

20 April 2011

International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH

Financial Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856-5116

Dear Board Members,

**Re: Exposure Draft ED/2011/01 Offsetting Financial Assets and Financial Liabilities**

Deloitte Touche Tohmatsu Limited (DTTL) is pleased to respond to ED/2011/1 *Offsetting Financial Assets and Financial Liabilities* (the 'exposure draft' or the ED).

We support the efforts of the IASB and FASB (together, 'the Boards') to converge presentation requirements for offsetting of recognised financial assets and recognised financial liabilities, including derivative instruments (hereafter referred to as financial assets and financial liabilities) to resolve the current significant presentation differences in statements of financial position prepared under U.S. GAAP and IFRSs. We also agree with the Boards' conclusion that better comparability will be achieved if application of the new offsetting model is made mandatory and not elective.

The Boards have concluded that the presentation of gross amounts of financial assets and financial liabilities generally provides more relevant information than a net presentation and that a gross presentation aligns more closely with the Conceptual Framework's emphasis on providing users with information about the reporting entity's future cash flows. We agree with this conclusion.

We also observe, however, that during the Boards' outreach efforts, users expressed a view that both gross and net information is useful and necessary for analysing financial statements. We therefore encourage the Boards to explore a linked presentation model as set out in Appendix B to this letter where a right of setoff will occur only upon a party's failure to pay or deliver (including in bankruptcy or insolvency), either because (1) the right is conditional or (2) the right is unconditional but the entity otherwise does not have the intent to invoke such right except upon default. In such instances, we believe a linked presentation may better meet the needs of users. Under this model, financial assets and financial liabilities would continue to be offset when the criteria in the ED are satisfied. However, financial assets and financial liabilities that do not meet both of the proposed offsetting criteria, but that are subject to a legally enforceable right of set-off in the event of a counterparty's failure to pay or deliver (including in bankruptcy or insolvency) would be displayed together, with a net subtotal, on the face of the statement of financial position. Thus, cash flow and credit risk

information would be displayed with equal prominence on the face of the statement of financial position. The presentation of credit exposures in the statement of financial position provides an additional indicator of the uncertainty of the entity's cash flows, and thus is consistent with the conceptual framework.

Appendix A below contains our detailed responses to the ED's questions, and Appendix B highlights significant other comments on the ED.

If you have any questions concerning our comments, please contact Veronica Poole in London at +44 (0) 207 007 0884 or Robert Uhl in the United States at +1 203 761-3152.

Sincerely,

A handwritten signature in black ink, appearing to read 'V. Poole', is positioned below the closing 'Sincerely,'.

Veronica Poole  
Global Managing Director  
IFRS Technical

## Appendix A — Responses to Questions

### ***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?*

#### **Response:**

We agree with the proposed offsetting criteria in principle. However, as discussed below, the boards should provide additional implementation guidance and illustrations in the final standard to clarify how the offsetting criteria should be applied in the following circumstances.

#### **Settlement Mechanisms**

##### *Net Settlement through Cash Collateral*

Many clearing houses require their members to provide the clearing house with cash collateral equal to the sum of the fair values of the instruments. Cash collateral is payable to or receivable from the clearing house depending on whether the total net fair value of a member's positions is negative or positive. Collateral is posted every day on the basis of the fair value of the instruments at the close of the previous day (in addition, an initial margin is also generally required to be posted to cover intra-day price fluctuations. In most cases, on the contractual settlement dates of individual derivative instruments (e.g., on the quarterly payment dates in the case of an interest rate swap that settles each quarter), amounts in the cash collateral account are used to settle the contract (i.e., separate gross payments are not exchanged between the clearing house member and the clearing house). In other words, on each settlement date, the cash collateral account is net settled against the contractual amounts owed or receivable for the derivative contracts; therefore, as of any given settlement date, the outstanding amount not net settled is the difference between the carrying value of the collateral account and the sum of the fair values of the instruments. At the maturity of all of the contracts, the collateral account will be zero because the sum of the fair values of the contracts will equal the collateral account of zero.

As proposed, paragraph C14 of the ED prohibits margin accounts and collateral obtained or pledged from being offset against recognised financial assets or financial liabilities. We do not believe that the Boards' rationale for prohibiting such offsetting justifies the creation of a special exception to the proposed offsetting criteria (i.e., the special rules that prohibit offsetting margin accounts and collateral even if the offsetting criteria are otherwise satisfied). We believe that if margin accounts or collateral obtained or pledged meet the proposed offsetting criteria, those amounts should be offset against the related financial asset and financial liability. For example, a cash collateral account, which is merely a financial receivable from or a financial payable to the counterparty, may meet the requirements for offsetting and, therefore, an entity should be permitted to offset such amounts.

In order to avoid diversity in practice, the final standard should provide implementation guidance that clarifies when an entity is required to offset cash collateral receivables and payables between clearing houses and exchanges and their members.

### *Simultaneous Settlement*

Paragraph C12 of the ED states that “[s]imultaneous settlement of two financial instruments may occur through, for example, the operation of a clearing house in an organised financial market or a face-to-face-exchange”. It could be inferred through the references to an ‘exchange’ and ‘clearing house’ that transactions settled on an exchange or through a clearing house always meet the simultaneous settlement criterion (even though there may be some period of time between settlement payments due to the mechanics of the exchange or clearing house), however this is not made clear by the ED. In particular, it is not clear whether settlement of financial instruments via an exchange or clearing house which settles multiple transactions in batches could meet the simultaneous settlement requirement. Similar concerns could exist for settlements executed through accounts at a central bank in certain jurisdictions.

The Boards should perform additional outreach with exchanges and clearing houses as well as other interbank settlement networks to gain a better understanding of the mechanics of their settlement procedures, assess whether the simultaneous settlement requirement is operational in practice, and determine the extent to which clarification of the criterion in paragraph 6(b)(ii) is necessary. Further, the Boards should provide implementation guidance that illustrates how transactions settled on an exchange or through a clearing house may or may not meet the simultaneous settlement criterion. Resolution of this issue is particularly important because current practice is diverse, and offset is often applied to instruments settled with exchanges or clearing houses that settle multiple transactions in batches as the entity’s credit risk for such transactions may be negligible.

### **Partial Rights of Offset**

The Boards should also clarify how the ED’s offsetting criteria would apply to financial assets and financial liabilities that are subject to periodic settlements (e.g., certain types of commodity derivative instruments that require settlement on a monthly basis on the basis of an observable index or interest rate swaps).

Paragraph 6 of the ED refers only to offsetting a “recognised financial asset and a recognised financial liability”. It does not refer to offsetting portions of these financial instruments, which implies that the unit of account for offsetting is the entire financial asset or financial liability. Paragraph 10(b), however, indicates that the right of set-off may apply to “all or a portion of an amount”. The Boards should reconcile these statements in the final standard and provide additional clarification. It also would be helpful if the Boards were to provide implementation guidance or illustrations that address how the offsetting guidance would apply to the following scenarios:

- *Scenario 1* — An entity has two 12-month derivative contracts (known as calendar year strips), with the same term, outstanding with the same counterparty. Each contract requires a monthly contractual settlement that is based on the index price of natural gas at location X for a given month. The entity intends to settle on a net basis the monthly cash flows arising from each monthly settlement of the contracts (actual contractual cash settlements occur on the same date).

At the end of the reporting period, Contract A is in a gain position (i.e., it is a derivative asset) and Contract B is in a loss position (i.e., it is a derivative liability). Under the proposed guidance, it is unclear whether an entity should offset the fair values of the two derivative contracts outstanding on a contractual settlement basis (i.e., view each of the remaining periodic settlements as a separate unit of account subject to offset) or whether offsetting should be performed for the entire term of the contract (i.e., only the fair value of Contract A and Contract B, representing the aggregate present value of all future settlements, would be offset as of the reporting date). How the entity is able to offset these instruments will affect the amount of net derivative assets and net derivative liabilities that may be recorded, since each forward contractual settlement may be in a gain position or a loss position depending on the shape of the forward curve of the underlying index.

- *Scenario 2* — In addition to the facts in Scenario 1 above, assume that the actual cash settlement (amount paid or received) for each contractual settlement period occurs the month after the settlement date. Therefore, as of any given reporting date within the term of the contract(s), an entity may record two amounts: (1) a trade receivable or trade payable for the settled portion of the contract(s) and (2) the fair value(s) for the remaining unsettled contractual payments. (Depending on the response to Scenario 1, the fair values could either be a single amount for each contract or multiple amounts representing each future settlement.) It is unclear from the ED whether the entity is able to offset the settled portion(s) (i.e., trade receivable/payable) against the fair value of the remaining unsettled portion(s) of the contracts for presentation purposes.
- *Scenario 3* — Assume facts similar to those in Scenario 1 above, except that Contract A has a six-month term and Contract B has a twelve-month term (e.g., January–June 20X1 for Contract A and January–December 20X1 for Contract B). All other contractual terms remain the same (e.g., monthly settlements, underlying settlement index). It is unclear whether an entity is required to offset the six months of Contract A with the first six months of Contract B (or the entirety of both contracts or no portions of the contracts) for presentation purposes.

We believe it is critical that the Boards provide clarification on application of the offsetting criteria to these fact patterns because contracts having multiple settlements (e.g., commodity derivatives, interest rate swaps, and cash instruments for which amounts paid, received, or both are based on different rates/indices) are commonly encountered in practice. In addition, if, on the basis of the scenarios above, the Boards conclude that offsetting is performed for the entirety of the contract (rather than for each periodic settlement), the Boards would also need to address how an entity that presents a ‘classified’ statement of financial position would classify such amounts. That is, for long-dated contracts containing periodic settlements, is the entire fair value presented as a long-term asset or liability, or should a portion of the fair value be presented as a short-term asset or liability?

### ***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 (i.e., 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?*

#### **Response:**

We agree that an entity must have an unconditional and legally enforceable right of set-off to offset a financial asset and a financial liability. We also agree that the right of set-off must be legally enforceable in all circumstances. We note that the guidance could be further clarified by noting that procedural requirements within the control of the reporting entity do not cause a right to be conditional.

### ***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?*

#### **Response:**

We agree that the offsetting criteria should be applied to both bilateral and multilateral arrangements. We also believe that for multilateral arrangements, the right of set-off must be explicitly designated in a formal agreement between all parties. We understand that although offsetting of multilateral arrangements is not a common practice, such arrangements may arise as part of certain tax planning strategies.

### ***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?*

#### **Response:**

We support the Boards' efforts to require entities to provide disclosure that responds to financial statement users' desire for information about net credit exposures. However, we have significant concerns about certain aspects of the ED's proposed disclosure requirements. Many of these concerns arise from uncertainty about whether certain types of instruments or arrangements fall within the scope of the proposed disclosures. It would be helpful if, in addition to responding to some of the specific scoping questions noted below, the final standard provided more clarity on the Boards' underlying objective and framework with respect to its disclosure requirements. For example, is the objective to show the entity's net credit exposure for all of its financial instruments or only those subject to offsetting and related arrangements? Similarly, if certain instruments also have financial guarantees, should the existence of those guarantees also be included in the disclosures to

provide a complete picture of the entity's credit exposure? Also, we encourage the Boards to continue to solicit feedback from users and preparers regarding whether the benefits of certain disclosures outweigh the costs and operational challenges of providing those disclosures. In particular:

- The Boards should determine how the proposed disclosure requirements will interact with existing disclosure requirements in IFRSs and U.S. GAAP for credit risk, collateral and derecognition. For example, IFRS 7 *Financial Instruments: Disclosures* already requires certain quantitative disclosures of the amount of credit risk at the end of the reporting period (paragraphs 36–38) as well as disclosures about collateral and derecognition (paragraphs 13–15) of financial assets. In addition, it is unclear in the ED whether an entity that continues to recognise a ‘failed-sale’ asset (i.e., the asset does not meet the derecognition requirements in IAS 39 *Financial Instruments: Recognition and Measurement*) and a corresponding liability to the counterparty is required to disclose the ‘collateralised borrowing’ in the tabular disclosure proposed by paragraph 12 of the ED.
- Paragraph 12 of the ED requires disclosures to be provided by ‘class of financial instruments’. However, the ED does not indicate whether the definition of ‘class’ is consistent with the definition used in IFRS 7 and in the Boards’ fair value measurement project (e.g., proposed ASC 820-10-50-2C<sup>1</sup> in the FASB’s exposure draft *Fair Value Measurements and Disclosures* (issued June 29, 2010)). To avoid diversity in practice, the Boards should clarify whether the definition of class, as used in the ED, is consistent with that used in other accounting standards and at what level of granularity the definition should be applied (given that, in practice, credit risk management systems often operate at a different level of granularity from that used in measurement).
- We question the usefulness of requiring separate columnar disclosure (proposed in paragraph 12(b)(ii)) of the portfolio-level credit adjustment for each class of financial asset and financial liability. The Boards should solicit feedback from preparers and users regarding the costs and benefits of providing this information. If this disclosure requirement is retained in the final standard, the Boards should clarify their rationale and modify the illustrative tabular disclosure in paragraph IE1 to show the portfolio-level credit adjustments.
- Paragraph 12(d) requires an entity to disclose the amount of financial assets and financial liabilities with a conditional right of set-off “separately by each type of conditional right” in the tabular disclosure. It would be helpful if the example in paragraph IE1 illustrated the disclosure for an entity with more than one type of conditional right of set-off.
- It is unclear from the proposed disclosure requirement in paragraph 12(f) whether the disclosure of ‘collateral held’ is meant to include collateral held but not recognised or whether the disclosure is limited to collateral that is held and recognised. For example, in certain situations, an entity (i.e., the obligor) may post collateral in a restricted account that is only available to the creditor in the case of default. It would be helpful if the Boards were to clarify whether collateral that is held (but not recognised) is required to be included in the proposed tabular disclosure.
- Paragraph 15 of the ED should more clearly indicate when an entity is exempt from the proposed disclosure requirements. We believe the Boards expect entities to provide such disclosures if they hold financial assets or financial liabilities that may be subject to a ‘conditional’ or an

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<sup>1</sup> FASB Accounting Standards Codification Topic 820, *Fair Value Measurements and Disclosure*.

‘unconditional’ right of set-off. If this is the Boards’ intent, paragraph 15 could be clarified as follows (changes are underlined): “has no financial assets and financial liabilities at the reporting date that are subject to a right of set-off, conditional or unconditional, and the entity has neither obtained nor pledged”. . .

***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?*

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

**Response:**

We agree that the final standard should require retrospective application for all comparative periods. However, we encourage the Boards to perform outreach with the preparer community to assess what system and operational changes might be necessitated by the proposed presentation and disclosure requirements and ensure that sufficient transition time is provided to allow preparers to enact such changes. In addition, we believe that in some jurisdictions the proposed requirements could significantly affect entities’ capital ratios (e.g., leverage ratio) as computed under existing regulatory requirements. We encourage the Boards to provide an adequate transition period (with early adoption permitted) that will enable regulators in those jurisdictions to modify their rules in response to the new accounting standard before entities are required to adopt it.

Furthermore, we believe that the guidance in the final standard should have its own transition guidance that is independent of (i.e., not linked to) an entity’s adoption of any other standard. This might most easily be accomplished by issuing the final standard as a separate IFRS (and not as an amendment to IFRS 7, IFRS 9 *Financial Instruments* or IAS 32).



## **Appendix B: Other Significant Comments**

### **Linked Presentation**

We believe that the Boards should explore a linked presentation model for certain financial assets and financial liabilities that do not meet both of the ED's offsetting criteria.

Under such an approach, financial assets and financial liabilities that meet both of the proposed offsetting criteria in the ED (i.e., unconditional and legally enforceable right of set-off and intent to settle net or simultaneously) would be offset and presented net on the statement of financial position. If the proposed offsetting criteria are not met, the financial asset and financial liability would be presented gross on the statement of financial position. Financial assets and financial liabilities that do not meet both of the proposed offsetting criteria, but that are subject to either (1) a conditional right of set-off in the event of a counterparty's failure to pay or deliver (including in bankruptcy or insolvency) or (2) an unconditional right of set-off where there is no intention to settle net or simultaneously in the ordinary course of business, would be displayed together, with a net subtotal, on the face of the statement of financial position. The linked presentation approach continues to show gross amounts in a manner consistent with the cash flow emphasis of the conceptual framework but also displays information about the entity's net credit exposures with equal prominence on the face of the statement of financial position.

We believe that an entity's use of a linked presentation should not depend on whether an entity intends to settle such financial assets or financial liabilities net or simultaneously in the ordinary course of business because, in the case of the conditional rights in question, if the right of set-off were ever triggered (e.g., upon bankruptcy or default of the counterparty), an entity would avail itself of its legal rights to offset to minimise its economic losses. An entity would also avail itself of these rights in scenarios where the right to set-off is unconditional but an entity does not have the intention to settle net or simultaneously in the ordinary course of business except upon default.

Were the Boards to pursue this proposal, they should consider:

- whether linked presentation could be applied to multilateral contracts when there is an agreement in place that clearly establishes a legal right for the debtor to offset the amount due from a third party against the amount owed to a creditor;
- whether the application of linked presentation should be mandatory or elective; and
- appropriate disclosures supporting linked presentation. For example, the tabular disclosure requirements proposed by paragraph 12 of the ED would need to be amended to require disclosure of amounts subject to linked presentation to reconcile to an entity's net credit exposure as reported on the statement of financial position.

### **Impact on Other IFRSs**

The IASB should consider whether conforming amendments should be made to offsetting guidance in paragraph 71 of IAS 12 *Income Taxes* and paragraph 116 of IAS 19 *Employee Benefits* because both IASs specifically note that the offsetting guidance in those standards is similar to that in IAS 32.

### **Amendments to FASB Accounting Standards Codification**

- Paragraph 22 in Appendix D of the FASB's exposure draft *Balance Sheet, Offsetting* (the "FASB ED") proposes to delete guidance related to presentation of construction liabilities in ASC 910-405-45-1 and 45-2, thus eliminating the requirement to offset advances that are

payments on account of work-in-progress against the related asset. It is unclear why this proposed amendment is being made in conjunction with the ED because the scope of the FASB ED is limited to “all financial assets and derivative assets . . . and financial liabilities and derivative liabilities”. However, (1) it is debatable whether the related asset would be considered a financial asset and (2) the obligation associated with the advance received is not considered a financial liability since the obligation is satisfied by the future performance of the entity. We encourage the FASB to reconsider and eliminate this proposed amendment. If the FASB determines to retain the proposed amendment, at a minimum, it should provide its rationale in the final standard’s Basis for Conclusions and clarify whether the guidance in ASC 912-310 is affected similarly. The Boards also should consider how these proposed amendments to the Codification will interact with the proposed guidance in paragraph 64 of the exposure draft *Revenue Recognition* (issued 24 June 2010).

- On the basis of the proposed amendments to the Codification in Appendix D of the FASB ED, it appears that the Master Glossary section of ASC 210-20 will continue to retain the definition of “repurchase agreement” and “reverse repurchase agreement”. We recommend that since the FASB ED proposes to delete the paragraphs (e.g., ASC 210-20-05-03) in ASC 210-20 that refer to those definitions, the FASB should either delete these definitions from ASC 210-20 or move them from ASC 210-20 to the glossary section of another Codification subsection where these terms are used.
- The FASB should make conforming amendments to other Codification topics that may be affected by the proposed amendments to ASC 210-20. For example:
  - ASC 815-10-50-4B(a) requires an entity to disclose gross amounts of derivative assets and derivative liabilities “even when those instruments are subject to master netting arrangements”. If the FASB ED is finalised in its current form, the reference in ASC 815-10-50-4B(a) to master netting arrangement will be redundant because paragraph 8 of the FASB ED specifies that instruments subject to rights of set-off granted by master netting arrangements would not qualify for offsetting and would have to be presented gross.
  - ASC 820-10-50-3 states that disclosures required by ASC 820-10-50-2(a) through 50-2(bb) are presented “on a gross basis” and the disclosures required by ASC 820-10-50-2(c) and 50-2(d) can be presented “on either a gross or a net basis.” If the FASB ED is finalised in its current form, the FASB should amend ASC 820-10-50-3 to clarify how such disclosures should be presented.