International Financial Reporting Standard

Offsetting Financial Assets and Financial Liabilities

December 2011

BASIS FOR CONCLUSIONS – AMENDMENTS

[IAS 32]

[Related to AASB 2012-3]

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Amendments to the Basis for Conclusions on IAS 32 *Financial Instruments: Presentation*

After paragraph BC74, headings and paragraphs BC75–BC120 are added.

Amendments to the application guidance for offsetting financial assets and financial liabilities

Background

BC75 Following requests from users of financial statements and recommendations from the Financial Stability Board, in June 2010 the IASB and the US national standard-setter, the Financial Accounting Standards Board (FASB), added a project to their respective agendas to improve, and potentially achieve convergence of, the requirements for offsetting financial assets and financial liabilities. The boards made this decision because the differences in their requirements for offsetting financial assets and financial liabilities cause significant differences between amounts presented in statements of financial position prepared in accordance with IFRSs and amounts presented in statements of financial position prepared in accordance with US GAAP. This is particularly so for entities that have large amounts of derivative activities.

BC76 Consequently, in January 2011 the Board published the exposure draft *Offsetting Financial Assets and Financial Liabilities*. The proposals in the exposure draft would have established a common approach with the FASB. The exposure draft also proposed disclosures about financial assets and financial liabilities that are subject to set-off rights and related arrangements (such as collateral agreements), and the effect of those rights and arrangements on an entity's financial position.

BC77 As a result of the feedback received on the exposure draft, the IASB and the FASB decided to maintain their current offsetting models. However, the boards noted that requiring common disclosures of gross and net information would be helpful for users of financial statements. Accordingly, the boards agreed on common disclosure requirements by amending and finalising the disclosures that were initially proposed in the exposure draft. The amendments *Disclosures—Offsetting Financial Assets and Financial Liabilities* (Amendments to IFRS 7) were issued in December 2011.

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BC78 In addition, the IASB decided to add application guidance to IAS 32 to address inconsistencies identified in applying some of the offsetting criteria. This included clarifying the meaning of 'currently has a legally enforceable right of set-off' and that some gross settlement systems may be considered equivalent to net settlement.

Requirements for offsetting financial assets and financial liabilities

Criterion that an entity 'currently has a legally enforceable right to set off the recognised amounts' (paragraph 42(a))

BC79 To meet the criterion in paragraph 42(a) of IAS 32, an entity must currently have a legally enforceable right to set off the recognised amounts. However, IAS 32 did not previously provide guidance on what was meant by 'currently has a legally enforceable right to set off'. Feedback from the exposure draft revealed inconsistencies in the application of this criterion by IFRS preparers. Consequently, the Board decided to include application guidance in IAS 32 (paragraphs AG38A–AG38D) to clarify the meaning of this criterion.

BC80 The Board believes that the net amounts of financial assets and financial liabilities presented in the statement of financial position should represent an entity's exposure in the normal course of business and its exposure if one of the parties will not or cannot perform under the terms of the contract. The Board therefore clarified in paragraph AG38B that to meet the criterion in paragraph 42(a) of IAS 32 a right of set-off is required to be legally enforceable in the normal course of business, the event of default and the event of insolvency or bankruptcy of the entity and all of the counterparties. The right must exist for all counterparties so that if an event occurs for one of the counterparties, including the entity, the other counterparty or parties will be able to enforce the right of set-off against the party that has defaulted or gone insolvent or bankrupt.

BC81 If a right of set-off cannot be enforced in the event of default and in the event of insolvency or bankruptcy, then offsetting would not reflect the economic substance of the entity's rights and obligations and would therefore not meet the objective of offsetting in paragraph 43 of IAS 32. The Board uses the term 'in the event of default and in the event of insolvency or bankruptcy' to describe scenarios where an entity will not or cannot perform under the contract.

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BC82 The use of the word 'currently' in paragraph 42(a) of IAS 32 means that the right of set-off cannot be contingent on a future event. If a right of set-off were contingent or conditional on a future event an entity would not currently have a (legally enforceable) right of set-off. The right of set-off would not exist until the contingency occurred, if at all.

BC83 In addition, the Board believes that the passage of time or uncertainties in amounts to be paid do not preclude an entity from currently having a (legally enforceable) right of set-off. The fact that the payments subject to a right of set-off will only arise at a future date is not in itself a condition or a form of contingency that prevents offsetting in accordance with paragraph 42(a) of IAS 32.

BC84 However, if the right of set-off is not exercisable during a period when amounts are due and payable, then the entity does not meet the offsetting criterion as it has no right to set off those payments. Similarly, a right of set-off that could disappear or that would no longer be enforceable after a future event that could take place in the normal course of business or in the event of default, or in the event of insolvency or bankruptcy, such as a ratings downgrade, would not meet the currently (legally enforceable) criterion in paragraph 42(a) of IAS 32.

BC85 The application of the word 'currently' in paragraph 42(a) of IAS 32 was not a source of inconsistency in practice but rather a question that arose as a result of the wording in the exposure draft. Consequently, the Board decided that further application guidance was only required for the legal enforceability part of the criterion.

BC86 In developing the proposals in the exposure draft, the Board concluded that the net amount represents the entity's right or obligation if (a) the entity has the ability to insist on net settlement or to enforce net settlement in all situations (ie the exercise of that right is not contingent on a future event), (b) that ability is assured, and (c) the entity intends to receive or pay a single net amount, or to realise the asset and settle the liability simultaneously.

BC87 Some respondents were concerned that the terms 'in all situations' and 'the ability is assured' as referred to in paragraph BC86 create a higher hurdle than IAS 32 today. The Board however believes that the conclusions in the exposure draft are consistent with the offsetting criteria and principle in IAS 32, specifically paragraphs 42, 43, 46 and 47. In addition, the application guidance in paragraph AG38B of IAS 32 addresses respondents' concerns by clarifying the circumstances in which

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an entity should be able to net (ie what 'in all situations' means), and by requiring legal enforceability in such circumstances, a term commonly used in applying IAS 32 today.

Applicability to all counterparties

BC88 The proposals in the exposure draft required that the right of set-off be legally enforceable in the event of default and in the event of insolvency or bankruptcy of 'one of the counterparties' (including the entity itself). There were differing views as to whether the requirement that the right of set-off must be enforceable in the event of the entity's default and/or insolvency or bankruptcy changed the criteria in IAS 32 today.

BC89 Some respondents disagreed that the right of set-off must be enforceable in the events of default and insolvency or bankruptcy of the entity. Although consideration is given to enforceability today to achieve offsetting in accordance with IAS 32, some have only focused on the effects of the insolvency or bankruptcy of the counterparty. These respondents questioned whether legal opinions as to enforceability in the event of their own insolvency or bankruptcy could be obtained and considered this to be a change in practice from IAS 32 that could increase costs and the burden for preparers. They also believed that such a requirement would be inconsistent with the going concern basis of preparation for financial statements.

BC90 Other respondents, however, agreed that, to represent the entity's net exposure at all times, the right of set-off must be enforceable in the insolvency or bankruptcy of all of the counterparties to the contract.

BC91 The Board believes that limiting the enforcement of the right of set-off to the event of default and the event of insolvency or bankruptcy of the counterparty (and not the entity itself) is not consistent with the principle and objective of offsetting in IAS 32.

BC92 If a right of set-off cannot also be enforced in the event of default and in the event of insolvency or bankruptcy of the entity, then offsetting would not reflect the economic substance of the entity's rights and obligations or the financial position of the entity (ie offsetting would not reflect an entity's expected future cash flows from settling two or more separate financial instruments in accordance with paragraph 43 of IAS 32) and would therefore not meet the objective of offsetting in IAS 32.

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BC93 Consequently, the Board decided to clarify that, to meet the offsetting criterion in paragraph 42(a) of IAS 32, a right of set-off must be enforceable in the event of default and in the event of insolvency or bankruptcy of both the entity and its counterparties (paragraphs AG38A and AG38B of IAS 32).

Criterion that an entity 'intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously' (paragraph 42(b))

BC94 In the exposure draft the boards noted that offsetting financial assets and financial liabilities is appropriate and reflects the financial position of an entity only if the entity has, in effect, a right to, or an obligation for, only the net amount (ie the entity has, in effect, a single net financial asset or net financial liability). The amount resulting from offsetting must also reflect the entity's expected future cash flows from settling two or more separate financial instruments. This is consistent with the principle in paragraph 43 of IAS 32.

BC95 When developing that principle the boards understood that entities may currently have a legally enforceable right and desire to settle net, but may not have the operational capabilities to effect net settlement. The gross positions would be settled at the same moment such that the outcome would not be distinguishable from net settlement. As a result the boards included simultaneous settlement as a practical exception to net settlement. Simultaneous settlement was intended to capture payments that are essentially equivalent to actual net settlement. The proposals in the exposure draft also defined simultaneous settlement as settlement 'at the same moment'.

BC96 Simultaneous settlement as 'at the same moment' is already a concept in paragraph 48 of IAS 32 that enables an entity to meet the criterion in paragraph 42(b) of IAS 32. However, feedback received during outreach indicated that there was diversity in practice related to the interpretation of 'simultaneous settlement' in IAS 32. Many preparers and accounting firms have interpreted paragraph 48 of IAS 32 to mean that settlement through a clearing house always meets the simultaneous settlement criterion even if not occurring at the same moment.

BC97 Respondents also noted that settlement of two positions by exchange of gross cash flows at exactly the same moment (simultaneously) rarely occurs in practice today. They argued that 'simultaneous' is not operational and ignores settlement systems that are established to achieve what is economically considered to be net exposure.

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BC98 Some preparers also indicated that settlement through some gross settlement mechanisms, though not simultaneous, effectively results in the same exposure as in net settlement or settlement at the same moment and are currently considered to meet the requirements in IAS 32, without actually taking place 'at the same moment'. For particular settlement mechanisms, once the settlement process commences, the entity is not exposed to credit or liquidity risk over and above the net amount and therefore the process is equivalent to net settlement.

BC99 Paragraph 48 of IAS 32 states that simultaneous settlement results in 'no exposure to credit or liquidity risk'. In its redeliberations the Board considered gross settlement mechanisms with features that both (i) eliminate credit and liquidity risk; and (ii) process receivables and payables in a single settlement process. The Board agreed that gross settlement systems with such features are effectively equivalent to net settlement.

BC100 To clarify the application of the IAS 32 offsetting criteria and to reduce diversity in practice, the Board therefore clarified the principle behind net settlement and included an example of a gross settlement system with characteristics that would satisfy the IAS 32 criterion for net settlement in paragraph AG38F of IAS 32.

BC101 However, the Board decided not to refer specifically to clearing houses or central counterparties when describing systems that may be treated as equivalent to net settlement for the purposes of the set-off criterion. Systems that meet the principle in paragraph AG38F of IAS 32 may be referred to by different names in different jurisdictions. Referring to specific types of settlement systems may exclude other systems that are also considered equivalent to net settlement. In addition, the Board did not want to imply that settlement through specific systems would always meet the net settlement criterion. Entities must determine whether a system meets the principle in paragraph AG38F of IAS 32 by determining whether or not the system eliminates or results in insignificant credit and liquidity risk and processes receivables and payables in the same settlement process or cycle.

Offsetting collateral amounts

BC102 The proposals in the exposure draft specifically prohibited offsetting assets pledged as collateral (or the right to reclaim the collateral pledged) or the obligation to return collateral sold with the associated financial assets and financial liabilities. A number of respondents disagreed with

the proposed treatment of collateral and noted that the proposed prohibition was more restrictive than the offsetting criteria in paragraph 42 of IAS 32.

BC103 The offsetting criteria in IAS 32 do not give special consideration to items referred to as 'collateral'. The Board confirmed that a recognised financial instrument referred to as collateral should be set off against the related financial asset or financial liability in the statement of financial position if, and only if, it meets the offsetting criteria in paragraph 42 of IAS 32. The Board also noted that if an entity can be required to return or receive back collateral, the entity would not currently have a legally enforceable right of set-off in all of the following circumstances: in the normal course of business, the event of default and the event of insolvency or bankruptcy of one of the counterparties.

BC104 Because no particular practice concerns or inconsistencies were brought to the Board's attention related to the treatment of collateral in accordance with the offsetting criteria in IAS 32, and as the concerns that arose originated from the proposals in the exposure draft, the Board did not consider it necessary to add application guidance for the treatment of collateral.

Unit of account

BC105 Neither IAS 32 nor the exposure draft specifies the unit of account to which the offsetting requirements should be applied. During the outreach performed on the exposure draft, it became apparent that there was diversity in practice regarding the unit of account that was used for offsetting in accordance with IAS 32.

BC106 Entities in some industries (for example, energy producers and traders) apply the offsetting criteria to identifiable cash flows. Other entities apply the offsetting criteria to entire financial assets and financial liabilities. For those entities (for example, financial institutions), applying the offsetting criteria to individual identifiable cash flows (portions of financial assets and financial liabilities) within contracts would be impractical and burdensome, even though requiring application of the offsetting criteria to entire financial instruments results in less offsetting in the statement of financial position.

BC107 The Board acknowledged that the focus of the offsetting model is the entity's net exposure and expected future cash flows from settling the related financial instruments.

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BC108 The Board also noted that some of the entities for whom the offsetting requirements are most relevant are those that would have the most significant operational challenges with applying the model to individual cash flows (such as financial institutions with large derivative activities). This is important to consider because IAS 32 requires offsetting if the offsetting criteria are met.

BC109 On the other hand, if the application of the offsetting criteria to individual cash flows was prohibited, entities in some industries (for example, energy producers and traders) that apply the criteria in IAS 32 to individual cash flows of financial instruments, and achieve set-off on that basis today, would no longer be permitted to do so.

BC110 The Board considered clarifying the application guidance in IAS 32 to indicate that offsetting should apply to individual cash flows of financial instruments. However, if it made such clarification, the Board felt that it would be necessary to consider an exemption from this requirement on the basis of operational complexity. This would result in the offsetting requirements still being applied differently between entities.

BC111 Although different interpretations of the unit of account are applied today, the Board concluded that this does not result in inappropriate application of the offsetting criteria. The benefits of amending IAS 32 would not outweigh the costs for preparers and therefore the Board decided not to amend the application guidance to IAS 32 on this subject.

Cost-benefit considerations

BC112 Before issuing an IFRS or an amendment to an IFRS, the Board seeks to ensure that it will meet a significant need and that the overall benefits of the resulting information will justify the costs of providing it. The Board issued *Offsetting Financial Assets and Financial Liabilities* (Amendments to IAS 32) to eliminate inconsistencies in the application of the offsetting criteria in paragraph 42 of IAS 32 by clarifying the meaning of 'currently has a legally enforceable right of set-off' and that some gross settlement systems may be considered equivalent to net settlement.

BC113 Some respondents were concerned that requiring a right of set-off to be enforceable in the event of default and in the event of insolvency or bankruptcy of the entity would increase the cost of applying the offsetting criteria in IAS 32, if, for example, they needed to obtain additional legal opinions on enforceability. However, the Board noted that without this clarification the offsetting criteria would continue to be applied inconsistently, and the resulting offsetting would be inconsistent with the offsetting objective in IAS 32. This would also

reduce comparability for users of financial statements. Consequently, the Board concluded that the benefit of clarifying this criterion outweighed the cost to preparers of applying these amendments.

BC114 During redeliberations the Board also considered feedback received on the proposals in the exposure draft related to the treatment of collateral and unit of account. However, as described in greater detail in other sections of this Basis for Conclusions, the Board did not consider it necessary to add application guidance for the treatment of these items.

BC115 The amendments to the IAS 32 application guidance (paragraphs AG38A–AG38F of IAS 32) are intended to clarify the Board's objective for the offsetting criteria and therefore eliminate inconsistencies noted in applying paragraph 42 of IAS 32.

BC116 Based on the considerations described in the Basis for Conclusions of these amendments, and summarised in paragraphs BC112–BC115, the Board concluded that the benefits of *Offsetting Financial Assets and Financial Liabilities* (Amendments to IAS 32) outweigh the costs to preparers of applying those amendments.

Transition and effective date

BC117 During redeliberations, the Board originally decided to require retrospective application of the application guidance in paragraphs AG38A–AG38F of IAS 32 for annual periods beginning on or after 1 January 2013. The Board did not expect significant changes in practice as a result of the clarifications made to the application guidance and hence aligned the effective date and transition of these amendments with that of *Disclosures—Offsetting Financial Assets and Financial Liabilities* (Amendments to IFRS 7), issued in December 2011.

BC118 However, the Board received additional feedback from some preparers that the clarifications to the application guidance could change their practice. These preparers indicated that they needed more time to evaluate the effects of the amendments. They indicated that it would be difficult for them to make this assessment in time to allow application of the amendments to the application guidance for the first comparative reporting period.

BC119 Preparers therefore requested that the Board consider aligning the effective date of the amendments with the revised effective date of IFRS 9 *Financial Instruments* (1 January 2015), with earlier application allowed. This would give them sufficient time to determine if there would be any changes to their financial statements.

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BC120 The Board believed that the amendments to the IAS 32 application guidance should be effective as soon as possible to ensure comparability of financial statements prepared in accordance with IFRSs. In addition, the Board did not consider that the effective date needed to be aligned with that of IFRS 9. However, the Board also understood the concerns of preparers. The Board therefore decided to require the amendments to the IAS 32 application guidance to be effective for periods beginning 1 January 2014 with earlier application permitted. This would provide a balance between the time needed to implement the amendments with the need for consistent application of the IAS 32 offsetting requirements.