Exchange has an excellent interactive education section on its website (www.cboe.com) that encourages scenario analysis with different strike prices, exercise dates, and other terms.

Limitations on intercompany derivatives Large organizations often centralize their hedging functions for a variety of reasons, including (a) one department (or subsidiary) has expertise in derivatives markets (including a subsidiary that might actually be a derivatives dealer) or (b) it is more efficient for the company to monitor its exposures globally and enter into as few derivative transactions as possible. To document this transfer of risk between entities, "internal" or intercompany derivatives are written between the central treasury department and the subsidiary seeking to hedge its exposure (and then the central treasury department would enter into an offsetting contract with a derivatives dealer). Internal derivatives do not qualify for hedge accounting in consolidation, except in narrow circumstances involving foreign currency hedges, and numerous criteria must be met. (The specific circumstances are discussed later in the "Foreign Currency Hedging" section of this chapter.) A parent company may enter into a derivative with a third party and designate it as a hedge of a subsidiary's risk in consolidation; however, in situations involving foreign currency hedges, certain additional conditions must be met. (ASC 815-20-25-23 through 25-32)

To qualify for hedge accounting in the *separate company* financial statements of a hedging subsidiary, the subsidiary must be a party to the derivative, whether it is with a related party (e.g., a sister subsidiary or the parent company) or with a third party. (ASC 815-20-25-46A)

Hedged Items

ASC 815-20 permits an entity to hedge specific assets, liabilities, contracts, and other transactions that affect (or will affect) earnings. An entity may hedge either (1) the entire change in fair value (or cash flow) arising from a hedged item or (2) changes in fair value or cash flow arising from some but not all of the risks inherent in a hedged item, subject to certain limitations. (ASC 815-20-25-11 and 25-13) If the entire change in fair value is not designated as being hedged, two or more risks (interest rate risk, foreign exchange risk, and credit risk) simultaneously may be designated as being hedged. (ASC 815-20-25-15) ASC 815 uses the phrase, "change in fair value (or cash flow) attributable to the risk being hedged" in situations where only some designated risks have been hedged, as permitted. For example, a foreign-currency denominated bond would bear all of the following types of risk:

- Credit risk
- Interest rate risk (including prepayment risk)
- Foreign currency risk.

An entity is permitted to hedge one or more of those risks, provided that the derivative (or combination of derivatives) would be highly effective in offsetting

changes from those designated risks. Perhaps the most common example of this practice is swapping the interest rate on a debt instrument. In such cases, only interest rate risk is being hedged. The swap offers no protection against changes in credit risk, so changes in credit quality do not affect hedge accounting (except when default becomes possible). ASC 815-20 imposes certain limits on what qualifies as a discretely hedgeable risk—the limits on interest rate risk are discussed below. Other limitations are discussed in the fair value and cash flow hedge accounting sections.

PRACTICE POINTER: This “bifurcation by risk” approach applies only to hedged items. A derivative (hedging instrument) may not be separated by risk, even if it is a compound derivative that has been bifurcated from a hybrid instrument. Designations of selected risks and the methods of assessing effectiveness must be meticulously documented, to avoid second-guessing by auditors and regulators.

OBSERVATION: Although the bifurcation-by-risk approach seems unnecessarily complex at first glance, it was actually a concession by the FASB so that gains and losses from unhedged risks (such as credit) do not flow through earnings and make the intended hedge seem ineffective.

Hedges of interest rate risk The definition of interest rate risk in ASC 815-20 is critically important for hedgers to understand. If an entity seeks to hedge the interest rate risk of a hedged item, it must identify a *benchmark interest rate* inherent in (or explicitly stated in) that instrument. A benchmark interest rate is a widely quoted rate in an active market that is indicative of the overall level of interest rates attributable to high-credit-quality obligors in that market. Benchmark rates will be determined on a market-by-market basis. In the United States, Treasury rates, the LIBOR swap rate, and the Fed Funds Effective Swap Rate (also called the Overnight Index Swap or OIS Rate) are the only acceptable benchmark rates. Any spread above the benchmark rate is considered a component of credit risk, not interest rate risk. (ASC 815-20-25-6A)

PRACTICE POINTER: The narrow definition of benchmark interest rates significantly limits which hedging transactions will result in the desired level of offset in the income statement. Later in this chapter, “shortcut methods” of assessing the effectiveness of interest rate swaps in hedges of interest rate risk are described that mitigate those concerns for a narrow subset of transactions. Entities must understand that variable rates that are not linked to a benchmark rate can disqualify a transaction from the shortcut methods and cause ineffectiveness to be recognized in earnings. That issue is highlighted again in the relevant sections. The Author’s Note earlier in this chapter notes that the FASB is considering changing this requirement to allow the index rate in a variable-rate instrument to be the hedged risk.

Disqualified Hedged Items

The following items may not be designated as the hedged item in a fair value hedge or a cash flow hedge:

- An investment accounted for by the equity method in accordance with ASC 323-10 *Investments/Equity Method and Joint Ventures/Overall*.
- A noncontrolling interest in a consolidated subsidiary.
- An equity investment in a consolidated subsidiary.
- A firm commitment or plan either to enter into a business combination (or a combination of not-for-profit entities) or to acquire or dispose of a subsidiary, a noncontrolling interest, or an equity method investment.
- An equity instrument issued by the entity and classified in stockholders’ equity in the statement of financial position. (ASC 815-20-25-43(c)(6) and ASC 815-20-25-15(h)(2))
- An existing or forecasted asset or liability that is (or will be) remeasured with the changes in fair value attributable to the hedged risk reported currently in earnings. (ASC 815-20-25-43(c)(3) and 815-20-25-15(d)) Re-measuring a foreign-currency-denominated asset or liability using the spot rate in accordance with ASC 830 does not meet this condition. (ASC 815-20-25-29)

Other prohibitions that apply to fair value hedges or cash flow hedges are discussed later in this chapter in the applicable section; however, the prohibitions mentioned above apply across the board. Exhibit 14-3 summarizes some common economic hedging strategies that do not qualify for hedge accounting under ASC 815-20 (the reasons disqualifying some of these transactions are discussed in later sections).

OBSERVATION: A prohibition against hedge accounting simply means that the entity may not defer gains and losses on the derivative. It does not mean that entities cannot engage in economic hedging strategies.

EXHIBIT 14-3 TRANSACTIONS THAT DO NOT QUALIFY FOR HEDGE ACCOUNTING

Strategy	Reason Does Not Qualify	Treatment of Derivative
1. Hedging net income (e.g., for foreign currency exposure)	Derivative must be linked to specific transaction	Mark to fair value through earnings
2. Hedge of EPS (intended to hedge the number of shares or potential shares in the denominator)	Not a transaction that affects earnings (also, no antidilution in EPS)	Mark to fair value through earnings*
3. Use interest rate swap to open or close a gap identified by asset/liability management techniques	Derivative must be linked to specific transaction	Mark to fair value through earnings

CHAPTER 17

OFFSETTING ASSETS AND LIABILITIES IN THE BALANCE SHEET

CONTENTS

Overview	17,001
Background	17,001
Accounting Guidance	17,003
Disclosures	17,013
Audit Considerations	17,017
International Financial Reporting Standards (IFRS)	17,017
Illustrations	17,018

OVERVIEW

Generally, assets and liabilities should only be offset (netted against each other) in the balance sheet when a right of setoff exists and the entity intends to exercise that right. Exceptions to the general rule exist for certain types of financial instruments, including derivatives and repurchase agreements, and certain industry practices. Offsetting relates only to the display of recognized assets and liabilities in the financial statements. It differs from derecognition (removal) in that no gain or loss is recognized and the assets and liabilities that are offset both still "exist" for accounting purposes.

BACKGROUND

ASC 210-20-45, *Balance Sheet/Offsetting/Other Presentation Matters* provides guidance related to offsetting of assets and liabilities in the financial statements. It establishes the general principle that assets and liabilities should not be offset unless a legal right of setoff exists that the entity intends to exercise. Two exceptions to that principle allow for netting of derivatives that are subject to a master netting agreement between two parties and for receivables and payables arising from repurchase agreements and reverse repurchase agreements that meet several conditions.

Display versus Derecognition

When a recognized asset and recognized liability are offset against each other, they are presented in the financial statements as a single net asset or liability (depending on which item is greater). Although the net effect on the balance sheet may be similar, offsetting is different from derecognizing an asset and extinguishing a liability in the following respects:

- No gain or loss is recognized.
- Unlike a transfer of assets where the entity surrenders control (a sale), the reporting entity continues to control the asset it owns.

- Unlike an extinguishment of debt, where the debtor is legally released, the debtor remains obligated to repay the debt.

Offsetting is simply a method of displaying outstanding claims to cash and debts that the entity *intends* to offset. Offsetting is an accounting *election* when certain conditions are met, rather than an accounting requirement.

Motivation for Netting

Entering into contracts with the legal right of setoff helps companies manage their credit risk and settlement risk with counterparties. Offsetting assets and liabilities subject to such a right may be considered to better reflect the true risks to which the company is exposed.

From a financial reporting perspective, netting in the balance sheet affects footings of total assets and liabilities (and subtotals, such as current assets and current liabilities) and related financial ratios. Depending on the specific assets and liabilities involved, offsetting could affect the following key ratios (among others):

- Current ratio
- Return on assets
- Leverage ratio
- Debt to equity.

For example, assume a company had the following current assets and liabilities at a reporting period, including both a receivable from Company A and a payable to Company A for which it had the right of setoff. Note the differences in total current assets and liabilities and certain financial ratios that arise from netting the two amounts in the balance sheet.

	Receivable and Payable Reported Separately		Net
Current Assets:			
Cash	\$150		\$150
Receivable from Company A	250		150
Other current assets	400		400
	<u>\$800</u>		<u>\$700</u>
Current liabilities:			
Payable to Company A	\$100		—
Other current liabilities	300		300
	<u>\$400</u>		<u>300</u>
Net income	\$15		\$15
Working capital	400 (800 – 400)		400 (700 – 300)
Current ratio	2.0:1 (800 ÷ 400)		2.33:1 (700 ÷ 300)
Return on assets ratio	.019 (15 ÷ 800)		.021 (15 ÷ 700)

Although working capital is not affected by the change in presentation, the company's current ratio and return on assets ratio improve when the receivable

and payable to Company A are netted. Therefore, offsetting of current assets and current liabilities can affect a company's perceived liquidity and profitability.

From a business standpoint, entities in capital-intensive industries often must hold capital against recognized asset balances, according to prescribed formulas. Accordingly, netting assets and liabilities helps companies reduce their capital requirements (as permitted by applicable regulation).

PRACTICE POINTER: Regulatory accounting principles for financial institutions and statutory accounting principles for insurance companies generally follow GAAP with respect to offsetting in the balance sheet.

ACCOUNTING GUIDANCE

General Principle

Recognized assets and liabilities should only be offset against each other in the balance sheet if a legal right of setoff exists that the entity intends to exercise. (ASC 210-20-05-01) A debtor having a valid right of setoff may, but is not required to, offset the related asset and liability and report the net amount. (ASC 210-20-45-2)

Demonstrating the Right of Setoff

A right of setoff is a debtor's legal right to satisfy all or a portion of a debt owed to another party with funds owed to the debtor by that same party. ASC 210-20-45-1 identifies four conditions that must all be met for the right of setoff to exist:

- Each of two parties owes the other determinable amounts.
- The reporting entity has the right to set off the amount payable with the amount receivable from the other party.
- The reporting entity intends to set off.
- The right of setoff is enforceable at law.

Note that even though the right of setoff is a "legal" term, for accounting purposes, the right of setoff does not exist unless the reporting entity intends to set off the two amounts. Two exceptions to the intent condition are discussed later in this chapter.

Two parties owe each other determinable amounts In order for a valid right of setoff to exist, the two parties must each owe each other determinable amounts. Thus, an entity may not offset receivables and payables with different counterparties, even if a mechanism is in place to facilitate their net settlement. In addition, contingent or estimated amounts may not be offset, as they are not "determinable."

For purposes of the offsetting analysis, cash on deposit at a financial institution is considered by the depositor as *cash* rather than a receivable from the financial institution. (ASC 220-20-55-18A) Accordingly, cash collateral placed with a bank may not be offset against a loan from that same bank. However, financial institutions that accept deposits may have balances due to and from the same depository institution (referred to as reciprocal balances). Reciprocal balances should be offset if they will be offset in the process of payment or collection. (ASC 942-305-45-1)

PRACTICE POINTER: The offsetting guidance for reciprocal balances applies only to financial institutions and should not be applied by analogy in other situations. (SOP 01-6, par. A.47) [Author's Note: Content not codified but restriction remains applicable.]

The amounts owed between the parties need not be in the same currency or bear the same interest rate if the other criteria are met. (ASC 210-20-45-3)

The reporting entity intends to net settle In addition to having a legal right to settle balances net, the reporting entity must intend to set off the asset and liability in question. This condition is necessary to faithfully represent the entity's expected sources and uses of cash. (ASC 210-20-45-4) An entity can demonstrate its intent to net settle by documenting its intent and, if applicable, by a history of execution of setoff in similar situations. (ASC 210-20-45-5)

An arrangement that provides for the legal right of offset only in the event of the default of one of the parties to the contract does not meet the accounting definition of the right of setoff because the parties do not intend to net settle the contract in the normal course of business.

If the maturities of the receivable and payable differ, only the party with the nearer maturity may present the receivable and payable net in the balance sheet, because the party with the longer term maturity must settle in the manner that the other party selects at the earlier maturity date. (ASC 210-20-45-3)

If a receivable or payable does not have an explicit settlement date, the entity cannot assert that it intends to net settle the transaction. (ASC 940-405-55-1, *Financial Services—Broker and Dealers/Liabilities/Implementation Guidance and Illustrations*)

The right of setoff is enforceable at law Laws and regulations may impose restrictions or prohibitions against the right of setoff in certain circumstances, which may contradict the rights otherwise provided by contract or as a matter of common law. Therefore, it is important that legal constraints be

considered to determine whether the right of setoff is enforceable. (ASC 210-20-45-8)

OBSERVATION: Various trade organizations, such as the Securities Industry and Financial Markets Association and the International Swaps and Derivatives Association have sought to establish standard netting agreements that would be upheld in jurisdictions around the world to reduce this legal risk.

"Enforceable at law" encompasses the notion that the right of setoff should be upheld in bankruptcy. The nature of support required for an assertion in financial statements that a right of setoff is enforceable at law is subject to a cost-benefit constraint and depends on the facts and circumstances. All of the information that is available, either supporting or questioning enforceability, should be considered. Offsetting is appropriate only if the available evidence, both positive and negative, indicates that there is reasonable assurance that the right of setoff would be upheld in bankruptcy. (ASC 210-20-45-9)

PRACTICE POINTER: A right of setoff can be *enforceable at law* even if it is not specifically included in the contractual agreements if regulatory procedures or normal business practices would offset the contracts. (FIN-39 basis for conclusions, par. 47)

Exceptions to the General Rule

Offsetting Derivative Assets and Liabilities

Generally, the fair value of a derivative asset (including any amounts recognized as accrued receivables) should not be offset against the fair value of a derivative liability (including any amounts recognized as accrued payables) unless all four of the criteria for offsetting are met. (ASC 815-10-45-4)

However, when derivatives are entered into with the same counterparty under a *master netting agreement*, even if the reporting entity does *not* have the intent to net settle, the reporting entity may offset the fair value amounts recognized for derivative instruments and the fair value amounts (or approximate fair value amount) recognized for the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable). Any accrual component related to periodic receivables and payables recognized as part of the contract's fair value may also be offset for contracts executed with the same counterparty under a master netting agreement. (ASC 815-10-45-5)

PRACTICE POINTER: The balance sheet asset or liability associated with cash collateral is recognized under ASC 860-30-25-3 as a separate receivable for return of cash collateral posted or a separate payable for an obligation to return cash collateral received.

PRACTICE POINTER: The guidance related to the use of approximate fair values is specific to this situation and may not be applied by analogy in other situations. (ASC 815-10-45-5)

Under a master netting arrangement, individual contracts are effectively consolidated into a single agreement between the two counterparties. Cross-product master netting arrangements consolidate a variety of types of derivative products with a single counterparty. If one party fails to make a payment under a master netting arrangement, the other party is entitled to terminate the entire arrangement and demand the net settlement of all contracts. (FIN-39 basis for conclusions, pars. 21 and 30)

PRACTICE POINTER: When derivatives are entered into subject to a master netting agreement, they do not automatically qualify for netting. The legal enforceability of the contract must be evaluated.

This guidance is applicable to contracts that meet the definition of a derivative in ASC 815, *Derivatives and Hedging* and that are measured at fair value, regardless of whether they qualify for a scope exception to ASC 815. However, if a master netting arrangement covers multiple instruments, some of which do not meet the definition of a derivative in ASC 815 or are not recognized at fair value, a reporting entity is still permitted to offset fair value amounts related to other derivative instruments under that master netting agreement that do qualify for offsetting. In that case, the reporting entity must develop a supportable methodology for determining the amount of cash collateral receivable or payable that can be offset against the net derivative position. (FSP FIN-39-1 basis for conclusions, pars. A7-A8)

A reporting entity must make an accounting policy decision as to whether to offset fair value amounts recognized for derivatives and fair value amounts (or approximate fair value amounts) recognized for cash collateral receivables and payables executed with the same counterparty under a master netting agreement and must apply that choice consistently. If elected, the reporting entity may offset fair value amounts related to derivative instruments only if those amounts are offset against the fair value amounts (or approximate fair value amounts) related to cash collateral. However, if the amount recognized for the right to reclaim cash collateral or the obligation to return cash collateral is deemed not to be a fair value amount (or an amount that approximates fair value), the reporting entity may offset fair value amounts related to the derivative instruments only. (ASC 815-10-45-6)

OBSERVATION: If elected as an accounting policy, net presentation of fair value amounts recognized for receivables or payables related to cash collateral and fair value amounts recognized for related derivative contracts executed with the same counterparty under a master netting arrangement is *required* (subject

to the exception above), because it is a true representation of the amount of credit risk exposure under the entire arrangement.

Although this is technically an accounting election, most financial institutions consistently elect to offset their derivative contracts with the same counterparty in the balance sheet.

Offsetting Receivables and Payables from Repurchase Agreements

In a repurchase agreement (repo), one party sells securities to another party with an agreement to repurchase them at a stated price plus interest at a specified date. A repurchase agreement accounted for as a collateralized borrowing is a repo that does not qualify for sale accounting under ASC 860, *Transfers and Servicing*. The payable under a repurchase agreement accounted for as a collateralized borrowing refers to the amount of the seller's obligation recognized for the future repurchase of the securities from the buyer. (ASC 210-20-20, glossary term, "Repurchase Agreement Accounted for as a Collateralized Borrowing")

A reverse repurchase agreement accounted for as a collateralized borrowing (also known as a reverse repo) refers to a transaction that is accounted for as a collateralized lending in which one party buys securities from another party with an agreement to resell them at a stated price plus interest at a specified date. The receivable under a reverse repurchase agreement accounted for as a collateralized borrowing refers to the amount due from the seller for the repurchase of the securities from the buyer. (ASC 210-20-20, glossary term, "Reverse Repurchase Agreement Accounted for as a Collateralized Borrowing")

The guidance on offsetting only applies to repurchase agreements and reverse repurchase agreements that have been accounted for as collateralized borrowings under ASC 860. Most, but not all, repurchase agreements are accounted for as collateralized borrowings. The accounting for repos and reverse repos is addressed in Chapter 9, "Repurchase Agreements, Securities Lending Arrangements and Other Pledges of Collateral."

PRACTICE POINTER: Investment companies (e.g., mutual funds) use the same terminology to refer to the opposite transactions.

PRACTICE POINTER: Even though certain aspects of repurchase agreement transactions are similar to securities lending transactions, ASC 210-20-45 *only* applies to repurchase agreements and may not be applied by analogy to other transactions that might be similar economically. (ASC 940-405-55-1)

Banks, broker dealers, and other financial institutions often operate as both borrowers and lenders in the repo market on the same day. ASC 210-20-45-11 and 45-12 and ASC 210-20-45-14 through 45-17, provide that amounts recognized as payables under repurchase agreements accounted for as collateralized borrowings may be offset against amounts recognized as receivables under reverse