

Staff preliminary views on IASB ED/2011/1 *Offsetting Financial Assets and Financial Liabilities*

1. Principles for offsetting criteria

1.1 A key difference between IFRSs and US GAAP pertaining to financial instruments is the presentation of financial assets and financial liabilities on the face of the balance sheet. IAS 32 *Financial Instruments: Presentation* generally prescribes stricter conditions to qualify for offsetting between financial assets and financial liabilities than US GAAP. For example, as opposed to US GAAP, IAS 32 prohibits financial instruments under a master netting arrangement to offset each other on balance sheet unless the conditions in paragraph 42 of IAS 32 are met. The table below compares the offsetting criteria of ED/2011/1, IAS 32 and US GAAP.

ED/2011/1	IAS 32	US GAAP
Offsetting is required on the face of the balance sheet when there is: (a) unconditional and legally enforceable right to set off the financial asset and financial liability; and (b) intention either to settle the financial asset and financial liability on a net basis, or to realise the financial asset and settle the financial liability simultaneously. (paragraph 6)	Offsetting is required on the face of the balance sheet when there is: (a) current legally enforceable right to set off the recognised amounts; and (b) intention either to settle on a net basis, or to realise the asset and settle the liability simultaneously. (paragraph 42)	An entity may elect to offset fair value amounts for certain assets and liabilities subject to master netting agreements even in the absence of an intention to settle net. Entities are not required to offset financial assets and financial liabilities in the statement of financial position even if the criteria for offset are met.

1.2 ED/2011/1 is expected to result in more financial assets and financial liabilities to be presented on a gross basis on the face of the balance sheet than under current US GAAP.

Unconditional and Legally Enforceable Right to Set Off

1.3 While the proposed offsetting criteria in ED/2011/1 is not expected to change the outcomes under IAS 32, staff note that ED/2011/1 clarifies that the right to offset must also be ‘unconditional’. Paragraphs C5 and C6 of ED/2011/1 further clarify that aside from a contract, a right of set off may also arise as a result of a provision in law (or a regulation). For example, the bankruptcy and insolvency laws of a jurisdiction may impose restrictions on, or prohibitions against, the right of set off in bankruptcy, insolvency or similar events. Accordingly, even if an entity has a legal right to set off under its contract, the bankruptcy regime that governs the insolvency of the counterparties need to be considered to determine whether the legal right to set off is ‘unconditional’ and enforceable in all circumstances.

1.4 Staff note the application of ‘unconditional’ in ED/2011/1 in comparison to other Standards, for example, paragraph 69(d) of IAS 1 *Presentation of Financial Statements*, which states that “an entity shall classify a liability as current when... it does not have

an ‘unconditional’ right to defer settlement of the liability for at least twelve months after the reporting period...”. In particular, staff are aware that in practice the ‘unconditional’ criterion in paragraph 69(d) of IAS 1 is applied in a going concern context. The IASB’s proposed clarification of the meaning of unconditional, which includes assessing conditionality in the context of bankruptcy or insolvency calls into question how that term should be interpreted in other IFRSs. Staff consider that if the ‘unconditional’ requirement were applied in the proposed context under IAS 1, all liabilities would most likely be classified as ‘current’.

- 1.5 Staff also consider that if the proposed requirement for a right to set off to be unconditional and legally enforceable in all circumstances, including at times of bankruptcy or insolvency, is included in IFRS 9 *Financial Instruments*, this notion should be incorporated in the principles of the Standard and not in the guidance.
- 1.6 In addition, paragraph C15 of ED/2011/1 includes guidance that if a right to set off is conditional to the occurrence of a contingent event, that right should be reassessed for offsetting when the contingent event has occurred. This guidance clarifies that conditional right can become unconditional after a specified contingent event occurs.
- 1.7 Staff consider that the requirement for reassessment of the right of set off when conditions have changed should be incorporated in the principles of the Standard and not in the guidance.

Intention to Settle on a Net Basis or Simultaneously

- 1.8 Consistent with IAS 32, ED/2011/1 proposes that net presentation on the face of the balance sheet requires the intention for settlement on a net basis or simultaneously. Staff note the contrast in the IASB’s use of ‘intention’ between ED/2011/1, and IFRS 9 and other ongoing financial instruments projects. Staff note that the IASB has been moving away from the notion of intent when determining the classification of financial assets in IFRS 9 and when applying the proposed hedge accounting or impairment objectives. Instead, the IASB has been incorporating criteria based on an entity’s business model or strategy. Staff consider the IASB could usefully apply a similar criterion, that is, the way in which an entity manages its financial assets and financial liabilities, for the purposes of offsetting rather than relying on an assessment of an entity’s intention.

Questions for the Board:

- (1) Does the Board share the staff concern (paragraph 1.4) about the proposed clarification of the notion of ‘unconditional and legally enforceable at all times’?**
- (2) Does the Board agree with staff views (paragraphs 1.5 and 1.7) regarding incorporating some guidance to the principles of the Standard?**
- (3) Does the Board agree with staff views (paragraph 1.8) about the notion of ‘intent’ and the preferred use of a criterion based on an entity’s business model?**

2. Collateral obtained or pledged

- 2.1 ED/2011/1 prohibits offsetting assets pledged as collateral or the obligation to return collateral obtained, and the associated financial assets and financial liabilities (paragraph 9). Paragraph C14 of ED/2011/1 notes that margin accounts related to derivative contracts are considered a form of collateral.

- 2.2 While staff agree that margin accounts could be described as a form of collateral, it is not clear why the IASB made the conclusion in paragraph C14. Staff consider that margin accounts are a form of collateral because the accessibility of the margin account by a clearing house or a bank is contingent on margin calls, hence presenting a conditional right. However, staff note that paragraphs BC62 and BC63 only address the reasoning for why collateral assets and liabilities are prohibited, but not why margin accounts are considered collateral. Staff recommend the IASB provide some reasoning that explains the relationship between margin accounts and collateral and accordingly, why their offset against the relevant financial assets is prohibited.

Question for the Board:

- (4) Does the Board agree with staff views (paragraph 2.2) about providing more basis for the relationship between margin accounts and collateral?**

3. Multi-lateral set off arrangements

- 3.1 IAS 32 notes that an arrangement involving two or more parties, that is, a multi-lateral arrangement, may be eligible for offset as long as the offsetting conditions are met, however such a circumstance is unusual. ED/2011/1 proposes that multi-lateral arrangements continue to be eligible for offsetting.
- 3.2 Staff support the IASB's conclusions that, although multi-lateral offsetting is likely to be unusual, there is no basis for explicitly excluding multi-lateral set off arrangements from the scope of offsetting if all the criteria proposed in paragraph 6 of ED/2011/1 are met.

Question for the Board:

- (5) Does the Board agree with staff views (paragraph 3.2) regarding multi-lateral set off arrangements?**

4. Disclosures

- 4.1 ED/2011/1 proposes to separately disclose the amounts of financial assets and financial liabilities that the entity has an unconditional right and legally enforceable right to set off but that the entity does not intend to settle net or simultaneously [paragraph 12(c)]. ED/2011/1 also proposes to separately disclose the amount and a description of each type of conditional right of set off, including the nature of those rights and how management determines each type of conditional right (paragraphs 12(d) and 13).
- 4.2 In addition, ED/2011/1 proposes to separately disclose the amount of cash collateral and the fair value of other financial instruments that were obtained or pledged in respect of the entity's financial assets and financial liabilities [paragraph 12(f)].
- 4.3 Overall, staff are supportive of the proposal to provide gross to net reconciliations by class of financial instruments [paragraphs 12(a) and 12(b)] as staff consider disaggregation of information, especially those that make up the net amounts of rights and obligations, to be useful to some groups of users. However, staff consider the proposed information in paragraphs 12(c), 12(d) and 13 to be unnecessary when they do not already meet the offsetting criteria. Staff note the IASB's conclusion in paragraph BC72, that users unanimously support robust disclosures regardless of the offsetting criteria, but consider that the cost burden in making disclosures about each

conditional right of set off (including the nature of those rights and how management determines each type of conditional right) might overwhelm user benefits.

- 4.4 Staff agree with paragraph BC77 of ED/2011/1 regarding the user benefit in disclosing the value of collateral pledged or obtained as such information aids in the understanding of an entity's net exposure. However, staff note that IFRS 7 already requires detailed disclosures of collateral information in paragraphs 14, 15, 36(a), 36(b) and 38, and ED/2011/1 does not propose an amendment or any cross-reference to existing IFRS 7. If the proposed disclosure requirements on collateral information proceed, staff recommend that the IASB review and if necessary rationalise the disclosure paragraphs relating to collateral information in IFRS 7.

Questions for the Board:

- (6) **Does the Board agree with staff views (in paragraph 4.3) regarding the cost burden versus user benefits in making the proposed disclosures in paragraphs 12(c), 12(d) and 13 of ED/2011/1?**
- (7) **Does the Board agree with staff views (in paragraph 4.4) regarding the need for the IASB to review and rationalise its existing disclosure paragraphs in IFRS 7 relating to collateral information?**