

Staff
Paper

Project **Offsetting Financial Assets and Liabilities**Topic **Offsetting model - IFRSs**

Introduction/Purpose of the paper

1. At the 14 June 2011 joint meeting, the boards discussed alternatives for a converged approach to offsetting financial assets and financial liabilities.
2. The following alternative offsetting approaches were discussed and voted on by the boards at that meeting:
 - (a) **Alternative 1** - the approach proposed in the exposure draft *Offsetting Financial Assets and Financial Liabilities* (the ED). This is a model based on an unconditional right and intention to offset, taking into account the analysis and recommendations of the staff in Agenda Papers 5B-5D/Memos 15B-15D (June 2011). (Those papers are substantially the same as Agenda Papers 6B – 6D, to be discussed at this session.),
 - (b) **Alternative 2** - an approach which requires offsetting if an entity *currently* has a legally enforceable right to set off the recognised amounts and intends either to settle net or settle simultaneously (ie the approach in IAS 32) and
 - (c) **Alternatives 3 and 3a** - approaches based on conditional rights of offset for some derivative instruments
3. The IASB voted unanimously in favour of an offsetting model based on an unconditional right and intention to offset (**Alternative 1**). The majority of the FASB voted in favour of an approach that allows offset of derivative instruments if an entity has a conditional right of set-off (**Alternative 3**).

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of 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 IASB. Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the IASB at public meetings are reported in *IASB Update*. Official pronouncements of the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

4. The boards also noted that users consistently asked that information be provided to help reconcile any differences in the offsetting requirements for IFRSs and US GAAP. The boards therefore decided to work on converging disclosure requirements to assist users in comparing financial statements prepared in accordance with IFRSs and US GAAP.
5. The staff recommendation for revised disclosure requirements will be discussed by the boards at the July joint meeting.
6. The staff notes that the Board's decision at the June meeting to pursue Alternative 1 was taken in the context of a joint project to replace the offsetting requirements/ guidance in both IFRSs and US GAAP with a common offsetting standard. Some also note that the offsetting requirements in IAS 32 were reopened with an objective of reaching a converged solution and question the appropriateness or need for change absent convergence.
7. Following the boards' preference for different offsetting approaches and hence the decision not pursue a common offsetting model, the staff is asking the Board in this paper to reconfirm whether they would like to:
 - (a) move forward with the ED, as modified by Agenda Papers 6B-6D (**Approach A**), or
 - (b) retain the current offsetting requirements in IAS 32 *Financial Instruments: Presentation* (**Approach B**).
8. **This paper assumes that any disclosure requirements that the boards may develop will supplement either of the above approaches.**

Section A: Way Forward

9. As noted in paragraph 3, at the 14 June 2011 meeting the boards voted for different underlying approaches to offsetting. The IASB voted unanimously for Alternative 1, which is referred to as **Approach A** in this paper (paragraph 7(a)).

10. The staff notes that an alternative retaining the offsetting approach in IAS 32 (Alternative 2 Agenda Paper 5A/Memo 15A- Appendix B)) was also presented at the June meeting but was not chosen by the IASB.
11. Given that the boards did not agree on a common approach to offsetting, the staff would like to confirm whether the Board wants to take Approach A or Approach B. The main difference between these approaches, other than the modifications in response to feedback received, is that **Approach A** (paragraph 7(a)) requires offset on the basis of a right of set-off that is enforceable *at all times* while **Approach B** (paragraph 7(b)) would require offset if an entity *currently* has a legally enforceable right of set-off.
12. **Approach A** is the approach proposed in the ED, revised to address feedback received.
13. **Approach B** is the current offsetting approach in IAS 32.
14. **Approach A** and **Approach B** are outlined in further detail in Section B below.

Section B: Alternative Approaches

Approach A: Continue with proposals in the ED, as revised

15. Alternative A would involve finalising the approach proposed in the ED. The approach proposed in the ED requires an entity to offset a recognised financial asset and a recognised financial liability when the entity:
 - (a) has an unconditional and legally enforceable right to set off the financial asset and financial liability and
 - (b) intends either:
 - (i) to settle the financial asset and financial liability on a net basis or
 - (ii) to realise the financial asset and settle the financial liability simultaneously.
16. Many respondents to the ED, while supportive of the general model, raised concerns regarding treatment of certain items. Agenda Papers 6B-6D discuss how the boards might address the concerns raised by respondents in respect of the proposed approach in the ED (ie unit of account, treatment of collateral

and simultaneous settlement) . Appendix 2 of this paper summarises these proposed modifications to the approach proposed in the ED.

17. In the ED the boards concluded that the net amount represents the entity's right or obligation if (a) the entity has the ability to insist on a net settlement or enforce net settlement in all situations (ie the exercise of that right is not contingent on a future event), (b) that ability is assured, and (c) the entity intends to receive or pay a single net amount, or to settle simultaneously¹.
18. Thus the ED requires the right of set-off to be enforceable in bankruptcy, default or insolvency and in the normal course of business in order to make sure that the right of set off will and can be exercised and that the entity's exposure is the net amount at all times². This is because if the right of offset cannot and may not be exercisable in some scenarios (such as the entity's own default or bankruptcy), offsetting may not reflect the economic substance of the transaction or financial position of the entity.
19. Arguably, presenting a financial asset and a financial liability net when the entity does not have a right both in the normal course of business and bankruptcy /default would paint a misleading picture of its financial position as the net amount is not necessarily its net exposure.
20. Moreover, some would argue that a right of set-off that is not enforceable in bankruptcy is counterintuitive. A right of offset is crucial in bankruptcy and if that right cannot be enforced in bankruptcy it begs the question why an entity should be allowed to present net as its net exposure.
21. Some respondents believe that the proposals in the ED, as modified, will address implementation concerns faced by IAS 32 preparers today and the resultant diversity in practice.
22. The feedback received in response to the ED highlighted the following inconsistencies in the application of offsetting requirements in IAS 32:
 - (a) Currently enforceable right of set-off –

¹ Paragraphs BC11

² AP 6D discusses some implementation issues regarding enforceable *at all times* and the staff's recommendation for resolving such issues.

- (i) IAS 32 indicates an entity must *currently* have a legally enforceable right of set-off. There is considerable diversity in practice as to the meaning of this phrase. As IAS 32 does not give specific guidance about what ‘**currently**’ means, some have interpreted this to mean a right of offset that is enforceable only in the normal course of business.
 - (ii) Others interpret IAS 32 as requiring a right of set-off that is enforceable in both bankruptcy or insolvency and in the normal course of business.
- (b) Legally enforceable –
- (i) IAS 32 requires that the right to setoff should be ‘legally enforceable’. However, it does not provide specific guidance as to the degree of assurance required to meet the ‘currently enforceable’ criterion.
 - (ii) Hence some argue that the assessment of enforceability should cover only normal course of business whilst others assess enforceability in the normal course of business and in bankruptcy or insolvency of one or both parties.
- (c) Simultaneous settlement criterion –
- (i) IAS 32 defines simultaneous settlement to mean “at the same moment.” However, many respondents indicated that simultaneous settlement is interpreted in various ways in practice today by IFRS preparers.
 - (ii) For example, many preparers and accounting firms have interpreted IAS 32 to mean that settlement through a clearinghouse always meets the simultaneous settlement criterion. Even within the same accounting firm, this criterion is interpreted differently across IFRS jurisdictions.
 - (iii) Others believe simultaneous settlement criterion is met only when settlement occurs at the same moment (as explicitly stated in IAS 32 paragraph 48). And still others analogise to the

guidance in FASB ASC Topic 210 Balance Sheet paragraph 20-45-11³ to interpret and apply the simultaneous settlement criterion in IAS 32 for repurchase and reverse repurchase agreements.

(d) Unit of account –

- (i) Some industries (eg energy producers and traders) apply the offsetting criteria to identifiable cash flows and achieve offsetting in that way in accordance with IFRSs today. Other industries (eg banks) apply the offsetting criteria to individual financial instruments and, in some case, to groups of financial instruments but not to identifiable cash flows (portions of financial assets and financial liabilities).
- (ii) Thus there is diversity in practice as to the unit of account that the offsetting guidance in IAS 32 should or can be applied to. This reduces comparability of accounts prepared under IFRS today.

(e) Collateral/Variation margin –

- (i) IAS 32 is silent on whether an entity can offset collateral/variation margin and the related financial asset or financial liability. The standard also does not provide any indication as to when the offsetting guidance can be applied to groups of financial instruments and as to whether in some cases offsetting a group of financial assets and financial liabilities meet the offsetting criteria.
- (ii) Today some apply the guidance to achieve offset of such items (that are settled in a particular way on some exchanges or clearing houses). Others do not apply the guidance in that manner or have not considered that the guidance can or should be applied in that way.

³ Formerly FASB Interpretation (FIN) No. 41 *Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements (an interpretation of APB Opinion No. 10 and a modification of FASB Interpretation No. 39)*

23. Thus some argue that the Board should address the diversity in practice to improve comparability of financial statements prepared in accordance with IFRSs. The staff notes that Agenda Papers 6B – 6D provide analysis of those issues and recommendations as to how the Board might address those concerns.
24. Some argue that, should the Board decide to address the above differences, it would inevitably arrive at an approach similar to or the same as **Approach A**.
25. They also believe that the work needed to address the above differences has largely been completed and therefore finalising the recommended changes is a logical next step in the process.
26. Some also believe that the revised ED approach would move the IFRS offsetting requirements closer to the basic US GAAP offsetting guidance (ie the general offsetting requirements in US GAAP as opposed to the specific exemptions for derivatives). This could make the proposed disclosure requirements more meaningful as both standards would start from a similar base (other than for offset of derivatives). See comparison of these requirements in Appendix 1.
27. Some also argue that even if the approach in the ED, as modified (**Approach A**), does not result in converged offsetting requirements, it would be an improvement from a conceptual standpoint, to existing IFRS.

Approach B: Maintain the current guidance in IAS 32

28. IAS 32 paragraph 42(a) requires that an entity *currently* has a legally enforceable right to set off in order to set off its financial assets and financial liabilities on the statement of financial position.
29. As noted in paragraph 22(a)(i) IAS 32 does not provide any guidance on what ‘currently’ means. Some have interpreted this to mean a right of set-off that is exercisable or enforceable only in the normal course of business.
30. Those that interpret ‘currently’ as “enforceable only in the normal course of business” believe that the statement of financial position is intended to show an entity’s position in the normal course of business. They argue that as financial

statements are prepared on a going concern basis, it is only necessary that the (unconditional) right of offset be enforceable in the normal course of business.

31. As a going concern approach to presentation does not involve consideration of what the parties can do in bankruptcy or default of either party it is argued that it is not appropriate to prepare financial statements and present financial assets and financial liabilities based on those assumptions.
32. Based on paragraph C6 in the ED⁴, entities would have to obtain a level of assurance that the right can be enforced even in the event of default. Some respondents expressed concern that the ED's requirements to determine what might or could happen in the event of default or bankruptcy (in addition to the normal course of business) will impose additional burden and cost on preparers to prove that contracts are enforceable in all circumstances (while these respondents believe that today they do not have to do so).
33. Respondents also raised concerns that the legally enforceable criterion in the ED is more restrictive than the current IAS 32 criteria and therefore would result in less offsetting in practice. They indicated that, frequently in practice, they currently have the right to offset only in the normal course of business but are not sure if they can do so in the case of default or bankruptcy. In some jurisdictions legal assurance may contain conditions that call its robustness into doubt, particularly where no case law precedent on bankruptcy is available. Although every effort has been made to put the best possible arrangements in place this issue will remain for some jurisdictions. As these respondents focus on a going concern basis they also argue that an additional focus on rights in bankruptcy is not relevant.
34. Some IFRS preparers are of the view that the approach to offsetting in IAS 32 is consistent with the definition of assets and liabilities (i.e. their rights and obligations) as well as how they do business, and has stood the test of time during the financial crisis. They also believe that IAS 32 has not created significant diversity in practice for IFRS preparers.

⁴ Paragraph C6 states that "whether an entity's right of set-off meets the legally enforceable right of set-off criterion will depend on the law governing the contract and the bankruptcy regime that governs the insolvency of the counterparties. Therefore, the laws applicable to the relationships between the parties...need to be considered to ascertain whether the right of set-off is enforceable in all circumstances."

35. In addition, maintaining the current guidance with additional disclosure requirements may be seen as the most cost-effective way forward for IFRS preparers, especially in light of the considerable volume of changes that may result from forthcoming IFRSs including in the accounting for financial instruments.

Section C: Questions for the Board

36. The staff would like the Board to confirm whether:
- (a) it would like to move forward with the proposals in the ED, as revised (**Approach A**), or
 - (b) it would like to retain the offsetting requirements in IAS 32 (**Approach B**).
37. **Both approaches will include modified disclosure requirements as analysed by the staff paper in the July joint board meeting.**
38. As noted in paragraphs 21 to 27, **Approach A** has the advantage of clarifying IAS 32, removing the diversity in practice in the application of that offsetting guidance (legal enforceability and simultaneous settlement) and providing a more conceptual approach to offsetting.
39. **Approach A** would also bring IAS 32 more in line with other IFRSs that reference legal enforceability to achieve offsetting; namely IAS 12 *Income Taxes* paragraphs 71-76 and IAS 19 *Employee Benefits* paragraphs 116-117 (paragraphs 131 -132 as amended in June 2011).⁵
40. As noted in paragraph 35, **Approach B** has the advantage of not requiring changes to current practice for IFRS preparers, which may be more beneficial from a cost perspective, especially in light of the proposed changes to other IFRSs. Also, given that the IASB and the FASB have not supported the same approach to offsetting some argue that the main impetus to change the offsetting requirements in IAS 32 has gone.

⁵ IAS 12 paragraphs 71(a) and 74(a) refer to “legally enforceable rights to set off”. IAS 19 paragraph 116 (131 as revised) refers to offsetting plan assets and liabilities when an entity has a legally enforceable right. Neither refer to **current** rights of set off.

Question 1: Way forward

Which alternative set out in paragraph 36 would the Board like to pursue?

- (a) **Approach A:** Move forward with the proposals in the ED, (with consideration of the recommendations in Agenda Papers 6B-6D),
or
- (b) **Approach B:** Retain the existing IAS 32 model for offsetting.

If neither, why? What other approaches would the Board like to pursue, and why?

Appendix 1: Comparison to US GAAP guidance

The following tables illustrate the two approaches and compare them to the main US GAAP offsetting guidance (before the exception for derivatives and repurchase/reverse repurchase agreements). Even though the boards will not be converging offsetting requirements, the staff has provided this comparison to show the differences between the models going forward.

General approaches

	IFRS approaches		US GAAP
	A	B	Basic model ⁶
Enforceable currently only		X	
Unconditional/enforceable at all times	X		X
Intent to settle net	X	X	X
Intent to settle simultaneously (at the same moment)		X	
Intention to settle simultaneously, modified	X		X ⁷
Collateral, modified	X		X ⁷
Unit of account, modified	X		X ⁸

⁶ Before the exception for derivatives netting and repurchase and reverse repurchase agreements.

⁷ US GAAP – simultaneous settlement guidance applies to repurchase and reverse repurchase agreements only

⁸ One interpretation of US GAAP

Scenario analysis for offsetting under various approaches

Scenario	Description	IAS 32 (a),(c)	ED, as revised (d)	US GAAP basic model	US GAAP exception
1.	- A group of financial instruments each comprising of a single cash flow and settling on the same date - Right of set-off both in the normal course of business and in bankruptcy - Intention to settle net - No variation margin	Y(c)	Y (b)	Y(c)	Y
2.	- Same as Scenario 1, except instruments settle on different dates	N	N	N	Y
3.	- Same as Scenario 1, except right of set-off is exercisable only in the normal course of business	Y	N	N	N
4.	- Same as Scenario 1, except right of set-off is exercisable only in bankruptcy and therefore no intention to settle net	N	N	N	Y
5.	- Same as Scenario 1, the reporting entity has entered into an offsetting trade and each of the two positions comprises of multiple cash flows. The cash flows coincide.	Y	Y	Y	Y
6.	- Same as Scenario 1, except: (a) financial instruments with multiple, non-coinciding cash flows, and (b) no intention to settle net	N	N	N	Y
7.	- Same as Scenario 6, except variation margin is present and variation margin and underlying trades settled separately	N	N	N	Y
8.	- Same as Scenario 6, except variation margin is present and there is a single settlement process for variation margin and underlying trades	Y	Y	Y(c)	Y
9.	- Same as Scenario 1, except intention to settle simultaneously and there is collateral for the transaction but not in the form of variation margin (eg, repos and reverse repos)	Y	Y	Y(c)	Y
10.	No right of offset	N	N	N	N

(a) Generally, IAS 32 results in similar offsetting results as the ED [as revised], except when the reporting entity is not certain of its ability to set off the amounts in all circumstances - eg, in the default or bankruptcy of the counterparty.

(b) Offsetting would be permitted here consistent with how netting is permitted under the master netting agreement - eg, payment netting by date and by currency.

(c) One interpretation of these standards

(d) Assumes all staff recommendations in papers 6B-6D are accepted.

Appendix 2:

Summary of proposed modifications to the proposals in the ED

1. At the 17 May 2011 joint meeting, the boards discussed the feedback received on the proposals in the ED (Agenda Paper 5/Memo 13A – May 2011).
2. As a result of the feedback received and the boards request for further analysis, the staff prepared the following papers to discuss how the Board might address issues raised by respondents. These papers are only relevant if the boards decide to pursue **Approach A** in this paper.
 - (a) Agenda Paper 6B: Unit of account and treatment of collateral (Agenda Paper 5B/Memo 15B - June 2011 meeting)
 - (b) Agenda Paper 6C: Simultaneous settlement and intent criteria (Agenda Paper 5C/Memo 15C – June 2011 meeting)
 - (c) Agenda Paper 6D: Right of offset: Unconditional and legally enforceable (Agenda Paper 5D/Memo 15D – June 2011 meeting)

These papers and the staff recommendations therein are summarised below.

Agenda Paper 6B: Unit of account and treatment of collateral

3. This paper discusses how the Board might address the concerns raised about the prohibition of offset of collateral, as well as potential approaches to addressing the issue of unit of account. In this paper, the staff recommends:
 - (a) that the offsetting criteria not be applied to individual cash flows of financial instruments;
 - (b) that it be clear in the guidance that the offsetting requirements can be applied to individual financial instruments, including a portion of a financial asset against an entire financial liability and vice versa;
 - (c) that a group of financial instruments that have identical or coinciding payment dates and meet the offsetting criteria should be offset;
 - (d) to clarify that when variation margin or collateral posted qualifies (legally) as settlement of the related contracts, there is no question of offset;

- (e) to clarify that collateral that the parties can offset against the counterparty's obligations only if the counterparty defaults or when the counterparty is unable to perform its obligations (eg initial margin/independent amount and contributions to the default fund) cannot be offset against the related financial asset or financial liability (i.e. conditional rights in the ED);
- (f) that if collateral or margin posted or received meets certain conditions (ie the party making the variation payment has no right to insist on the return of the variation margin paid and the party holding the collateral has no obligation to return the amounts posted as collateral and the variation margin forms or will form part of the settlement of the underlying contracts), an entity should be required to offset the collateral or margin and the related financial asset or financial liability and
- (g) that offsetting must be applied to groups of financial instruments that operate with a variation margin system such that an entity can demonstrate an intent to settle net (and the core principle in the ED and the offsetting criteria are met).

Agenda Paper 6C: Simultaneous settlement and intent criteria

- 4. This paper addresses concerns raised about the definition of simultaneous settlement in the ED, as well as the meaning of intent.
- 5. In Agenda Paper 6C the staff recommends that the Board broaden the definition of simultaneous settlement to include gross settlement mechanisms with features that eliminate credit and liquidity risk (or result in insignificant credit or liquidity risk) and under which processing of receivables and payable occur in a single settlement process⁹ that is effectively akin to net settlement.
- 6. Agenda paper 6C also asks the Board whether it prefers to:
 - (a) make no changes to the proposed intent criteria or guidance;
 - (b) move the wording on intent in the ED from the application guidance to the main standard;

⁹ A process that provides for both the settlement of the underlying contracts and payment of variation margin in a single payment (Agenda Paper 1B/Memo 14B -May 2011)

- (c) include additional application guidance to clarify that intent means **ability** (ie the entity not only has the legal right but the necessary processes in place) to settle net or settle simultaneously or
- (d) include application guidance to clarify that intent means an entity **can and will** settle net or settle simultaneously.

Agenda Paper 6D: Right of offset: Unconditional and legally enforceable

- 7. This paper discusses concerns raised about the proposed definition of unconditional and legally enforceable right of set-off in all circumstances. It also discusses the level of assurance, if any, required to conclude a right of set-off is 'legally enforceable'.
- 8. In Agenda Paper 6D the staff recommends that the Board:
 - (a) clarify that the right of set-off should be legally enforceable in both the normal course of business and in the insolvency, bankruptcy or default of the counterparty (ie replace 'in all circumstances' with both in normal course of business and in default, bankruptcy and insolvency);
 - (b) amend the guidance in the ED (paragraph C15) such that if a right of set-off is only exercisable on a particular date (or period), it will qualify as an unconditional right of set-off for payments that are due on that date (or in that period);
 - (c) retain the requirement that the right of set-off must be legally enforceable in the normal course of business and in the event of default, bankruptcy or insolvency of **either** party;
 - (d) clarify that if the entity can take the action unilaterally (eg the action is procedural in nature), the fact that an action is needed before exercising the right to set off should not be considered 'conditional' or a future event for the purpose of applying the offsetting criteria and
 - (e) explicitly state as part of the application guidance that reasonable assurance as to enforceability of the right of set-off is required taken into account all relevant facts and circumstances (to avoid divergence in practice).