
Project	Offsetting Financial Assets and Liabilities
Topic	Appendix B: Currently enforceable right of set-off and intention to offset (Alternative 2)

Introduction

1. This paper details arguments for and against **Alternative 2** of the proposed offsetting approaches set out in Agenda Paper 5A /Memo 15A.
2. **Alternative 2** would require offsetting of financial instruments (a recognised financial asset and a recognised financial liability) if an entity *currently* has a legally enforceable right to set off the recognised amounts (and intends either to settle net or settle simultaneously)¹.

Arguments for Alternative 2

3. IAS 32 *Financial Instruments: Presentation* paragraph 42(a) requires that an entity '**currently** has a legally enforceable right to set off'² in order to set off its financial assets and financial liabilities on the statement of financial position.
4. As IAS 32 does not give specific guidance as to what is meant by **currently** legally enforceable, some have interpreted this to mean a right of offset that is exercisable only in the normal course of business. Thus some respondents to the ED indicated that they prefer the offsetting approach in IAS 32 (ie only in the normal course of business).
5. Those that interpret currently legally enforceable as “enforceable 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

¹ For purposes of this paper it is assumed that the entity meets the criterion of “intends either to settle net or settle simultaneously”.

² Assumed for purposes of this paper that the other offsetting criteria are met.

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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.

6. 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.
7. Paragraph C6 of the ED also notes 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 (e.g. contractual provisions, the law governing the contract, and the bankruptcy laws of the parties) need to be considered to ascertain whether the right of set-off is enforceable in all circumstances.”
8. Based on paragraph C6, 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 today they do not have to do so).
9. Respondents also raised the concern 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 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. In some jurisdictions although every effort has been made to put the best possible arrangements in place this issue will remain.
10. In addition, many who currently apply the offsetting criteria in IAS 32 are of the view that the approach to offsetting in IAS 32 is consistent with the definition of

assets and liabilities (ie their rights and obligations) as well as how they do business, and has stood the test of time during the financial crisis.

Comparison to Alternative 1

11. Alternative 1 (Appendix A to Agenda Paper 5A/Memo 15A) would require offsetting based on the approach in the ED (ie a legally enforceable right to offset **at all times**). Often preparers may 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.
12. As noted in paragraph 9, a criterion requiring enforceability **at all times** also calls into question the level of legal assurance necessary to be assured that the rights are legally enforceable. This may be problematic in some jurisdictions, particularly where no case law precedent on bankruptcy is available. Although every effort has been made to put the best possible arrangements in place in those jurisdictions, this issue will remain.
13. As a result, respondents raised concerns that the legal enforceability criterion in the ED too restrictive and may result in less offsetting than in practice today. In addition, as these respondents focus on a going concern basis they would argue that additional focus on rights in bankruptcy is not relevant.

Comparison to Alternative 3

14. Alternative 3 (Appendix C to Agenda Paper 5A /Memo 15A) would require offsetting based on conditional rights of offset for some or all financial instruments.³
15. As noted in paragraphs 5 and 6, many argue that the statement of financial position is intended to show the entity's position in the normal course of business. They further 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. A going concern approach to presentation does not involve a consideration of what the parties can do in bankruptcy or default of either party. Therefore those supporting **Alternative 2**

³ This approach is similar to the current US GAAP exception (Topic 815: Derivatives and Hedging in the *FASB Accounting Standards Codification; paragraph 815-10-45-5*) today.

would argue that it is not appropriate to prepare financial statements and present financial assets and financial liabilities effectively on the assumption of bankruptcy or default. They also argue that it is more intuitive to present what an entity can do in the normal course of business than in the event of default or bankruptcy.

16. Supporters of **Alternative 2** share concerns about focusing solely on conditional rights for certain types of contracts as well as whether credit risk should be the sole basis for offsetting. See analysis of these issues in more detail in Alternative 1 to offsetting approaches (Appendix A to Agenda Paper 5A/Memo 15A).
17. Based on the analysis in paragraphs 3 to 15, of the three alternatives, **Alternative 2** is arguably the most workable approach to interpret and apply in practice.

Arguments against Alternative 2

18. The boards concluded in the ED that offsetting is consistent with the objective of financial reporting if (on the basis of its rights and obligations associated with the financial instruments) the entity has in effect a right or obligation for only the net amount.⁴ The net amount represents the entity's right or obligation only 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 amount, or to settle the asset and liability simultaneously.⁵
19. Many respondents who support the proposed criteria in the ED believe that an entity has a net exposure only when the entity has the right to offset at all times, including bankruptcy or default. Ignoring these scenarios or offsetting only when it can be done in the normal course of business does not give a true view

⁴ ED, BC17

⁵ ED, BC18

of an entity's exposure (at all times). Using a currently enforceable criterion may also result in less restrictive requirements and more netting than what is currently proposed in the ED. While the staff believe that whether more or less netting is achieved should not be the basis for the boards' decisions (rather the question should be the appropriateness of the netting that is achieved), some see this as an advantage, while others see this as an argument against **Alternative 2** (using only 'currently enforceable').

20. Others also argue that an enforceable right of set-off that doesn't also exist in bankruptcy is counterintuitive. An entity can assume in the normal course of business that its transactions will be settled by both sides as indicated in the contracts. A right of set-off that is also enforceable in the event of default or bankruptcy is seen by many as a more crucial right of set-off, especially in times of hardship or distress. Without a right both in the normal course of business and bankruptcy /default, an entity is providing a misleading picture of its financial position as the net amount is not necessarily its net exposure at all times.