IFRS FASB

IASB/FASB Joint Board Meeting
September 2010

IASB Agenda reference **8A**

FASB Agenda reference

Staff Paper

Project	**Offsetting of financial assets and liabilities**
Topic	**Usefulness and appropriateness of offsetting**

DRAFT

Purpose

1. At the June 2010 meeting, the boards discussed offsetting (or netting) and asked the staff for additional information. This paper addresses the question about the usefulness of offsetting financial assets and liabilities in general.
2. Having considered the issues raised at that meeting, the staff has decided to address the boards' request in stages. As a starting point, the staff believes the boards should first address ***why*** financial assets and liabilities shall or can be offset in the statement of financial position. This, we believe, will help shape discussions going forward, in particular, in developing criteria for offset.
3. This paper addresses the following:
   a. Analysis of the issue
   b. Economic implications of offset arrangements
   c. Whether and when offsetting on the face of the statement of financial position is appropriate or provides useful information
4. This paper is accompanied by 3 other papers:
   a. **Agenda paper 8B** – sets out possible approaches to offsetting based on different risk types that the Boards could consider, should you decide to allow offset
   b. **Agenda paper 8C** – provides a summary of the feedback received on staff outreach to users of financial statements on the issue

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

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c. **Agenda paper 8D** – addresses the question of enforceability of bilateral netting arrangements including master netting agreements

5. Based on international outreach by the IASB staff, there is no consensus among the different types of users, among users from same investment house or bank or jurisdiction. Of the users that prefer net presentation on the face of the statement of financial position (from the IASB outreach), a majority stated preference for such presentation only where there is unconditional right to offset in the ordinary course of business (ie a right that is not only to be exercised in bankruptcy or in the event of default of a party to the contract). However, about a third of the respondents to the IASB survey indicated they had no preference between whether the right to offset was unconditional or conditional. The FASB staff outreach to analysts however points to a majority support for net presentation on the face of the statement of financial position based upon a conditional right of offset, although, responses from some of the FASB's Investors Technical Advisory Committee and a minority were in favour of a gross presentation.

Staff Views

6. Some staff believe that offsetting, generally, does not meet the objective of financial reporting, as set out in paragraphs 17 - 20 and hence financial assets and liabilities should be presented gross on the face of the statement of financial position. Those staff are of the view the only circumstance in which offsetting of financial assets and liabilities on the face of the financial statements **may** provide better information to users of financial statements will be where doing so reflects or provides information about an entity's expected future cash flows from settling two or more financial instruments.

7. These staff believe that it is more appropriate to require the gross positions to be presented on the face of the statement of financial positions and require entities to explain in the notes to the accounts their risk management approach, as it is currently done for hedge relationships and similar risk mitigating strategies. Those staff believe that this approach will be consistent with the role and use of disclosures as set out in the Boards *Frameworks*.

8. Other staff believe that offsetting of financial assets and liabilities on the face of the statement of financial position meets the objectives set out in paragraphs 17 - 20. Those staff believe, in particular, that netting is appropriate when an entity undertakes a number of financial instrument transactions with a single counterparty under a master netting agreement and the agreement provides the non-defaulting counterparty with the right to close out on a net basis all financial instruments covered by the agreement in the event of default by the other counterparty. These staff believe that it is appropriate to present the counterparty's net credit risk on the face of the balance sheet when the instruments are subject to an arrangement similar to the ISDA master netting agreement.

A. Analysis of the Issue

9. Offsetting, in accounting, is the presentation of assets and liabilities on a net basis in the primary financial statements. Offsetting is a presentation issue (how a financial asset and liability should be presented in a statement of financial position or how other elements should be presented in a primary financial statement). In contrast, recognition and derecognition address whether an asset or liability exists and whether continued recognition in the primary financial statements is appropriate.

10. Although conceptually different, offsetting that results in a net amount of zero and derecognition resulting in no gain or loss are indistinguishable in their effect on the statement of financial position. (Likewise, not recognising assets and liabilities of the same amount in financial statements achieves similar reporting results). Offsetting has traditionally been required (or permitted) when there is both a right and intention to offset two or more contracts. The view is that offsetting in such situations, in effect, represents that the entity has a single financial asset or financial liability.

B. Economic implications of offsetting (netting) arrangements

11. Offsetting arrangements allow market participants to

    (a) manage (and reduce) counterparty credit risks; and

(b) manage liquidity risk.

12. Netting arrangements, in general, reduce the credit risk exposures of market participants to counterparties relative to their gross exposures on the same set of underlying contracts.

13. Such mechanisms also permit the management of existing market risk exposures by taking on offsetting contracts with the same counterparty. These arrangements eliminate the need to negotiate the termination value of existing contracts.

14. For a regulated financial institution, position netting may also have regulatory capital implications.

C. Whether and when offsetting on the face of the statement of financial position is appropriate or provides useful information

15. The shared goal of the boards is to produce high quality financial reporting standards to assist in the efficient functioning of economies and the efficient allocation of resources in capital markets.

16. Hence in evaluating whether and when offsetting (netting) on the face of the statement of financial position is appropriate or provides useful information, the boards should consider whether netting is consistent with the objectives and the qualitative characteristics of financial reporting information as described in the conceptual frameworks.

Objectives of financial reporting

17. The existing *frameworks* of both the IASB and the FASB focus on providing information that is useful to a wide range of users in making economic decisions. This is the fundamental objective of information presented in financial statements. Both frameworks list a variety of present and potential users including equity investors, lenders, other creditors, employees, suppliers, customers, and governmental agencies.

18. Subsequent analysis, in this paper, is based more on the Exposure Draft – *An improved conceptual Framework for Financial reporting: The objectives of financial reporting* (“Conceptual Framework ED”), as it reflects the Boards common position and current thinking on the objectives of financial reporting and

the associated qualitative characteristics. We believe the ED is broadly consistent with the existing *Frameworks* of both Boards.

19. In Chapter 1, paragraph OB2 of the Conceptual Framework ED, the boards indicated that - "the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in making decisions in their capacity as capital providers…."

20. The Conceptual Framework ED further explains that the decisions that capital providers make include whether and how to allocate their resources to a particular entity (that is, whether and how to provide capital) and whether and how to protect or enhance their investments. It also emphasises that when making those decisions, capital providers are interested in assessing the entity's ability to generate net cash inflows and management's ability to protect and enhance the capital providers' investments. It further states that an entity's capital providers are directly interested in the amount, timing, and uncertainty of cash flows from dividends, interest, and the sale, redemption, or maturity of securities or loans.

21. As set out in the boards' respective (existing) *Frameworks*, information about an entity's economic resources and the claims to them (its financial position), can provide a user of the entity's financial statements an insight into the amount, timing, and uncertainty of its future cash flows. That information also is expected to help capital providers to identify an entity's financial strengths and weaknesses and to assess its liquidity and solvency.

22. Thus the objective of financial reporting necessitates provision of information in the statement of financial position about the economic resources of the entity (its assets) and the claims on those resources (its liabilities and equity).

23. Some staff believe that offsetting, generally, does not meet the objective of financial reporting, as set out in paragraphs 17 - 20 and hence financial assets and liabilities should be presented gross on the face of the statement of financial position. Those staff are of the view the only circumstance in which offsetting of financial assets and liabilities on the face of the financial statements **may** meet the objective in paragraphs 17 - 20 will be where doing so reflects or provides

information about an entity's expected future cash flows from settling two or more financial instruments.

24. Other staff believe that in making an assessment of which offsetting model best meets the objectives of the conceptual framework, the boards should consider paragraph OB8 from the Conceptual Framework ED which states, "individual primary users have different, and possibly conflicting, information needs and desires. The Board, in developing financial reporting standards, will seek the information set that will meet the needs of the maximum number of primary users."

25. These staff believe that offsetting does meet the objective set out in paragraphs 17 - 20 when an entity undertakes a number of financial instrument transactions with a single counterparty under a master netting agreement and the agreement provides the non-defaulting counterparty with the right to close out on a net basis all financial instruments covered by the agreement in the event of default by the other counterparty. These staff believe that it is appropriate to present the counterparty's net credit risk on the face of the balance sheet when the instruments are subject to an arrangement similar to the ISDA master netting agreement.

26. The staff believes that the objective set out in paragraphs 17-20 is generally not met and hence offsetting is not appropriate when.

    (a) Several different financial instruments are used to emulate the features of a single financial instrument ('a synthetic instrument');

    (b) Financial assets and liabilities arise from financial instruments having the same primary risk exposure but involve different counterparties;

    (c) Financial or other assets are pledged as collateral for non recourse financial liabilities;

    (d) Financial assets are set aside in trust by a debtor for the purpose of discharging an obligation without those assets having been accepted by the creditor in settlement of the obligation (for, example, a sinking fund arrangement); or

(e) Obligations incurred as a result of events giving rise to losses are expected to be recovered from a third party by virtue of a claim made under an insurance contract.

Qualitative characteristics of financial reporting

27. Capital providers are interested in financial reporting because it provides information that is useful for making decisions. The qualitative characteristics are the attributes that make information provided in financial statements useful to users.

28. The Boards have tentatively agreed to the following qualitative characteristics as part of the joint Conceptual Framework project[1] –

    (a) **Relevance** – information is relevant if it is capable of making a difference in the decisions made by users in their capacity as capital providers;

    (b) **Faithful representation** – financial information that faithfully represents an economic phenomenon depicts the economic substance of the underlying transaction, event or circumstances (ie to be complete, neutral and free from material error);

    (c) **Comparability** – the quality of information that enables users to identify similarities in and differences between two sets of economic phenomena;

    (d) **Understandability** – the quality of information that enables users to comprehend its meaning;

    (e) **Verifiability** – a quality of information that helps assure users that information faithfully represents the economic phenomena that it purports to represent; and

    (f) **Timeliness** – having information available to decision makers before it loses its capacity to influence decisions.

29. The staff is of the view that characteristics (a) – (c) are the most relevant characteristics for the issue at hand and hence the following analysis focuses on those characteristics.

[1] Exposure Draft – *An improved conceptual framework for financial reporting: The objectives of financial reporting.*

Relevance

30. The qualitative characteristic of relevance is concerned with how closely linked an economic phenomenon is to the decisions of capital providers. Application of the qualitative characteristic of relevance identifies which economic phenomena should be included in financial reports so as to provide users of the financial statements with decision-useful information. Relevance helps in identifying the item to be included in the financial statements but not how that item should be presented or shown in the financial statements.

31. The economic phenomena in this issue are the economic resources of the entity (its assets) and the claims on those resources (its liabilities) arising from financial contracts/instruments.

32. There is no question as to the relevance of recognising or reflecting the assets and liabilities arising from such contracts in financial statements. As noted in paragraph 30, relevance however refers to the economic phenomena, not to how they should be presented or shown in the financial statements.

33. Offsetting appears to meet the relevance criteria if doing so reflects an entity's expected future cash flows (from settling two or more separate financial statements), as such information would provide users with information about the amount, timing, and uncertainty of the entity's net future cash flows. In such scenario, one may even argue that the entity has a single financial asset or financial liability by virtue of the link between the asset and the liability and hence that is the information that is relevant to users of the financial statements.

34. To be able to conclude that a particular item of information will affect users' decisions, it may require an understanding of how capital providers use financial reporting information and how financial reports might better serve their needs.

35. Based on international outreach by the IASB staff, there is no consensus among the different types of users, among users from the same investment house or bank or jurisdiction. The FASB staff outreach however points to a majority support for net

presentation on the face of the statement of financial position, although, responses from some of the members of the FASB's Investors Technical Advisory Committee and a significant minority were in favour of a gross presentation.

36. However, users are nearly unanimous that both gross and net information are useful and both are required for analysing any financial statement. They are also nearly unanimous in their preference for a converged solution in this area. Users also indicated a preference for a mandatory requirement to offset if the criteria are met (should the Boards decide to allow offsetting). A summary of the feedback from the outreach is set out in paper 8C.

37. The staff notes that netting will have an impact on reported total assets and liabilities. These totals are used by many users in measuring or calculating leverage, solvency and other key indicators. To the extent that netting reduces users' ability to compute these metrics, one may conclude that netting on the face of the balance sheet provides less relevant information to users.

38. Netting involves aggregating assets and liabilities. Financial assets and liabilities may have different impacts on the financial position of an entity and hence users may take them into account differently in predicting future cash flows.

39. Presenting such assets and liabilities as an aggregated amount/balance may not be conducive for analysis aimed at assessing the amount, timing and uncertainty of future cash flows. On the other hand, presenting assets and liabilities separately could assist users in understanding an entity's financial results and in predicting its future cash flows. Conversely, it could be argued that presenting information on a gross basis does not provide any more information about the timing of cash flows than does presenting information on a net basis.

Faithful representation

40. The staff notes that, once relevance is applied to determine which economic phenomena are related to or necessary for the decisions to be made, faithful representation is applied to determine how that information should be presented (on the face of the financial statements) so that it best corresponds to the relevant phenomena. Application of the faithful representation characteristic determines

whether a proposed presentation or communication in words and numbers is faithful (or unfaithful) to the economic phenomena being presented or communicated.

41. Unfaithful representation of a relevant economic phenomena results in information that is not decision useful and vice versa.

42. The businesses of entities are routinely affected by a variety of transactions and events. The financial statements portray the effects of those transactions and events with highly summarised numbers and words. Users however often treat each individual item, subtotal or other part of a financial statement differently.

43. Although offsetting on the basis of absence or mitigation of a particular risk may provide a partial outlook of the relevant phenomenon, it might not provide a complete representation of the economic phenomenon. For example, netting on the basis of mitigation or elimination of a particular risk may mask the presence of other risks and the presentation or communication may not be complete. Some staff believe that net presentation (of the gross fair value of the outflows and the inflows) on the face of the statement of financial positions reduces users ability to understand the implied economic leverage position of an entity.

44. Those staff believe that aggregating the asset and liability positions of several of such instruments could further reduce users' ability to understand the risk exposures of an entity arising from such contracts. If these positions are aggregated, users cannot, for example, determine which side of contracts an entity holds and therefore the risks the contracts pose. Investors can better assess these risks if they know which side of such contracts an entity holds.

45. Other staff disagree with the view set out in paragraphs 43 and 44 (as discussed above). These staff believe that even without offsetting these risk exposures are not evident on the face of the balance sheet. They also do not believe that if these positions are aggregated, users cannot determine which side of contracts an entity holds as this information is not conveyed even when there is no offsetting. They agree that investors can better assess these risks if they know which side of such contracts an entity holds but they are of the view that the balance sheet does not convey this information regardless of whether there is offsetting or not.

46. Some staff believe that, under existing and proposed guidance, where an entity enters into a contract that effectively hedges its exposure to a particular risk, the entity is not required or permitted to present the asset and the liability in that hedge relationship net on the face of the statement of financial position. Some staff therefore question why net presentation should be allowed or required where a master netting agreement reduces an entity's credit exposure (one type of risk) on financial contracts.

47. Other staff believe that this question is not on point because the counterparty to the derivative that is hedging the risk is generally different than counterparty to the hedged risk and in many cases the hedged risk is not a financial asset or liability or otherwise measured at fair value as is the requirement under US GAAP for offsetting derivative assets and liabilities.

Comparability

48. Netting of financial assets and liabilities may impact mostly financial institutions. Information about an entity is more useful if it can be compared with similar information about other entities. However, netting assets and liabilities may make it difficult for users to perform a benchmark analysis of entities across industries. For example, a key tool in portfolio allocation and cross industry analysis is asset efficiency and leverage ratios. Netting of financial assets and liabilities could distort such ratios and make cross sector comparisons difficult.

The role of disclosures

49. As discussed earlier, the Boards Conceptual *Frameworks* establish that the purpose of the statement of financial position is to provide information about financial position of an entity. Further both *Frameworks* conclude that of the elements of financial statements, those which are directly related to the measurement of financial position and are thus shown in the statement of financial position, are assets, liabilities and equity (as so defined in the *Frameworks*).

50. The IASB *Framework* explains that in addition to the elements of financial statements, financial statements also contain notes and supplementary schedules

and other information. For example, they may contain additional information that is relevant to the needs of users about the items in the balance sheet and income statement such as disclosures about the risks and uncertainties affecting the entity, information about geographical and industry segments and the effect on the entity of changing prices**.**

51. Moreover, in paragraph 37, the IASB *Framework* acknowledges that preparers of financial statements have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that may occur. It explains that such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements (ie in measurement).

52. Paragraph 54 of FASB Concept Statement 1 states that – "Financial reporting should include explanations and interpretations to help users understand financial information provided. For example, the usefulness of financial information as an aid to investors, creditors, and others in forming expectations about a business enterprise may be enhanced by management's explanations of the information. Management knows more about the enterprise and its affairs than investors, creditors, or other "outsiders" and can often increase the usefulness of financial information by identifying certain transactions, other events, and circumstances that affect the enterprise and explaining their financial impact on it. …..Moreover, financial reporting often provides information that depends on, or is affected by, management's estimates and judgment. Investors, creditors, and others are aided in evaluating estimates and judgmental information by explanations of underlying assumptions or methods used, including disclosure of significant uncertainties about principal underlying assumptions or estimates. Financial reporting may, of course, provide information in addition to that specified by financial accounting standards, regulatory rules, or custom".

53. Hence the role and use of disclosures as set out in the Boards *Frameworks* is something that needs to be considered in this project. .

Staff Conclusion

54. The staff believes that unless offsetting provides information about an entity's expected future cash flows it would not meet the objective of financial reporting. However, there is disagreement amongst the staff about the extent to which offsetting provides such information. There is also disagreement amongst users about the extent to which offsetting provides information about expected future cash flows.

Question for the boards:

Based on the analysis and different staff views expressed in this paper, as well as the different views expressed in feedback from the users of financial statements in agenda paper 8C (IASB) / 3 (FASB), do the boards wish to consider alternative approaches to offsetting on the face of the financial position? The possible approaches the boards could consider will include those described in agenda paper 8B 3 (FASB), as well as an alternative of allowing no offsetting.