

## Heads Up

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Differences in the boards' rules on offsetting financial assets and financial liabilities have resulted in significant quantitative presentation differences in balance sheets prepared under U.S. GAAP and IFRSs.

## FASB Proposes Guidance on Balance Sheet Offsetting for Financial Assets and Financial Liabilities

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### Introduction

On January 28, 2011, the FASB issued an [exposure draft \(ED\)](#), *Offsetting*, in a joint effort between the FASB and the IASB (the "boards") to converge their accounting standards on the offsetting of financial assets and financial liabilities.<sup>1</sup>

Differences in the boards' rules on offsetting financial assets and financial liabilities have resulted in significant quantitative presentation differences in balance sheets prepared under U.S. GAAP and IFRSs (see [Appendix A](#) of this *Heads Up* for a comparison of the offsetting requirements under U.S. GAAP, IFRSs, and the ED). Such differences impair the comparability of financial statements produced by entities with large financial instrument and derivative portfolios. The rules proposed by the boards are intended to address this disparity. The proposed model for offsetting is similar to the offsetting requirements under IAS 32<sup>2</sup> and could represent a significant change for entities that prepare financial statements under U.S. GAAP because it could require a significant expansion (i.e., "grossing up") of their balance sheets. This, in turn, could skew traditional financial ratios (e.g., leverage ratio) and performance metrics unless such measures are redefined by regulators and analysts to take into account the new requirements.

The proposed offsetting requirements apply to all recognized financial assets and financial liabilities, including derivative instruments (financial and nonfinancial).<sup>3</sup> Comments on the proposal are due April 28, 2011.

### Offsetting Criteria

The ED would require an entity to offset a recognized financial asset and a recognized financial liability and present the net amount in its statement of financial position if the entity **both**:

- Has an **unconditional** and **legally enforceable** right to set off the financial asset and financial liability.
- **Intends** either to settle the financial asset and financial liability net or to realize the financial asset and settle the financial liability **simultaneously**.

<sup>1</sup> The IASB also issued an ED on the same date. There are subtle differences between the FASB's and IASB's EDs, primarily with respect to terminology used under U.S. GAAP and IFRSs. However, the two EDs are meant to achieve convergence between the standards on offsetting under U.S. GAAP and IFRSs.

<sup>2</sup> IAS 32, *Financial Instruments: Presentation*.

<sup>3</sup> All references in this *Heads Up* to financial assets and financial liabilities include derivative instruments (financial and nonfinancial). Note that the FASB's ED uses the term "eligible" assets and liabilities when referring collectively to financial and derivative assets and liabilities.

An entity that fails to satisfy either criterion would be prohibited from offsetting the financial asset and the financial liability in the statement of financial position. The ED also prohibits an entity from offsetting a transferred financial asset that fails the derecognition criteria against the related financial liability.

**Editor’s Note:** The boards’ rationale for these criteria (which are described in greater detail below) is that financial assets and financial liabilities that meet the criteria are, essentially, a single asset or liability and should be presented as such in the statement of financial position. The boards believe that a net presentation for such instruments reflects an entity’s expected cash flows from settling two or more separate financial instruments and its right to or obligation for only the net amount.

### “Unconditional and Legally Enforceable Right” Criterion

The ED specifies that for entities to offset a financial asset and a financial liability in the statement of financial position, the right of setoff must be both unconditional and legally enforceable. The right of setoff is considered unconditional if its exercise is not contingent upon the occurrence of a future event; it is considered conditional if it becomes exercisable only upon the occurrence of a future event, such as bankruptcy, insolvency, default, or change in control.

In addition to being unconditional, the right of setoff also must be legally enforceable in both the normal course of business and in other situations, such as default, insolvency, or bankruptcy (i.e., it must be legally enforceable in **all** circumstances). Therefore, an entity would need to consider the laws and regulations governing the contracts in each applicable jurisdiction to determine whether the “legally enforceable” requirement is met. If the unconditional right of setoff is not legally enforceable in all circumstances, an entity would be precluded from offsetting the financial asset and the financial liability in its statement of financial position.

The ED also specifies that the right of setoff that was conditional at inception of the contract may meet the unconditional criterion if the contingent event occurs. However, a right of setoff that is contingent upon some certain future event or that is exercisable only before a specified date does not meet the unconditional right of setoff criterion.

**Editor’s Note:** Derivative instruments and related cash collateral receivables or payables subject to master netting arrangements are **not** likely to qualify for offsetting under the proposed model because netting provisions under master netting arrangements usually permit offsetting of assets and liabilities only in the case of default. Such a right of setoff would be considered “conditional” under the proposed model and would not satisfy the “unconditional” requirement. This may result in a significant expansion (grossing up) of balance sheets for financial institutions and other entities that have large portfolios of financial instruments.

### “Intent to Settle Net or Simultaneously” Criterion

Under the ED, in addition to meeting the “unconditional and legally enforceable right” criterion (discussed above), an entity also must intend either to settle the financial asset and financial liability net or to settle them simultaneously to qualify for offsetting presentation.

The intent to settle net or settle simultaneously is assessed from a reporting entity’s perspective and can be demonstrated by past practices, documented risk management and operating policies, and normal operating practices.

**Editor’s Note:** Although an entity may have the right to settle a financial asset and financial liability net, if the entity’s common practice is to settle the financial asset and financial liability separately (and not simultaneously) because of any circumstance (e.g., system limitations or business reasons), it will fail the intent criterion.

The ED specifies that for entities to offset a financial asset and a financial liability in the statement of financial position, the right of setoff must be both unconditional and legally enforceable.

An entity may still be able to offset, even though it does not intend to settle net, if it can demonstrate that it intends to settle the financial asset and financial liability simultaneously. The ED clarifies that simultaneous settlement means the settlements occur “at the same moment” (i.e., the entity has exposure only to the net amount).

**Editor’s Note:** An entity would not meet the simultaneous settlement criterion if processing limitations resulted in settlement occurring over a short period, even though the settlement value was fixed. In addition, if the settlement of the financial asset and financial liability occurs at the same stated time, but in different time zones, it is not considered simultaneous, because it would not have been considered to have occurred at the same moment.

When an entity assesses whether a contract satisfies the “intent to settle net or simultaneously” criterion, it needs to understand the settlement mechanisms available for its contracts.

### Application of the “Intent to Settle Net or Simultaneously” Criterion to Instruments Subject to Master Netting Arrangements, Central Clearing, or Exchanges

When an entity assesses whether a contract satisfies the “intent to settle net or simultaneously” criterion, it needs to understand the settlement mechanisms available for its contracts, including (1) the settlement provisions of the contract or master netting arrangement to which the contract is subject or (2) the settlement rules for any exchange or clearinghouse through which the contract may be settled. Such mechanisms may indicate that offsetting is required. For example, the settlement provisions of a master netting arrangement that require automatic setoff of payments that are due on the same day and in the same currency, or a clearinghouse’s rules that require automatic netting and cancellation of offsetting contracts, may satisfy the “intent to settle net” requirement.

Similarly, the ED indicates that certain central clearing counterparties or exchanges may give participants the right to set off amounts receivable and payable and may require that amounts for different product types be settled separately (i.e., gross settlement) but instantaneously (i.e., there is exposure only to the net amount). Such settlement provisions may satisfy the simultaneous-settlement requirement.

### Bilateral and Multilateral Setoff Arrangements

Generally, the notion of offsetting applies to bilateral arrangements and involves only two parties; however, the ED’s proposed model applies to all types of arrangements. Therefore, the ED may require offsetting for multilateral arrangements if the criteria for offsetting are satisfied. For example, entities A, B, and C may agree to set off amounts owed by A to B against amounts owed to A by C. In such an unusual circumstance, to the extent that the offsetting criteria are met, the ED requires offsetting of multilateral contracts.

### Margin Accounts and Collateral Obtained or Pledged

Certain contractual arrangements may require an entity to maintain a margin account with the counterparty or an exchange. The ED proposes that such margin accounts, which normally include liquid assets such as cash and securities, be reported separately; they would not be eligible for offset presentation. In addition, in certain transactions (e.g., repurchase agreements and reverse repurchase agreements), one of the parties may sell collateral pledged to it and recognize an obligation to return the collateral. The ED requires separate presentation of such collateral obligations. In its statement of financial position, an entity is prohibited from offsetting recognized financial assets and financial liabilities against any (1) pledged collateral, (2) right to reclaim collateral pledged, or (3) obligation to return collateral sold.

## Disclosures

The ED proposes new qualitative and quantitative disclosure requirements for financial assets and financial liabilities subject to offset. As of each reporting date, an entity would be required to present,<sup>4</sup> separately for financial assets and financial liabilities, and by class of financial instrument, the following (see example in [Appendix B](#)):

- a. The gross carrying amounts (before application of offsetting and portfolio level credit risk adjustments).
- b. Amounts offset under the proposed model to determine the carrying amounts in the statement of financial position.
- c. Portfolio level adjustments related to credit risk.
- d. The net carrying amount reported in the statement of financial position (i.e., (a) minus (b) minus (c)).
- e. The amounts of financial assets and financial liabilities that satisfy the “unconditional and legally enforceable right of setoff” criterion but fail the “intent to settle net or simultaneously” criterion.
- f. The amounts of financial assets and financial liabilities for which an entity has a conditional right of setoff (e.g., amounts subject to master netting arrangements that did not qualify for offsetting) disclosed separately by each type of conditional right.
- g. Net amount of financial assets and financial liabilities, after taking into account the preceding items (i.e., (d) minus (e) minus (f)).
- h. Amount of cash obtained or pledged as collateral (excluding any collateral that exceeds the amount in (d) above).
- i. Fair value of other financial instruments obtained or pledged as collateral (excluding any amounts that exceed the amount in (d) above).
- j. The net amount of financial assets and financial liabilities after considering all preceding items (i.e., (g) minus (h) minus (i)).

The ED specifies that the disclosure should be presented in a tabular format (unless another format is more appropriate). Further, an entity may aggregate the amounts disclosed in (f) above by similar rights of setoff (although those rights exercisable on default, bankruptcy, or insolvency must be distinguished from those exercisable in the normal course of business). An entity also must describe each type of conditional right of setoff, such as the nature of those rights and how an entity determines each type of right of setoff.

**Editor’s Note:** The boards proposed these disclosures because they believe that financial statement users should be informed about the net credit exposures of the entity. Entities need not provide these disclosures if their financial assets or financial liabilities are not, as of the reporting date, subject to (1) a right of setoff and (2) collateral arrangements.

## Effective Date and Transition

The ED does not specify an effective date. The boards seek feedback from constituents on the amount of time and effort they would need to implement the proposed requirements. The boards plan to discuss the effective date of the final standard after taking into consideration feedback received on the ED and the *Effective Dates and Transition Methods* discussion paper.<sup>5</sup>

The proposed presentation and disclosure guidance will be applied retrospectively to all periods presented.

<sup>4</sup> If the required disclosures are presented in different footnotes, an entity must provide cross-references to enable a reader to locate all of the required information.

<sup>5</sup> See Deloitte’s October 21, 2010, *Heads Up*.

The boards seek feedback from constituents on the amount of time and effort they would need to implement the proposed requirements.

## Appendix A — Comparison of Offsetting Requirements Under U.S. GAAP, IFRSs, and the ED

The following table compares the offsetting requirements under U.S. GAAP, IFRSs, and the ED.

Subject	U.S. GAAP (ASC 210-20 <sup>6</sup> )	IFRSs (IAS 32)	ED
Offsetting financial assets and financial liabilities — elective or required	Elective.	Required if all criteria are met.	Required if all criteria are met.
Offsetting criteria	<p>Entity may offset assets and liabilities in the balance sheet if a right of setoff exists. A right of setoff exists when all of the following conditions are met:</p> <ul style="list-style-type: none"> <li>• “Each of two parties owes the other determinable amounts.”</li> <li>• “The reporting [entity] has the right to set off the amount owed with the amount owed by the other party.”</li> <li>• “The reporting [entity] intends to set off.”</li> <li>• “The right of setoff is enforceable at law.”</li> </ul>	<p>Requires offsetting of a financial asset and financial liability if both criteria are met:</p> <ul style="list-style-type: none"> <li>• Entity “currently has a legally enforceable right to set off the recognised amounts.”</li> <li>• Entity “intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.”</li> </ul>	<p>Requires offsetting of a financial asset and financial liability if both criteria are met:</p> <ul style="list-style-type: none"> <li>• Entity has “an unconditional and legally enforceable right” to set off the financial asset and financial liability.</li> <li>• Entity intends either to (1) settle the financial asset and financial liability on a net basis or (2) realize the financial asset and settle the financial liability simultaneously.</li> </ul>
Exceptions	Certain exceptions granted (e.g., derivatives subject to master netting arrangements, repurchase agreements).	Not permitted. No exceptions granted.	Not permitted. No exceptions granted.
Offsetting amounts due from a third-party debtor against the amount due to a creditor (multilateral offsetting arrangements)	Not permitted.	Is permitted in “unusual” circumstances.	Is permitted in “unusual” circumstances.

<sup>6</sup> FASB Accounting Standards Codification Subtopic 210-20, *Balance Sheet: Offsetting*.

## Appendix B — Disclosure Illustration

The following table, adapted from the ED, illustrates one possible method of meeting the ED’s tabular disclosure requirements. Entities would also need to provide a similar table for financial liabilities subject to offsetting.

CU Million As of December 31, 20XX	(i)	(ii)	(iii) = (i) – (ii)*	(iv)	(v)	(vi) = (iii) – (iv) – (v)	(vii) Collateral Pledged		(viii)
Description	Gross Amount of Assets	Gross Amount of Liabilities Offset Against Assets in the Statement of Financial Position	Net Amount of Assets in the Statement of Financial Position	Gross Amount of Liabilities Subject to Conditional Rights of Setoff	Gross Amount of Liabilities Subject to an Unconditional and Legally Enforceable Right of Setoff but the Entity Does Not Intend to Settle Net or Simultaneously	Net Amount of Assets Before Deducting Collateral	Cash	Fair Value of Other Financial Instru- ments Received as Collateral	Net Exposure
Exchange traded financial instruments	X	X	X	X	X	X	X	X	X
OTC derivatives, repurchase and stock borrowing agreements, and similar financial instruments	X	X	X	X	X	X	X	X	X
Other financial instruments	X	X	X	X	X	X	X	X	X
Financial assets at fair value through profit or loss	X	X	X	X	X	X	X	X	X
<b>Total</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>
Financial assets at amortized cost	X	X	X	X	X	X	X	X	X
<b>Total</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>	<b>X</b>

\* Assumes the entity has not made portfolio-level adjustments in the fair value measurement of derivatives.

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