IASB/FASB Meeting
Week commencing 18 July 2011

IASB Agenda reference 3

FASB Agenda reference 16

Staff Paper

Project **Offsetting Financial Assets and Liabilities**

Topic **Disclosures – Cover Note**

Introduction

1. At the May 2011 joint board meeting, the boards discussed the comment letters and feedback received on the exposure draft *Offsetting Financial Assets and Financial Liabilities* (the Exposure Draft or ED).

2. At the 14 June, 2011 joint board meeting, the boards discussed alternative approaches for offsetting financial assets and financial liabilities in the statement of financial position. The boards considered the following alternative approaches to offsetting:

   (a) **Alternative 1**—This approach requires an unconditional right of setoff that is legally enforceable both in the normal course of business and in bankruptcy, insolvency, or default and intention to settle a financial asset and financial liability net or simultaneously.

   (b) **Alternative 2**—This approach requires offset if an entity currently has a legally enforceable right to set-off a financial asset and financial liability and the entity intends to settle the financial asset and financial liability net or simultaneously.

   (c) **Alternative 3**—This approach provides an exception from the general offsetting criteria for derivative instruments and allows offsetting of fair value amounts recognized for derivatives and fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral arising from derivative instrument(s) recognized at fair value with the same counterparty under a master netting agreement. This approach requires a right of setoff that is only enforceable in bankruptcy, insolvency, or default of one of the counterparties.

(i) Alternative 3a—This approach limits the exception for offsetting of derivative instruments under Alternative 3 to only collateralized derivatives with daily variation margin postings.

3. The IASB supported Alternative 1. The FASB supported Alternative 3.

4. The boards noted that users consistently asked that information be provided to help reconcile any differences in the offsetting requirements under IFRS and US GAAP so the boards decided to work on converging disclosure requirements to assist users comparing financial statements prepared under IFRS and US GAAP.

Purpose of the paper

5. This paper is accompanied by two other papers, Agenda Papers 3A and 3B /Memos 16A and 16B:

    (a) **Agenda Paper 3A/Memo 16A – Disclosures: Scope**

    This paper addresses respondents' comments about the scope of the offsetting disclosure requirements. In particular, the paper focuses on whether the disclosure requirements should be restricted to some types of entities, financial instruments or situations.

    (b) **Agenda Paper 3B /Memo16B – Disclosure Alternatives**

    In the light of the boards' decision to work on converging disclosure requirements to assist users comparing financial statements prepared under IFRS and US GAAP, the staff has identified alternative sets of disclosure requirements for the boards' consideration. This paper sets out those alternative disclosure requirements.

6. This cover note also summarizes additional considerations on disclosures that were raised by respondents.

Respondents' comments on proposed disclosures

7. IASB Agenda Paper 5/ FASB Memo 13A (May 2011) provided a summary of the comment letters and feedback received on the ED.

8. As noted in the feedback summary, users almost unanimously supported the proposed disclosures. Irrespective of their individual views for offsetting on the statement of financial position, there was consensus that both gross and net information is useful and required for analysing financial statements.

9. However, many preparers were concerned about various operational and cost-benefit aspects of the disclosures and asked the boards to consider modifying the proposed disclosures for various items.

10. In addition to the issues directly analysed in Agenda Papers 3A-3B/Memos 16A-16B, respondents raised other concerns on the proposed disclosure requirements in the ED (paragraphs 11 to 33). **The staff has not provided separate analysis of those additional issues as the staff believes the analysis and recommendations in Agenda Papers 3A and 3B/Memos 16A and 16B address those concerns.**

11. For the sake of completeness, the staff has summarised below those additional issues that respondents raised in their comment letters.

Disaggregation

12. The Exposure Draft requires that entities provide the required disclosures by class of financial instruments.

13. A number of respondents, especially those that do not present information by class on the statement of financial position, were concerned about the requirement to provide detailed information by class of financial instruments. They asked the boards to consider requiring information based on other factors, such as by counterparty, to align with how the credit risk of such instruments is managed.

14. Respondents noted that portfolio-level adjustments and collateral are often calculated and managed at a counterparty level. In addition, if an entity does

not net a particular set of instruments on the statement of financial position based on a conditional right of set-off, determining positions that might be offset based on such rights would be a significant burden.

15. Some respondents noted that IFRS 7 *Financial Instruments: Disclosures* and Topic 820, *Fair Value Measurements and Disclosures,* explain how to determine a class of financial instrument. They urged the boards to clarify whether the term 'class of financial instrument', as used in the Exposure Draft, is consistent with that used in other accounting standards and at what level of granularity the definition should be applied. They suggested that if the boards maintain this wording, any reference to class should clarify that it is intended to refer to a broad category of financial assets and liabilities such as "derivative assets" or "repurchase agreement liabilities", and not to sub-categories of those instruments.

16. In addition, many users have requested comparable information but most have not requested specific levels of disaggregation beyond distinguishing between derivatives and sale and repurchase and reverse sale and repurchase agreements and securities lending amounts.

17. However, some users have requested a breakdown of information by type so that they were able to determine if the valuation of the amounts being offset were based on independently verifiable amounts, especially because the capital charges on some over-the-counter products are greater than exchange traded products.

Collateral

18. Paragraph 12(f) of the ED requires disclosure of the amount of financial instrument collateral obtained or pledged in respect of an entity's financial assets and financial liabilities.

19. Many respondents also commented on the duplicative nature of some aspects of the proposed disclosure requirements. They were concerned that some of the proposed disclosures are currently required by US GAAP or IFRSs.

20. Some respondents urged the boards to review the proposed disclosures in the context of existing and proposed disclosure requirements to ensure that the level of disclosure requirements is balanced and consistent across the entire accounting regime for financial instruments.

21. IFRS 7 already requires disclosure of qualitative and quantitative information about credit, market and liquidity risk arising from financial instruments and how an entity manages its exposures to those risks. Entities are required to disclose maximum exposure to credit risk without taking into account any collateral or other credit enhancement. However, the maximum exposure takes into account amounts offset in the statement of financial position.

22. Additionally, Topic 815, *Derivatives and Hedg*ing and Topic 825, *Financial Instruments* (US GAAP) have similar requirements for credit risk. Topic 825 requires that an entity disclose its policy of requiring collateral or other securities, as well as its policy of entering into master netting agreements, information about master netting agreements and the extent to which they would reduce an entity's maximum amount of loss due to credit risk.

23. Topic 815 also requires disclosure of the gross fair value of derivative instruments. This disclosure applies only to derivative instruments. Hence, the gross amounts receivable or payable in respect of sale and repurchase and reverse sale and repurchase agreements are not required to be disclosed.

24. A few respondents questioned whether disclosure of non-financial collateral, such as property in a mortgage portfolio, would also be useful to users in assessing the risk exposures of the portfolio.

25. Users consistently indicated that collateral is important in their review of an entity's credit exposure.

Portfolio-level adjustments

26. Paragraph 12(b)(2) of the ED requires an entity to disclose the portfolio-level adjustments made in fair value measurement to reflect the effect of the entity's net exposure to the credit risk of a counterparty or a counterparty's net exposure to the credit risk of the entity.

27. The majority of respondents that provided feedback on this requirement disagreed with including it within the offsetting disclosures. Some respondents noted that counterparty risk is a matter of measurement, rather than presentation, as mentioned in BC46. Respondents are concerned that portfolio-level adjustments are considered to be a component of valuation, rather than an offsetting issue, and are thus outside the scope of this project. They argue that they should rather be included in the disclosures on fair value measurement.

Level of granularity

28. Paragraphs 12 and 13 of the ED require disclosure of:

    (a) the amounts of financial assets and financial liabilities that the entity has an unconditional and legally enforceable right to set-off but that the entity does not intend to settle net or simultaneously;

    (b) the amounts of financial assets and financial liabilities that the entity has a conditional right to setoff, separately by each type of conditional right;

    (c) the net amount of financial assets and financial liabilities after taking into account the effect of the items in paragraphs 12(a)-(d) in the ED, and

    (d) a description of each type of conditional right of set-off separately disclosed.

29. Some respondents believe that the benefit of providing the level of information noted in paragraph 28 does not outweigh the costs to preparers of developing systems to assess and track those items.

30. Preparers were concerned that having to identify items that they had the right but not the intention to set-off (paragraph 28 (a)) would require extensive system and operational changes while providing little benefit to users.

31. Many preparers were concerned about having to search for and separate all conditional rights (paragraph 28 (b)), regardless of the type and substance. There could be conditions based on change of control or tax regulations, for example, and they questioned whether this provided additional value for users.

32. Some preparers also indicated that information about each type of conditional right is not used to manage credit risk and is unlikely to assist users in their assessment of an entity's performance.

33. A number of respondents suggested aggregating some of the information required by the proposed disclosures and recommended providing qualitative disclosures instead to reduce costs to preparers.

34. However, a majority of users agreed with the direction of the proposed disclosure requirements on offsetting and related credit mitigation arrangements and that the proposed quantitative information in a tabular format presented in the ED is helpful in understanding the risk profile of the entity.

35. As noted in paragraph 10, the staff has not provided separate analysis of the additional issues in paragraphs 12 to 34 as the staff believes the analysis and recommendations in Agenda Papers 3A and 3B/Memos16A and 16B address those concerns.