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IFRS Project Insights

Asset and Liability Offsetting

21 September 2011

In response to stakeholders' concerns (including those of the Basel Committee on Banking Supervision and the Financial Stability Board), the IASB and the FASB decided to jointly address differences in their respective standards on balance sheet netting of derivative contracts and other financial instruments. US GAAP currently permits an exception to the offsetting criteria for certain derivative contracts subject to a master netting agreement (a conditional form of netting where in the event of default or bankruptcy all asset and liability contracts are netted into a single payable or receivable amount) and repurchase agreements while IFRS does not permit a similar exception.

In January 2011, the IASB and FASB issued an exposure draft ED/2011/1 *Offsetting Financial Assets and Financial Liabilities* (ED), that would introduce additional application guidance under IFRS in applying the current offsetting principles in IAS 32. For example, the ED would clarify that a right of set-off that may be removed by a future event would not be an unconditional right of set-off. Similarly, if the right of set-off is exercisable only before a specific date, that right of set-off would not qualify as an unconditional right of set-off. However, a right of set-off that was conditional at inception of the contract may subsequently become unconditional if the contingent event occurs. The comment period ended on 28 April 2011. In May 2011, the Boards began their redeliberations of the proposals in the ED.

Tentative Decisions Reached During Redeliberations

At the June 2011 joint meeting, the IASB tentatively decided to reaffirm the proposal in the ED that would require offsetting when an entity has an unconditional right of set-off in the normal course of business and also in bankruptcy or default. However, the FASB reversed its tentative decision in the exposure draft by tentatively deciding to require offsetting for derivatives when an entity has a conditional right of set-off in bankruptcy or default as a result of having a master netting agreement in place.

At the July 2011 meeting, the IASB discussed whether to proceed with the proposals given that the Boards would not be issuing a converged standard. The IASB tentatively decided not to proceed with the proposals in the exposure draft and instead retain the guidance in IAS 32. However, the Board instructed the staff to identify potential approaches to clarify IAS 32 and develop supplemental guidance to resolve some of the issues identified during the offsetting project. In reaching this tentative decision, the majority of Board members felt that retaining the IAS 32 offsetting model and supplementing it with additional guidance may result in less implementation efforts but resolve some of the practice issues identified during the project. However, the IASB will move forward with its joint discussions on disclosure requirements.

In discussing disclosure requirements, the Boards tentatively decided to retain the original disclosure objective proposed in the exposure draft but to modify the scope of the disclosure requirements to apply only to instruments under an enforceable master netting agreement or similar arrangement and to clarify that an entity would not need to provide the required disclosures if the entity has no financial assets or financial liabilities subject to a right of set-off at the reporting date.

The Boards tentatively decided to require disclosure of (1) the gross amounts, (2) the amounts presented in the statement of financial position, (3) any other amounts that can be offset in the event of bankruptcy, insolvency or default of any of the parties (including cash and non-cash financial collateral) and (4) the entity's net exposure. Entities would have a choice of providing the effect of rights of set-off only enforceable and exercisable in bankruptcy, default or insolvency of either party not taken into account in arriving at the amounts presented in the statement of financial position (including collateral) to be presented either by major type of financial instrument and/or by counterparty.

At the September 2011 meeting, the Board considered whether inconsistencies within IAS 32 in the application of the offsetting requirements should be addressed and, if so, how.

Inconsistencies within IAS 32

The Board tentatively decided to address the inconsistencies by adding application guidance to IAS 32 to clarify that:

- A right of set-off must be legally enforceable both in the normal course of business and in the event of default, bankruptcy and insolvency of one of the counterparties.
- Gross settlement systems that have the following distinguishing factors would be considered equivalent to net settlement:
    - financial assets and financial liabilities that meet the right of offset criterion are submitted for processing at exactly the same point;
    - once submitted for processing, the transactions cannot be cancelled or altered [there is no liquidity or credit risk];
    - there is no potential for the cash flows arising from the assets and liabilities to change once they have been submitted for processing unless the processing fails [there are no potential change in cash flows];
    - if the processing of one asset or liability that is offset against another fails, then the processing of the related security used as collateral also fails [there is always net exposure /similar to a securities transfer system or delivery versus payment];
    - processing is carried out through the same settlement depository [(for example, delivery versus payment or the same depositary account] and
    - there is a high likelihood that an intraday credit facility is available and would be honoured until the settlement process is complete [there is no settlement (liquidity/credit) risk].

Location of offsetting requirements, application guidance and converged disclosures

The Board tentatively decided that the offsetting criteria and amendments to the offsetting application guidance should remain in IAS 32, and that the disclosures should be placed in IFRS 7 Financial *Instruments: Disclosures.*

Application guidance—effective date and transition

The Board tentatively decided that the amendments to the offsetting application guidance should be applied retrospectively and be effective for annual and interim reporting periods beginning on or after 1 January 2013.

Consequential amendments

The Board tentatively decided that no consequential amendments to other IFRSs were necessary as a result of the offsetting project.

Disclosures—effective date and transition

The Board tentatively decided that the revised disclosure requirements should be applied retrospectively and be effective for annual and interim reporting periods beginning on or after 1 January 2013.

Due process considerations

The Board tentatively decided that neither the amendments to the IAS 32 application guidance nor the converged disclosure requirements require re-exposure.

Thinking ahead

The offsetting project identified various application issues associated with IAS 32. The tentative decisions to clarify that a right of set-off must be legally enforceable both in the normal course of business and in the event of default, bankruptcy and insolvency of one of the counterparties and with respect to when gross settlement systems would be considered equivalent to net settlement may have an effect on an entity's financial statements depending on the specific terms of the transactions and an entity's current accounting policy.

Next steps

The final standard on disclosures and the clarifying amendments to IAS 32 are expected to be issued in the fourth quarter of 2011.