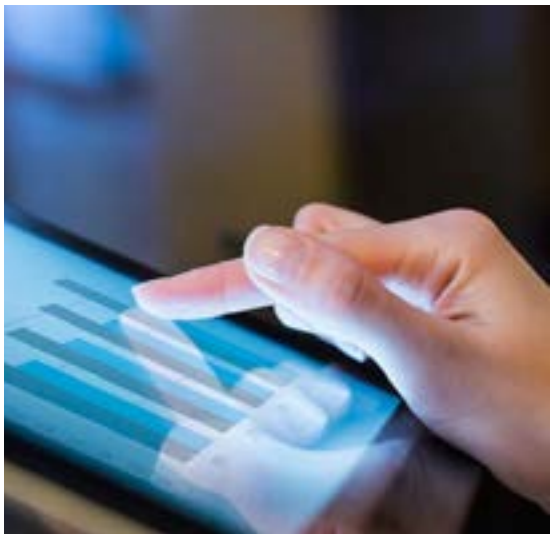
The Essentials—Issue No. 3

The Essentials—Sizing Up the Balance Sheet



Comparing the financial statements of banks across the globe can be a tricky exercise, because the size of the balance sheets can differ significantly depending on whether they are prepared under IFRS or US GAAP. One of the primary reasons for this is that IFRS and US GAAP have different offsetting requirements. This usually results in IFRS balance sheets for banks 'appearing' to be larger (all else being equal). Fortunately, this comparability problem is mitigated by similar disclosure requirements under IFRS and US GAAP that we think many investors will find helpful.

Leveraging the notes

What is a bank's leverage ratio? ... That depends

What is the asset leverage ratio of a bank?[1] The answer: it depends.

This is because the ratio can look quite different for a bank reporting under IFRS than it does for a bank under US GAAP, even if the banks have identical underlying portfolios.

Inside this issue:

"Look both ways before you cross the street. And look at the notes before you compare banks under IFRS with those under US GAAP."

In this issue of *The Essentials*, we explain the reason for this difference and how required note disclosures can give investors the information they need to:

(a) make better comparisons between the balance sheets of the global banks; and

(b) analyse a firm's risk management as it relates to counterparty credit risk and liquidity risk.

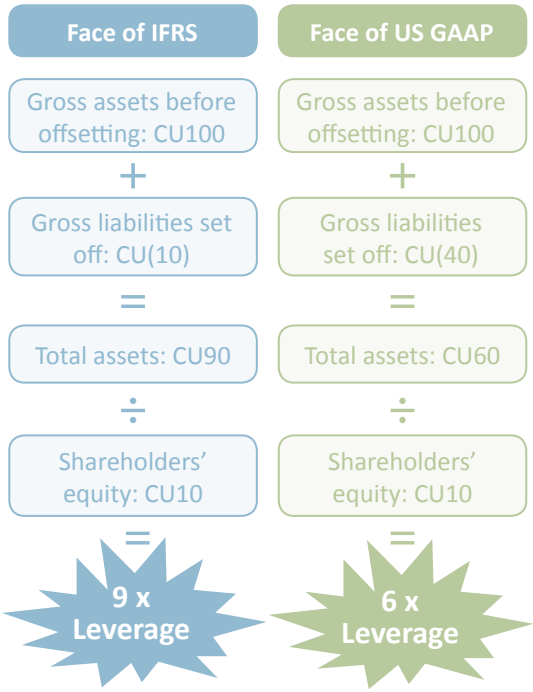
These useful disclosures are available regardless of whether the bank's financial statements are prepared in accordance with IFRS or US GAAP. We also touch on how these disclosures are linked to the developments in banking regulation—in particular the Basel III framework.

Getting behind the nets

The accounting Standard that addresses offsetting, IAS 32 *Financial Instruments: Presentation*, uses a different treatment for some offsetting arrangements than is used under US GAAP. This can result in significant differences between the size of balance sheets reported in accordance with IFRS compared to those reported in accordance with US GAAP.

[1] See Figure 1 on the following page for an example of the asset leverage ratio calculation.

Figure 1: One bank under two accounting Standards—an example of how the different treatment of offsetting arrangements can influence perceptions about leverage



- ***Same amount of gross assets:*** both banks have the same amount of gross assets.
- ***Same amount of gross liabilities:*** both banks have the same amount of gross liabilities.
- ***Different offsetting:*** both banks have in place the same rights to offset, however, the accounting for those arrangements is different.
- ***Different amounts of total assets reported in the balance sheet:*** the asset balances reported in the balance sheet are net of liabilities that were eligible under the respective accounting Standards to be offset.
- ***Same amount of shareholders' equity:*** all else being equal, the difference in accounting treatment for offsetting arrangements does not affect the level of reported shareholders' equity.
- ***Different levels of leverage:*** analysing leverage by using the face of the financial statements leads to a different impression of the level of leverage for the bank reporting under IFRS compared to the bank reporting under US GAAP. In this example the level of leverage is expressed as a multiple (total assets/ shareholders' equity), where a higher multiple implies higher leverage. Investors should be aware that banking regulators typically express the leverage ratio as a percentage (eg Tier 1 capital/Adjusted assets), where a lower percentage number implies higher leverage.

Common disclosures mitigate the accounting difference

The accounting guidance in IFRS and US GAAP that deals with offsetting does not require reconciliations of the actual reporting outcomes between the two sets of requirements, but there are similar disclosure requirements that can help investors make comparisons.

Under IFRS, for all financial instruments that are offset in the statement of financial position or that are subject to enforceable MNAs,[2] there shall be disclosed information that allows investors to evaluate the effects of the rights of set-off and other credit risk mitigants.[3] This information must be presented in a table separately for assets and liabilities. Figure 2 provides a stylised illustration.

Figure 2: Example of disclosure in IFRS notes

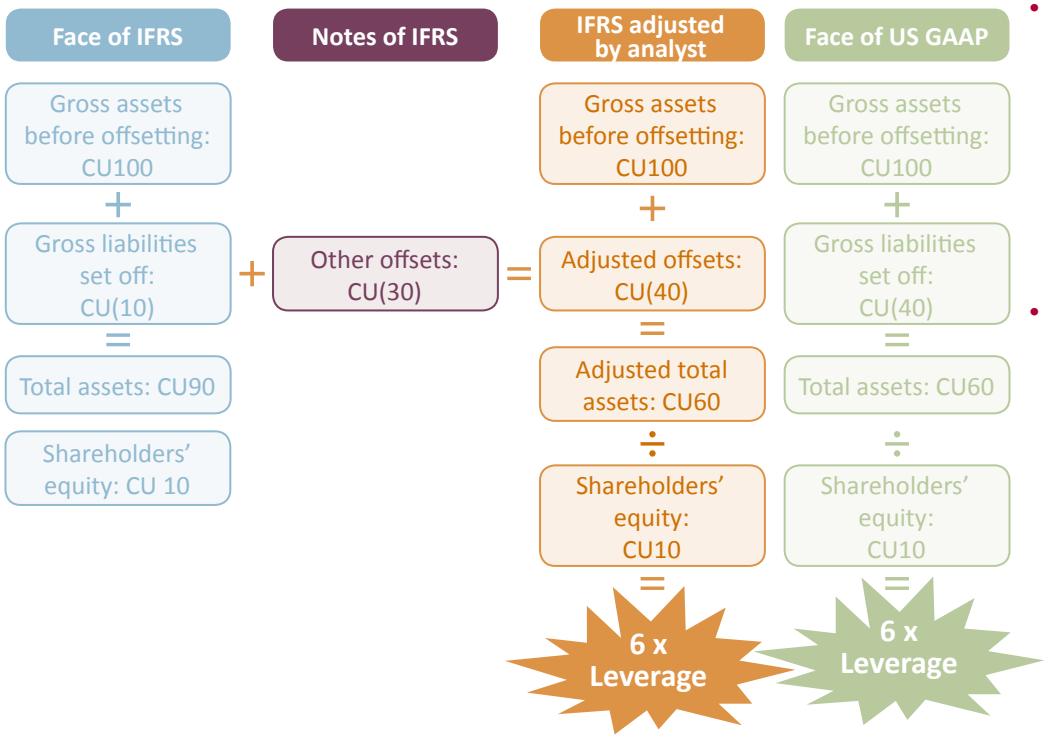
Financial instruments by category	Gross amounts of recognised financial assets before offsetting	Gross amounts of recognised financial liabilities set-off	Net amounts of financial assets presented in the statement of financial position	Other amounts not set-off in the statement of financial position		Net Amounts
				Impact of MNAs	Other impacts	
Financial instruments at fair value through profit or loss	100	(10)	90	(25)	(5)	**60**
Loans	100	(10)	**90**	0	0	**90**

Through these disclosures, investors are able to understand better the differences between the amounts reported under IFRS compared with those reported under US GAAP, particularly for the entities that have large amounts of derivative activities.

Figure 3 provides a stylised illustration of how an investor could evaluate the information reported under IFRS (in the statement of financial position and the notes) and use it to compare the information that has been reported under US GAAP.

[2] MNAs are explained in the 'jargon busting' section.
[3] IFRS 7 *Financial Instruments: Disclosures.*

Figure 3: Leveraging the notes, comparing the offsets



- Picking up from the comparison made in Figure 1, this figure illustrates how, by analysing disclosures in the notes, an analyst can perform adjustments that can make a comparison between a bank under IFRS and that under US GAAP more useful.
- A similar form of adjustment can be performed using the note disclosures that are required under US GAAP.

Jargon Busting

The accounting for companies in the banking sector is riddled with acronyms and industry-specific terms. The following points are intended to demystify some of the jargon investors see in this area:

(a) a right of set-off—a debtor's legal right to discharge all or part of the debt owed to another party by applying against that debt an amount that the other party owes to the debtor.

(b) A master netting arrangement (MNA)—an agreement between two counterparties who have multiple derivative contracts with each other. This agreement allows the net settlement of all these contracts through a single payment in the event of default on or termination of any one contract.

Note that 'offsetting' and 'netting' are often used interchangeably in accounting, but have different meanings in the context of MNAs.

Offsetting and set-off explained

Large banks that operate in the derivatives business trade with many counterparties. As part of their day-to-day risk management in managing relationships with counterparties, they usually use the 'rights of set-off' as risk management tools to help them manage counterparty credit risk and liquidity risk. These are legal rights to settle, or otherwise eliminate, all, or a portion, of an amount that is due to a creditor by setting-off against that amount all, or a portion, of the amount that is due from the creditor or a third party. The enforceability of the rights can vary by contract and jurisdiction.

In contrast to the rights of set-off, offsetting is an accounting term that is used to describe the presentation of the net amounts of financial assets and liabilities in the balance sheet as a result of an entity's rights of set-off. Offsetting is important because, when applied, it reduces the amounts of assets and liabilities presented in the balance sheet.

When do banks report a net figure?

Under IFRS (and US GAAP), when an entity meets specific criteria, it is allowed to offset certain assets and liabilities when presenting them in the balance sheet. These requirements are highly relevant to understanding the financial statements of banks, particularly those with wholesale or investment banking operations that use derivatives.

Under IFRS, a bank is *required* to offset a financial asset and a financial liability and report the net amount of the offsetting arrangement on its balance sheet when:

(a) it currently has a legally enforceable right to set-off its financial assets and financial liabilities; and

(b) it intends to do so, or to realise, the financial asset and the financial liability simultaneously.

Under US GAAP, a right of set-off exists when all of the following conditions are met:

(a) each of the two parties owes the other determinable amounts;

(b) the reporting party has the right to set-off the amount owed with the amount owed by the other party;

(c) the reporting party intends to set-off; and

(d) the right of set-off is enforceable by law.

A bank reporting under US GAAP that meets the criteria for net presentation may make an accounting policy choice to present, in the statement of financial position, either on a gross or a net basis. However, that policy should be applied consistently across all eligible transactions.

Although IFRS and US GAAP focus on similar criteria for offsetting to take place, if certain additional criteria are met then US GAAP provides an exception from condition (c) for the following financial instruments: derivative instruments and cash collateral posted subject to a master netting arrangement (MNA), and repurchase and reverse repurchase agreements. Such instruments that are subject to an enforceable MNA may be presented net under US GAAP when the other criteria are met.

As a result the different guidance dealing with offsetting as discussed, significant differences in the amounts of reported assets and liabilities can arise between banks reporting in accordance with IFRS compared to US GAAP.

How does this tie in with Basel III?

In the years following the 2008 financial crisis, the size of the balance sheet has taken on a greater significance in the eyes of bank regulators and hence investors.

We note that the Basel III banking rules are expected to incorporate a leverage ratio as a backstop to the risk-based solvency framework.

Why the increased interest in leverage ratios? We believe that this is, in part, because regulators concluded that the leverage ratio (equity-to-assets ratio) was a useful predictor of losses suffered during the financial crisis in addition to the ratio based on risk-weighted assets. Banks will start to report the Basel III leverage ratio in 2015.

It is not just Basel III that is putting greater emphasis on leverage ratios. Already, some jurisdictions have leverage ratio requirements in place (for example, Switzerland, USA, Canada and the UK) and others are examining proposals to introduce such measures (for example, Denmark, Netherlands and Sweden).

It should be noted that the leverage ratio calculated for bank regulatory purposes will differ from that calculated using an IFRS or a US GAAP balance sheet. This is because the regulatory calculations will frequently incorporate some specific adjustments. Nevertheless, the concepts behind the calculations are similar.

Contact us

If you would like to learn more about sizing up the balance sheet, *The Essentials* series or the IASB's investor engagement activities, visit: go.ifrs.org/Investor-Centre.

This issue of *The Essentials* has been compiled by the IFRS Foundation Education Initiative staff. The IFRS Foundation is an independent, not-for-profit organisation working in the public interest. One of the principal objectives of the IFRS Foundation is to develop a single set of high quality, understandable, enforceable and globally accepted International Financial Reporting Standards (IFRS) through its standard-setting body, the International Accounting Standards Board (IASB).

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