



Project	Offsetting Financial Assets and Liabilities
Topic	Right of offset: Unconditional and legally enforceable

Introduction/Purpose of the paper

1. Under the proposals in the ED, an entity would be required to offset (ie present as a single net amount in the statement of financial position) a recognised financial asset and a recognised financial liability when it has an unconditional and legally enforceable right of set-off and intends either to settle the asset and liability on a net basis or to realise the asset and settle the liability simultaneously (the offsetting criteria).
2. As briefly described in the ‘Feedback summary’ (AP5/Memo 13A - discussed at the May 2011 joint board meeting), several respondents to the ED asked the boards to clarify the following aspects of the offsetting criteria -
 - a) the definition of ‘unconditional’ right of set-off and the meaning of ‘enforceable in all circumstances’
 - b) the level of assurance, if any, required to conclude a right of set-off is ‘legally enforceable’.

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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A. Definition of ‘unconditional and meaning of legally enforceable’ in the ED

3. The ED defines an ‘unconditional (and conditional) right’ of set-off and a ‘legally enforceable right’ of set-off as follows¹.
 - *An unconditional right of set-off is a right of set-off the exercisability of which is not contingent on the occurrence of a future event.*
 - *A conditional right of set-off is a right of set-off that can be exercised only on the occurrence of a future event.*
 - *Legally enforceable right of set-off is a right of set-off that is enforceable in all circumstances (ie enforceable both in the normal course of business and on the default, insolvency or bankruptcy of one of the counterparties).*
4. The ED gives as an example of a conditional right, a right of set-off in a master netting agreement or in some non-recourse debt arrangements that are triggered on the occurrence of a future event, such as default or other credit related events. It also states that rights of set-off that are triggered only following changes in legislation or change in control of the counterparties are also conditional rights.²
5. The ED explains that whether an entity’s right of set-off meets the legally enforceable criterion will depend on the law governing the contract and the bankruptcy regime that will govern the insolvency of the counterparties.³

Restrictions on when the right of set-off can be exercised

6. In practice, when entities agree to net settle assets and liabilities in the normal course of business, they usually specify a future payment date(s) (or contemplate future payment dates). For example, they may agree to settle financial assets and liabilities due on a particular date (ie same maturity) net on that date. Alternatively, they may settle receivables and payables accumulated between them in a particular month at a specified date in the following month. In both cases some might argue there are restrictions or the exercisability of the right of set-off is

¹ Paragraphs 10 (c), (d) and (e) of the ED.

² ED paragraph C4

³ ED paragraph C6

conditioned on future payments being due or payable (ie set-off will only apply to the extent there are future payments available to be off set).

7. Also, the ED states that ‘if the right of set-off is exercisable only before a specific date, that right of set-off does not qualify as an unconditional right of set-off’⁴. Some respondents to the ED asked the boards to clarify the concept of ‘unconditional’ and whether the passage of time is a conditional event.
8. These respondents questioned whether the offsetting criteria are met if the right to set off is exercisable only on a particular date or during a particular period in the future⁵ (which may or may not coincide with the payment dates of the associated payments) but not exercisable as of today (ie at the end of the reporting period). This may be relevant for example if two contracts had a term of 5 years with corresponding annual payments but the right to set off was specifically stated to be available only for the first 3 years.
9. Others raised the same question with respect to the ‘enforceable in all circumstances’ requirement because the right described in paragraph 8 is exercisable only at a particular time (ie not all the time). If the right is only exercisable at a particular time, does it fail the ‘legally enforceable at all times’ criteria?

Remote events which could affect legal enforceability of the right to setoff

10. The ED required that the right of set off must be legally enforceable in all circumstances. Some respondents asked the boards to clarify whether that means that any conceivable event in the future that could hinder the legal enforceability of the right, regardless of how remote, must be considered in determining whether a right of set-off meets the ‘legally enforceable in all circumstances’ and/or ‘unconditional’ criteria. Some have gone so far as suggesting that, read literally, this would make any potential change in legislation in the future something that must be considered.

⁴ C15 of the ED.

⁵ It is assumed in this section that the rest of the criteria such as intention to settle net and the legal enforceability of the right in the event of default are met unless otherwise indicated.

11. Typically clauses are included in contracts that provide that a right of set-off would be invalidated if a particular pre-specified event occurs in practice. For example, parties may agree to a representation clause under which the right to set off is automatically invalidated if any undertakings or representations in the contract turns out to be incorrect in a material respect. On a strict reading, such clauses could be seen to render the right of set-off a 'conditional' right of set-off because the right to set-off is contingent on whether incorrect information (if any) is identified or has been given by the counterparty, even if the possibility of existence of such information is virtually zero.
12. More generally, there could be several events, so called 'Acts of God' such as flooding or earthquake, which are outside of control of humans which no one can predict or control. It would be difficult or impossible to obtain legal assurance or certainty that a right of set-off can be enforced at all times, as such events are a possibility in the future (although in many cases the probability of such occurrences will be extremely low). In practice, a clause called 'Force majeure' is often included in contracts that essentially free the parties from liability or obligation for all or some aspects of an executory contract when those events occur. Some argue that such clauses would make it impossible to obtain a legal opinion to confirm that a right of set-off is 'unconditional' or 'enforceable in all circumstances' because the occurrence of such events may invalidate the legal enforceability of the right of set-off, and hence could be deemed as conditional as it is contingent on the occurrence of those events.

Legal enforceability of the right to setoff on the default, insolvency, or bankruptcy of the reporting entity

13. The ED requires that the right of set-off must be enforceable in *all circumstances (ie enforceable both in the normal course of business and on the default, insolvency or bankruptcy of one of the counterparties)*.
14. Some respondents agree that the right of set-off must be enforceable in the bankruptcy of either of the parties to the contract. Other respondents requested that the boards clarify whether the enforceability of rights of setoff should take into account the reporting entity's own default, insolvency, or bankruptcy. They

believe that such a requirement would be inconsistent with the going concern principle of financial statement presentation.

Staff analysis and recommendation

15. The ED defines a right of set-off as ‘a debtor’s legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount all or a portion of an amount due from the creditor or a third party.’⁶
16. As the definition itself envisages an amount being due to each party either now or in the future, the uncertainty of there arising amounts payable between the parties should not typically be considered to be a conditional event (ie the fact that the payments subject to netting will only arise at a future date is not in itself a form of conditionality that prevents set-off). If the entity will settle the positions net and have the legally enforceable right to do so, the passage of time should not cause an arrangement to fail this criterion.
17. Also, the fact that the right to set off is exercisable only at a particular time (or during a particular period) and that time (or period) is when any payments are due should not preclude the agreement from meeting the ‘legally enforceable in all circumstance’ requirement. In contrast if the right of set off was not exercisable during a period when specific amounts are due and payable, then the payments cannot be offset as the entity has no right to offset those payments.
18. The phrase ‘in all circumstances’ is used in the ED to achieve the objective that the net amount should represent the entity’s net exposure at all times. Essentially the words ‘in all circumstances’ were used to emphasise that the right should be enforceable both (not either) ‘in the normal course of business’ and ‘in bankruptcy’ or similar events (see the definition of ‘legally enforceable’).
19. The staff notes that the majority of constituents read the criteria proposed in the ED to be consistent with the analysis in the preceding paragraphs. However, some seem to have read the words ‘in all circumstances’ to mean that the right must be available throughout the entire life of the contract.

⁶ Paragraph 10 (b) of the ED

20. The staff is also of the view that it would be difficult and inappropriate for the boards to prescribe *a priori* which types of remote events or clauses in a (if any) should or should not be taken into account in the assessment.
21. In order to avoid any diverging interpretation and inconsistent application of the offsetting criteria, the staff recommends that the boards remove the phrase “in all circumstances” and clarify 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. The staff believes that using these more specific words would also assist by clarifying the focus of the requirement.
22. In addition, the staff recommends that the boards amend the guidance in paragraph C15 of the ED, which would always preclude a right of set-off that is exercisable only before a specific date from qualifying as an unconditional right to set off. If a right to set-off is only exercisable on a particular date, as is often the case in practice, it meets the principle in the ED if, for payments due on that date, the entity has the intention to settle those payments net and that right of set-off is enforceable both in normal course of business and in bankruptcy, default or insolvency of the parties.
23. As noted in paragraph 14, some respondents disagree that the right of set-off must be enforceable in the bankruptcy, insolvency or default of the entity itself. Some staff agree with that view and suggest that the boards clarify that the legally enforceable right of set off is enforceable in the normal course of business and on the default, insolvency, or bankruptcy of **the** counterparty. They suggest that any final guidance clarify that the reporting entity is not required to evaluate legal enforceability of rights of setoff in the event of its own default, insolvency, or bankruptcy.
24. Other staff believe that the view that the right of set-off must be enforceable only in the default, insolvency or bankruptcy of the counterparty is not consistent with the principles and objective of the ED.
25. Paragraph 4 of the ED states the following
‘This [draft] IFRS establishes a principle for offsetting financial assets and financial liabilities, namely, an entity shall offset a recognised financial asset and recognised financial liability only when:

- (a) *on the basis of the rights and obligations associated with the financial asset and financial liability, the entity has a right to or obligation for only the net amount (ie the entity has, in effect, a single net financial asset or financial liability) and*
- (b) *the amount, resulting from offsetting the financial asset and financial liability, reflects an entity's expected cash flows from settling two or more separate financial instruments.*

26. The boards stated in the basis for conclusions that the above principle is met 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 net amount, or to settle the asset and liability simultaneously'.

27. The staff that agree with the requirement that the right of set-off must be enforceable in the default or bankruptcy or insolvency of either party believes that that view or approach is consistent with the principle in the ED and the basis for that conclusion. . They believe that if a right of set-off is not or cannot be asserted to be enforceable on the default or bankruptcy of the reporting entity, then offsetting may not reflect the economic substance of the transaction entered into by the entity or financial position of the entity. They therefore recommend that the boards should 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**.

Question 1: Restrictions on when the right of set-off can be exercised

1. Do the boards agree with the staff recommendations in paragraphs 21 and 22?

- (a) To clarify that the right of set-off should be legally enforceable in both 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)
and

- (b) To amend the guidance in C15 of the ED (which precludes a right to set off that is only exercisable before a specific date from qualifying as an unconditional right to set off) 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).

If not, why?

- 2. Which of the views in paragraphs 23 and 27 do the boards want to pursue? –
 - (a) any final guidance should clarify that the reporting entity is not required to evaluate legal enforceability of rights of setoff in the event of its own default, insolvency, or bankruptcy or
 - (b) the boards should 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.**

Procedural actions before exercising the right to setoff

- 28. Some respondents to the ED are not clear if the right of set-off is a conditional right and thus fails to meet the offsetting criteria, if an entity needs to take some action in order to exercise that right, even if it is just procedural in nature and is ‘within the control’ of the entity (ie whether all conditions precedent make a right of set-off ‘conditional’ for the purposes of the ED?).
- 29. For example, an entity may be required to notify the counterparty, in the form of a letter in advance to effect net settlement, under the terms of a contract. In some cases, an entity may need to go to court to obtain official permission to set off when a counterparty goes bankrupt (as a matter of process), although that right is

assured and such rights are upheld in the event of default of a counterparty, in that jurisdiction.

Staff analysis and recommendation

30. The ED requires the right of set-off to be ‘unconditional’ 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 times. This is because if the occurrence of a future event could prevent the entity from exercising the right to set off, offsetting may not reflect the economic substance of the transaction or financial position of the entity.
31. However, when the entity can take the action unilaterally (eg the action is procedural in nature), the staff believes that the mere fact that such an action is needed before an entity can exercise the right to set off should not be seen to render the exercisability of that right, in effect, contingent on a future event.
32. If the boards were to agree with the staff analysis, there would be a need to clarify accordingly in the final standard.
33. It should be noted that the probability of favourable or unfavourable outcome would have to be assessed separately as part of the ‘legal enforceability’ requirement. For example, when assessing the right of set-off in the event of default of the counterparty, an entity may be required to apply to a court (ie an action within the control of the entity) to effect set-off. This application requirement should not be treated as a conditional or a future event but the probability of a favourable judgment from the court should be assessed to conclude whether the right of set-off meets the offsetting criteria.

Question 2: Procedural actions before exercising the right of set-off

Do the boards agree with the staff recommendation in (paragraphs 31 and 32)-

- To 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

<p>a future event for the purpose of applying the offsetting criteria.</p> <p>If not, why?</p>
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B. Level of assurance required for ‘legally enforceable’

- 34. The ED requires the right to set off to be legally enforceable. Some of the constituents raised concerns about the level of assurance required to meet the criteria. Conceptually, this issue is relevant in both the normal course of business and bankruptcy situations because the ED requires the right to be enforceable in both scenarios. However, most of the comments made on this issue referred only to the latter (bankruptcy) situation because legal enforceability of a contract tends to be more challenging and uncertain in the event of default.
- 35. In some cases or in some jurisdictions, a clear legal basis and a strong body of case law and common practice may have developed in relation to enforceability of specific rights of set-off. U.S.-based respondents that commented on this issue acknowledged that the assessment of legal enforceability of right of set-off in the event of bankruptcy is already being performed today under U.S. GAAP.
- 36. However, in some cases and some jurisdictions there may not be case law precedent or specific legislation in that respect and thus more careful legal analysis may be required. This means that the level of certainty of enforceability will vary depending on the jurisdiction of the parties to the agreement.
- 37. Legal enforceability is a complex area. Often (and probably even typically) it would be the case that 100 per cent assurance as to enforceability in all circumstances is not available which is why respondents have raised this issue.

Staff analysis and recommendation

- 38. The concept of enforceability is already inherent in existing US GAAP and IFRS. US GAAP (Topic 210: Balance Sheet in the FASB Accounting Standards Codification®) requires that the right to setoff should be ‘enforceable at law’ and states that reasonable assurance is required that the right of setoff would be upheld

in the event of default, taking into account all the relevant information available⁷ (see below).

- State laws about the right of setoff may provide results different from those normally provided by contract or as a matter of common law. Similarly, the U.S. Bankruptcy Code imposes restrictions on or prohibitions against the right of setoff in bankruptcy under certain circumstances. Legal constraints should be considered to determine whether the right of setoff is enforceable.
- The phrase enforceable at law encompasses the idea that the right of setoff should be upheld in bankruptcy. The nature of support required for an assertion in financial statements that a right of setoff is enforceable at law is subject to a cost-benefit constraint and depends on facts and circumstances. All of the information that is available, either supporting or questioning enforceability, should be considered. Offsetting is appropriate only if the available evidence, both positive and negative, indicates that there is reasonable assurance that the right of setoff would be upheld in bankruptcy (Emphasis added).

39. On the other hand, IAS 32 does not give specific guidance as to the degree of assurance required to meet the criterion ‘currently enforceable’. Some would argue that IAS 32 does not require the right to setoff to be enforceable in the event of default (depending on the interpretation of ‘**currently** enforceable’ in IAS 32) and thus there has been less focus on this issue under IFRS to date.

40. Arguably, because the basis for allowing offset in the proposals (ED) if there is a legally enforceable right of set-off is founded on the premise that there should be a high degree of certainty that payments will be net in all circumstances, it is necessary to ensure that there is an appropriate level of comfort that such rights are enforceable. However, the staff is of the view that, if the boards were to provide further guidance on the level of assurance required to conclude on legal enforceability, such additional guidance should be general enough, such as ‘**reasonable assurance based on relevant facts and circumstances**’, to accommodate various legal environments. References to, or emphasis on, some

⁷ FASB ASC 210-20-45-8 and 210-20-45.

aspects of a particular legal system or procedure may have unintended consequences and make the guidance irrelevant and/or unduly costly to apply in other jurisdictions.

41. The staff notes that all businesses are expected to obtain reasonable assurance on enforceability of contractual rights as part of prudent risk management (in their day to day business) regardless of accounting requirements⁸. Also, the basic notion of enforceability underlies our literature (for example, IAS 32 defines a contract as an agreement between the parties that has ‘clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable by law.’⁹)
42. Based on the above analysis, the following alternatives are available to the boards in addressing the issue of level of assurance:

Alternative 1: Explicitly state as part of application guidance that reasonable assurance as to enforceability of the right of set-off is required (to avoid divergence in practice).

Alternative 2: Do not specify the level of assurance required and leave such determination to judgment and consideration of relevant facts and circumstances.

Question 4: Level of assurance

Which alternative in paragraph 42 do the boards wish to choose?

⁸ Some are concerned that it is difficult to obtain a particular level of legal assurance in the event of default (if required) in some jurisdictions where no case law precedent on bankruptcy is available. However, the issue should be addressed separately when the boards decide whether they confirm the criteria as proposed in the ED (ie legal enforceability even in the event of default).

⁹ Paragrahp13 of IAS 32