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Kevin Stevenson
Chairman
Australian Accounting Standards Board
PO Box 204
Collins Street West VIC 8007

via email: standard@aasb.gov.au

9 May 2011

Dear Kevin

Re: ED 209 *Offsetting Financial Assets and Financial Liabilities (proposed amendments to AASB 7 and AASB 132, and proposal relating to Tier 2 disclosure requirements)*

I am enclosing a copy of the PwC response to the International Accounting Standards Board's Exposure Draft ED/2011/1 *Offsetting Financial Assets and Financial Liabilities* [AASB ED 209]. The letter reflects the views of the PwC network of firms and as such includes our own comments on the matters raised in the exposure draft.

I am also responding to your request for comment on the tier 2 Supplement to ED 209 in Appendix A to this letter.

I would welcome the opportunity to discuss our firm's views at your convenience. Please contact me on (02) 8266 8350 if you would like to discuss our comments further.

Yours sincerely,

Regina Fikkers
Partner, PricewaterhouseCoopers

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Appendix A – Specific matters for comment

We do not have any comments on questions 3 and 5. Our responses to the remaining matters for comments are as follows:

1. Overall, would the proposals overall result in financial statements that are useful to users?

Subject to the specific comments made in our submission to the IASB, we believe that the proposals would result in financial statements that are useful to users.

2. Are there any regulatory issues or other issues arising in the Australian environment that may affect the implementation of these proposals, particularly any issues relating to (a) not-for-profit entities, and (b) public sector entities?

We do not believe that there are any regulatory or other issues that would affect implementation of the proposals for tier 1 or tier 2 entities in Australia.

4. Are the proposals in the best interests of the Australian and New Zealand economies?

Convergence of the offsetting rules under IFRS and US GAAP will enhance international comparability, especially among financial institutions. The proposals are therefore be in the best interests of tier 1 and tier 2 entities in Australia.

As for the tier 2 proposals, the introduction of the reduced disclosure regime has significantly reduced the regulatory burden for those entities that are eligible to report under tier 2 of the new regime. It is therefore in the best interests of the Australian economy if new standards provide consistent disclosure relief for tier 2 entities on a timely basis.

6. Should the proposed disclosures (paragraphs 11 – 15 and C16 – C20) in Exposure Draft ED/2011/1 also be applied to Tier 2 entities?

We agree with the AASB's proposal to exempt tier 2 entities from providing any of the disclosures set out in the ED.

International Accounting Standards Board
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20 April 2011

Dear Sir/Madam

Exposure Draft: Offsetting Financial Assets and Financial Liabilities

We are responding to the invitation of the IASB and FASB to comment on the exposure draft Offsetting Financial Assets and Financial Liabilities (the 'exposure draft'). Following consultation with members of the PwC network of firms, this response summarises the views of those member firms who commented on the exposure draft. 'PwC' refers to the network of firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

We welcome the effort of the Boards to develop a converged solution for offsetting financial assets and financial liabilities in the statement of financial position. The differences in the offsetting guidance in IFRS and US GAAP result in the single largest quantitative difference between the two frameworks for financial institutions with significant derivative activity. This exposure draft will provide a common approach that enhances international comparability, especially among financial institutions.

We agree with the principle of requiring net presentation of financial assets and liabilities when an entity has an unconditional and legally enforceable right to set off the financial asset and liability and intends either to settle on a net basis or settle the asset and liability simultaneously. Financial assets and liabilities presented on a gross basis generally provide information about an entity's ability to generate cash in the future, the nature and amounts of an entity's economic resources and claims, and the entity's liquidity and solvency. However, when the net settlement or simultaneous settlement conditions set out above are met, a net presentation is more appropriate.

We do have two significant concerns with the proposals in the exposure draft. First, we do not believe that derivative financial instruments and any related amounts of cash collateral that are subject to a master netting arrangement should be presented on a gross basis in the statement of financial position. Due to their unique characteristics, we believe a net presentation in the statement of financial position will be more meaningful for users.

Second, we are concerned with the requirement that simultaneous settlement must occur literally at the exact same moment in time. We believe that where there are appropriate levels of financial support in place to minimise credit and liquidity risk, financial instruments (e.g. repurchase and reverse repurchase agreements) that settle on the same day through clearinghouses and centralised counterparties should be presented net in the statement of financial position, as they are today under IFRS and US GAAP.

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Derivative financial instruments

As noted in the exposure draft, there is no consensus among users as to whether information about financial assets and financial liabilities should be presented gross or net in the statement of financial position. However there was consensus that both the gross and net amounts were useful and needed for financial analysis. We support providing both gross and net information in a complete set of financial statements, and believe the issues addressed in this exposure draft are not about what is presented in the financial statements taken as a whole, but where information is presented (i.e., in the statement of financial position or in the notes).

The Boards' main arguments for requiring gross presentation in the statement of financial position are that it is more useful in understanding an entity's ability to generate cash in the future, the nature and amounts of the entity's economic resources and claims, and the entity's liquidity and solvency. Whilst this may be appropriate for many financial assets and financial liabilities, we do not believe this is true for derivative financial instruments due to their unique nature and the manner in which they are transacted and managed.

A gross presentation of derivative assets and liabilities subject to master netting agreements will likely not provide users with any additional meaningful information regarding future cash flows. Furthermore, we believe a net presentation of derivative financial instruments will provide more decision making useful information about credit and liquidity risk for collateralised derivative positions.

Generation of future cash flows
Derivative financial instruments are required to be reported at fair value, which is a net amount that reflects the present value of expected net cash inflows and outflows of the contract. Although the fair value of a derivative is an estimation (or probability weighted estimation) of the present value of the expected net future cash flows at a point in time, the conditional and leveraged nature of derivative contracts means that the actual future cash flows are not discernable from the measure of fair value. Therefore, even for a single contract, additional disclosures would be required to truly provide information about the nature, timing and extent of future cash flows (and other risks) relating to derivative financial instruments. As a result, it is difficult to observe information about an entity's ability to generate future cash flows from current fair value amounts. Fair value amounts provide information about the amount an entity could generate by transferring a derivative asset or liability at the statement of financial position date. Therefore, unless an entity's intent is to sell or transfer the derivative financial instrument instead of performing under the terms of the contract, a gross presentation would not provide more meaningful information about the uncertainty of future cash flows from those contracts than the net amount would.

Credit risk
Derivative financial instruments are often subject to master netting arrangements. The failure to make one payment under the master netting agreement would entitle a counterparty to terminate the entire arrangement and to demand the net settlement of all contracts. A net presentation in these circumstances appropriately reflects the amount of credit risk exposure and therefore may better depict the nature and amount of an entity's economic resources and claims with respect to its derivative financial instruments. This is similar to the conclusion reached by the FASB in developing the current guidance in US GAAP.

Liquidity risk
For collateralised derivative contracts subject to master netting agreements, collateral is posted daily based on the net fair value of open positions with a particular counterparty. As a result, collateral is transferred between derivative counterparties on a net basis each day, except potentially on the day a derivative is settled. For example, consider an entity that enters into a forward agreement that requires one cash settlement at its maturity in three years time. That entity

also has other derivative contracts with the same counterparty with different tenors and has executed a master netting agreement that requires the posting of collateral. Throughout the life of that three year derivative financial instrument, collateral is transferred on a daily basis based on the net exposure to the counterparty. As a result, a net presentation would provide liquidity information that is more reflective of the entity's expected cash flows for every day of that derivative transaction's life, except potentially at maturity.

This is an important point when one considers that one of the principal differentiating factors in a financial institution's ability to weather the financial crisis was its ability to meet daily collateral requirements on their net position, and not the gross settlements at contract maturity.

A net presentation aligns with how preparers manage their business, manage their risks and price their derivative financial instruments. It is also consistent with how fair value is measured today and will be measured in the upcoming fair value measurement standard. The valuation of derivative assets and liabilities subject to master netting agreements depends in part on the net open risk position and is based on an exit price notion rather than a settlement notion.

On balance, we therefore support a net presentation as the principal reporting mechanism on the statement of financial position for derivative financial instruments and related cash collateral amounts subject to a master netting agreement.

Simultaneous settlement

The exposure draft clarifies that the realisation of a financial asset and the settlement of a financial liability are treated as simultaneous, and thus qualify for net presentation, only when the settlement occurs at the same moment in time (e.g., both transactions at 8:00am on the same day). Therefore, if settlements take place over the course of a single day, but not at the exact same moment, they would not meet the simultaneous settlement criteria, even if there were no substantive credit and liquidity risks associated with the timing difference. We believe that the proposed guidance is more restrictive than current practice and may preclude certain financial instruments (e.g. repurchase and reverse repurchase agreements), settled through a clearinghouse or centralised counterparty from qualifying for net presentation.

Repurchase and reverse repurchase agreements settled through many clearinghouses are sequentially processed in batches and therefore, are not "simultaneously" settled as defined in the exposure draft. The volume of transactions is significant and the settlement process for these agreements is complex and may involve a number of different processes and systems that make simultaneous settlement impracticable. However, clearinghouses are designed and operated to facilitate net settlement and typically have sufficient financial support in place to minimise any liquidity and credit risk. Furthermore, many of the clearinghouses are subject to strict governmental oversight to ensure their safety and soundness. These institutions are a key element in a number of financial reform efforts designed to promote the stability of the global financial system.

We believe the Boards should enhance the proposed guidance to continue to allow financial instruments to be presented on a net basis in the statement of financial position where settlement occurs on the same date through a clearinghouse or centralised counterparty that has adequate policies governing financial support to eliminate substantially any credit and liquidity risk.

Our answers to the specific questions in the exposure draft are attached in the Appendix to this letter. If you have any questions in relation to the letter please do not hesitate to contact John Hitchins - PwC Global Chief Accountant (+44 20 7804 2497), Paul Kepple - PwC US Chief Accountant (+1 973-236-5293), John Althoff (+44 20 7213 1175), or Chip Currie (+1 973-236-5331).

Yours faithfully

PricewaterhouseCoopers LLP

PricewaterhouseCoopers LLP

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Appendix

Responses to detailed questions in the exposure draft

Question 1 – Offsetting criteria: unconditional right and intention to settle net or simultaneously

The proposals would require an entity to offset a recognised financial asset and a recognised financial liability when the entity has an unconditional and legally enforceable right to set off the financial asset and financial liability and intends either (a) to settle the financial asset and financial liability on a net basis or (b) to realise the financial asset and settle the financial liability simultaneously. Do you agree with this proposed requirement? If not, why? What criteria would you propose instead, and why?

In general, we agree with this proposed requirement. However as noted in our cover letter, we believe that due to their unique nature, derivative financial instruments and any related cash collateral balances that are subject to master netting agreements should be presented on a net basis in the statement of financial position. In addition, we do not believe it is necessary for simultaneous settlement to be literally at the same moment in time. We believe financial instruments (e.g. repurchase and reverse repurchase agreements) should be presented on a net basis in the statement of financial position where settlement occurs on the same date through a clearinghouse or centralised counterparty that has adequate policies governing financial support to eliminate substantially any credit and liquidity risk.

In addition, should the Boards not agree with our view on derivative financial instruments and their related cash collateral balances as set out above, we also disagree with the proposed prohibition on netting of cash collateral balances as set out in paragraph C14. Where an entity meets the proposed offsetting criteria in paragraph 6 for the cash collateral given or received (i.e., the cash collateral is used to offset the related asset or liability at the time of settlement) we see no reason why they should be prohibited from being presented on a net basis.

Question 2 – Unconditional right of set-off must be enforceable in all circumstances

It is proposed that financial assets and financial liabilities must be offset if, and only if, they are subject to an unconditional and legally enforceable right of set-off. The proposals specify that an unconditional and legally enforceable right of set-off is enforceable in all circumstances (ie it is enforceable in the normal course of business and on the default, insolvency or bankruptcy of a counterparty) and its exercisability is not contingent on a future event. Do you agree with this proposed requirement? If not, why? What would you propose instead, and why?

As set out in our cover letter, we support this proposal subject to our perspectives on derivatives subject to master netting arrangements and repurchase and reverse repurchase agreements.

Question 3 – Multilateral set-off arrangements

The proposals would require offsetting for both bilateral and multilateral set-off arrangements that meet the offsetting criteria. Do you agree that the offsetting criteria should be applied to both bilateral and multilateral set-off arrangements? If not, why? What would you propose instead, and why? What are some of the common situations in which a multilateral right of set-off may be present?

We agree that the offsetting criteria should be applied to both bilateral and multilateral set-off arrangements. We do not see any reason why multilateral netting arrangements should be excluded from the scope if they meet the offsetting requirements.

In practice, we have seen some structured multilateral trades with set-off rights, as well as transactions involving multiple parties within a consolidated group that have set-off rights.

Question 4 – Disclosures

Do you agree with the proposed disclosure requirements in paragraphs 11-15? If not, why? How would you propose to amend those requirements, and why?

We agree with the views of users that it is important for both gross and net information to be provided. Therefore, we support the broad principle as set out in proposed paragraph 11. However, we prefer to provide flexibility to preparers to present the information based on how they manage their business, and more specifically, how they manage their credit risk. We do not support requiring specific minimum disclosures based on class of financial instrument nor providing information about conditional rights of set-off where these clauses are not considered to be a significant part of an entity's credit risk management (e.g. in certain loan and deposit contracts).

Portfolio-level adjustments for credit risk in fair value measurements are only one element in the valuation of portfolios of financial instruments. Credit risk valuation adjustments are also relevant in the valuation of financial instruments not valued as a portfolio. We do not believe that the Boards should require specific disclosure of the impact of one valuation input on only certain financial instruments. Such disclosure does not provide a complete picture to users of financial statements and thus we question its usefulness. In addition, we are concerned that the disclosure requirements go beyond what is required for a netting project. This requirement relates to the measurement of fair value and is not a relevant consideration in balance sheet offsetting. Therefore we do not support the requirement to disclose the portfolio level adjustment made in the fair value measurement to reflect the effect of the entity's net exposure to the credit risk of counterparties or the counterparties' net exposure to the credit risk of the entity.

Question 5 – Effective date and transition

(a) Do you agree with the proposed transition requirements in Appendix A? If not, why? How would you propose to amend those requirements, and why?

We support retrospective application as that will enhance comparability for users. However, if the proposals are finalised as written, there could be significant changes to practice and significant time required to compile the new disclosures. For example, we understand that the information required by the proposed deletion of ASC 940-320-45-3 is not readily available and will require modifications to systems in order to comply. Therefore, entities should be given a sufficient amount of time to consider the requirements and prepare the required disclosure information. We suggest 1 January 2014 as the earliest effective date. In addition, there should be an ability to early adopt to promote convergence as soon as possible.

(b) Please provide an estimate of how long an entity would reasonably require to implement the proposed requirements.

As this is more an operational question, we discussed this with a number of companies who have suggested that a period of 12-24 months should be sufficient to gather the information for the required disclosures.

Other Presentation Matters

We noted in the proposed modifications to the FASB Accounting Standards Codification that ASC 940-320-45-2 is proposed to be deleted. We are uncertain as to why this paragraph was proposed to be deleted and request that the FASB reconsider its deletion or include the rationale for its deletion in the basis of conclusions.