

## Staff Paper

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Project	<b>Offsetting Financial Assets and Liabilities</b>		
Topic	<b>IAS 32 - Application guidance</b>		

### Background/Purpose

1. At the June 2011 joint meeting, the IASB and the FASB discussed alternative approaches for offsetting recognised financial assets and recognised financial liabilities on the statement of financial position. The IASB supported the approach in the exposure draft *Offsetting Financial Assets and Financial Liabilities* (the ED), which is based on an unconditional right and intention to offset, amended for feedback received and staff recommendations. The FASB supported an approach consistent with the current US GAAP offsetting guidance, which permits conditional rights of set-off for some derivative instruments and cash collateral.
2. At the July 2011 joint meeting the boards agreed on converged disclosure requirements related to offsetting to assist users in comparing financial statements prepared in accordance with IFRSs and US GAAP.
3. Based on the decisions made in the June 2011 joint meeting, at the July 2011 IASB-only meeting the Board tentatively decided to retain the existing offsetting criteria in IAS 32 *Financial Instruments: Presentation*.
4. However, feedback received on the ED highlighted inconsistencies in the application of the offsetting requirements in accordance with IAS 32.
5. The Board asked the staff to prepare a paper to consider whether those inconsistencies should be addressed in the context of IAS 32 and, if so, how.
6. This paper therefore focuses on:

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 IFRSs (or US GAAP) do not purport to be acceptable or unacceptable application of IFRSs (or US GAAP).

The tentative decisions made by 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.

- (a) aspects of the feedback received on the ED that indicated inconsistencies in the application of IAS 32, and
  - (b) amendments that could be made to improve application of the IAS 32 requirements.
- 7. The inconsistencies identified in the application of IAS 32 relate to the:
  - (a) Meaning of ‘currently has a legally enforceable right of set-off’
  - (b) Application of the simultaneous settlement criterion
  - (c) Treatment of collateral /margin
  - (d) Unit of account
- 8. This paper also discusses:
  - (a) the location of the offsetting requirements and the recommended amendments to the offsetting application guidance;
  - (b) the location of the converged disclosure requirements and
  - (c) effective date and transition for the recommended application guidance.
- 9. This paper includes the following appendices:
  - (a) **Appendix A** – Agenda Paper 6D from the 22 July 2011 IASB-only meeting. Amongst other items, this paper discusses the meaning of ‘enforceable in all circumstances’, which pertains to the meaning of the term ‘currently’ in IAS 32.
  - (b) **Appendix B** – Agenda Paper 6C from the 22 July 2011 IASB-only meeting. This paper provides an analysis of the issues around simultaneous settlement, including the operationality of the definition of simultaneous settlement and an overview of different settlement systems.
  - (c) **Appendix C** – Agenda Paper 6B from the 22 July 2011 IASB-only meeting. This paper discusses how the Board might address the concerns raised about the unit of account for applying the proposed

offsetting criteria and the proposed prohibition of offsetting collateral and the related financial asset or financial liability.

10. The papers in the appendices are included for background purposes. They discuss amending the offsetting criteria in the ED for various issues including simultaneous settlement, collateral and the unit of account. As this paper (AP 8A) discusses these issues within the context of applying the offsetting requirements in IAS 32, much of the analyses in the above mentioned papers still apply.

#### A. Meaning of ‘currently has a legally enforceable right of set-off’

##### *Background*

11. IAS 32 paragraph 42(a) requires that  
‘a financial asset and a financial liability shall be offset ...when, and only when, an entity *currently* has a legally enforceable right to set off the recognised amounts’<sup>1</sup> - *emphasis added*.
12. IAS 32 does not give guidance on what is meant by ‘currently’ having a legally enforceable right to set off.
13. The ED proposed that an entity have an *unconditional and legally enforceable right to set off* in order to set off its recognised financial assets and financial liabilities-*emphasis added*. The ED defined these as follows:
  - (a) 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*”<sup>2</sup> - *emphasis added*
  - (b) a legally enforceable right of set-off is a right that is enforceable *in all circumstances* (ie both in the normal course of business and on default, insolvency or bankruptcy of *one of the counterparties*)<sup>3</sup> - *emphasis added*

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<sup>1</sup> Assumed for purposes of this paper that the other offsetting criteria are met.

<sup>2</sup> ED paragraph 10(c)

<sup>3</sup> ED paragraph 10(e)

14. The boards concluded that offsetting is consistent with the objective of financial reporting if (on the basis of its rights and obligations) the entity has in effect a right or obligation for only the net amount.<sup>4</sup>
15. The net amount represents the entity's right or obligation only if *the entity has the ability to insist on a net settlement or to enforce net settlement in all situations (ie the exercise of that right is not contingent on a future event)*, that ability is assured, and the entity intends to receive or pay a single amount, or to settle the asset and liability simultaneously.<sup>5</sup> - *emphasis added*
16. While IAS 32 does not give guidance on what is meant by the word 'currently' in the requirement 'currently has a legally enforceable right to set off', it is the staff's understanding that the proposals in the ED were not intended to change practice for IFRS preparers today.<sup>6</sup> However, the proposals came under scrutiny by some respondents and highlighted inconsistencies in the interpretation of the word 'currently' in IAS 32 today.

***Feedback received /current practice***

17. We have separated the feedback received on specific criteria in the ED (paragraphs 13 and 15) and our analysis of additional IAS 32 application guidance needed, if any, into three areas related to 'currently has a legally enforceable right of set-off' as follows:
  - (a) a right that is **not contingent on a future event** (ie an unconditional right),
  - (b) a right that is enforceable **in all circumstances** (ie in the normal course of business as well as the event of bankruptcy or default) and
  - (c) a right that is enforceable on the default, insolvency and bankruptcy **of one of the counterparties** (ie including the reporting entity).

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<sup>4</sup> ED, BC17

<sup>5</sup> ED BC18

<sup>6</sup> For example, see Derecognition Agenda Paper 11 from the January 2010 IASB-only meeting (in particular paragraphs 22 and 34) and Offsetting Agenda Paper 3A/Memo 8A from the November 2010 joint meeting (in particular paragraphs 6 and 8)

*A right that is not contingent on a future event*

18. A few concerns were raised about the application of this criterion to the proposals in the ED and hence IAS 32 today.
19. Some respondents are concerned that there are clauses included in contracts that provide that a right of set-off would be invalidated if a particular pre-specified event occurs in practice.
20. 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.

*A right that is enforceable in all circumstances*

21. Inconsistencies were noted in the interpretation of the word 'currently' with respect to the requirement that an entity 'has a legally enforceable right of set-off' in IAS 32 today.
22. Some entities interpret 'currently' to mean a right of set-off that is exercisable and enforceable in current conditions (ie being the normal course of business). These entities argue that this interpretation is appropriate because the statement of financial position is prepared on a going concern basis and is intended to show an entity's position in the normal course of business. They argue that due to the going concern assumption, consideration of what the parties can do in bankruptcy or default of either party is neither appropriate nor relevant.
23. Those respondents also 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) would impose an additional burden and cost on preparers to prove that contracts are enforceable in all circumstances.

24. 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.
25. In addition, as a result of the ED's focus on enforceability in bankruptcy and the use of the words 'in all circumstances', some respondents were concerned that the legally enforceable criterion in the ED is more restrictive than the current IAS 32 criterion and therefore would result in less offsetting in practice.
26. Other respondents asked whether consideration must be given to all conceivable events in the future that could hinder the legal enforceability of the right, regardless of how remote, to determine whether a right of set-off is legally enforceable 'in all circumstances'. Enforceability of the right may come into question based on clauses related to particular future events, no matter how insignificant. As a result, it would be impossible to obtain absolute legal assurance or certainty that a right of set-off can be enforced at all times.
27. For example, in practice, a clause called 'Force majeure' is often included in contracts that essentially frees the parties from liability or obligation for all or some aspects of an executory contract when 'Acts of God' occur. Some argue that such clauses would make it impossible to obtain a legal opinion to confirm that a right of set-off is 'enforceable in all circumstances' because the occurrence of such events may invalidate the legal enforceability of the right of set-off.
28. Other respondents support the proposed criteria in the ED. They believe that this requirement already exists in IAS 32, but is made clearer by the proposed language in the ED.
29. Those that support the proposals also believe that an entity has a net exposure only when the entity has the right to offset at all times, including in the event of bankruptcy or default.
30. Some that support the proposals in the ED 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.

31. 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 in the event of bankruptcy /default, in their view an entity is providing a misleading picture of its financial position as the net amount is not necessarily the entity's net exposure at all times. For example, an entity preparing its financial statements on a going concern basis could nonetheless have a counterparty that defaults or goes bankrupt.

*A right that is enforceable on the default, insolvency or bankruptcy of one of the counterparties*

32. The ED requires that the right of set-off must be enforceable both in the normal course of business and on the default, insolvency or bankruptcy of *one of the counterparties*<sup>7</sup> – emphasis added.
33. There were varying views as to whether the wording 'one of the counterparties' (ie including the entity itself) changed the criteria in IAS 32 today.
34. Some respondents disagree that the right of set-off must be enforceable in the bankruptcy, insolvency or default of the entity itself. They believe that such a requirement would be inconsistent with the going concern basis of preparation for financial statements.
35. Although consideration is given to enforceability today to support offsetting in accordance with IAS 32, some note that the focus to date has often only been on the effects of the bankruptcy of the counterparty. Focusing on the bankruptcy of the reporting entity as well as the counterparty could increase costs and be seen by many as a change in practice. These respondents question whether legal opinions as to enforceability on their own bankruptcy could be obtained and consider this to be a change in practice.
36. Other respondents however agree that the right of set-off must be enforceable in the bankruptcy of any of the parties to the contract.

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<sup>7</sup> ED paragraph 10(e)

37. Some respondents requested that the boards clarify whether the enforceability of rights of set-off should take into account the reporting entity's own default, insolvency, or bankruptcy.

*Staff analysis*

*A right that is not contingent on a future event*

38. The ED defines unconditional rights as rights that are not contingent on the occurrence of a future event (paragraph 13). The boards stated in the ED that this is one of the criteria that must exist to meet the objective of offsetting.
39. While IAS 32 does not explicitly refer to unconditional rights, the use of the word 'currently' in the offsetting criterion indicates that the right cannot be contingent on a future event.
40. If a right of set-off was contingent or conditional on a future event, an entity would not **currently** have a (legally enforceable) right. The right would not exist and therefore the entity couldn't currently have it until the contingency occurred, if at all.
41. The staff also believes that clauses such as those described in paragraphs 19 and 20 would not affect the application of current or unconditional. If the right exists today (at the reporting date), it is an unconditional right.
42. Therefore the staff concludes that the word 'currently' in IAS 32 encompasses the concept of a right that is not contingent on a future event, or an unconditional event as defined in the ED. As the word 'currently' in this respect is clear in IAS 32 today, the staff does not believe further application guidance is needed here.



*A right that is enforceable in all circumstances*

43. The ED notes that a right of set-off may be unconditional or conditional. Similarly, once the right of set-off exists, it may be enforceable only in some circumstances (eg only the normal course of business) or may be enforceable in all circumstances (eg in the event of default and bankruptcy).
44. Paragraph C3 of the ED proposes that to offset a financial asset and a financial liability in the statement of financial position the entity's right of set-off must be both unconditional and legally enforceable in all circumstances.
45. As the staff has already determined (paragraph 42) that the word 'currently' in IAS 32 refers to an unconditional right, we must now determine whether the Board intended that unconditional right to be enforceable in the normal course of business or in 'all circumstances'.
46. The staff would like to highlight that the IAS 32 criterion does not refer to a **currently enforceable** right (ie whether a right is enforceable now or in the future). Rather, it refers to **what rights the entity currently has (ie what are its unconditional rights and are they enforceable)**. This is an important distinction in clarifying the use of the word 'currently' in IAS 32.
47. In the November 2010 joint meeting the boards discussed whether an unconditional right of set-off should be enforceable both in the normal course of business, or in the event of default or bankruptcy of a counterparty, or both.<sup>8</sup>
48. In that meeting the staff noted that set-off may generally be available both outside and within bankruptcy. Except in bankruptcy or a similar event, the limits on contractual set-off are more practical than legal. Generally parties to a contract are free to agree on almost any terms for set-off they prefer and such rights will be effective so long as they are not displaced by bankruptcy or a similar event.
49. Therefore, the question for showing a net amount on the statement of financial position is whether an entity can enforce its right to offset in all circumstances. The availability of set-off in bankruptcy and insolvency varies by jurisdiction,

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<sup>8</sup> Agenda Paper 3A/Memo 8A from the November 2010 joint board meeting.

so it cannot be assumed that the set-off is automatically available outside the normal course of business. Even if set off is a contractual right, in bankruptcy the action of courts in some jurisdictions can prevent its enforcement.

50. The boards agreed that to achieve the objective of offsetting (ie that the net amount should represent the entity's net exposure at all times), an entity's unconditional right must be enforceable in all circumstances.<sup>9</sup> The ED stated that the words 'in all circumstances' mean that the right should be enforceable both (not either) 'in the normal course of business' and 'in bankruptcy' or similar events.<sup>10</sup>
51. The staff believes that by using the words 'in all circumstances' the intention of the Board was to ensure that the right of set-off was available (and enforceable) both in the normal course of business and in the event of default, bankruptcy and insolvency. Again, the staff's understanding is that the proposals in the ED did not intend to change practice for IFRS preparers today.
52. Based on the feedback received on the ED, in order to avoid divergent interpretation and inconsistent application of the offsetting criteria, the staff recommends that the Board include application guidance that confirms that the right of set-off must be legally enforceable both in the normal course of business and in the event of default, bankruptcy and insolvency. The staff believes that using these more specific words (rather than in all circumstances) would also assist by clarifying the focus of the requirement.<sup>11</sup>

*A right that is enforceable on the default, insolvency or bankruptcy of one of the counterparties.*

53. The Basis for Conclusions for the approach in the ED states that the offsetting 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

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<sup>9</sup> November 2011 joint board meeting

<sup>10</sup> ED paragraph 10(e)

<sup>11</sup> Further detail of this analysis can be found in Appendix C – Agenda Paper 6D from the 22 July 2011 IASB-only meeting.

entity intends to receive or pay a single net amount, or to settle the asset and liability simultaneously'.<sup>12</sup>

54. It might be argued that because financial statements are prepared on a going concern basis, it is appropriate to ignore the potential insolvency of the reporting entity in assessing the enforceability of the rights of set-off . However, this is a 'point in time view' ie focusing on the reporting entity being a going concern at the reporting date.
55. The ED requires the right of set-off to be enforceable at all times (ie in bankruptcy, default or insolvency and in the normal course of business) in order to make sure that the right of set-off can and will be exercised and that the entity's exposure is the net amount *at all times*. This is because if the right of offset cannot and may not be exercisable in some scenarios (such as on the entity's own default or bankruptcy), offsetting may not reflect the economic substance of the transaction or financial position of the entity.
56. Thus the staff believes that the view that the right of set-off must be enforceable only in the default, insolvency or bankruptcy of the counterparty (and not in the default, insolvency or bankruptcy of the entity itself) is not consistent with the principles and objective of offsetting as the Board stated in the ED and also is not consistent with the objective of offsetting in IAS 32 today.
57. We 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 and would not meet the objective of offsetting in IAS 32 today.

### ***Staff recommendation***

58. Based on the analysis in paragraphs 38-42, the staff does not believe that further clarification or application guidance is needed with respect to the word 'currently' in the context of an unconditional right in IAS 32 today.

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<sup>12</sup> ED paragraph BC18

59. Based on the analysis in paragraphs 43-57, the staff recommends that the Board include wording in IAS 32 that the right of set-off must be legally enforceable both in the normal course of business and in event of default / bankruptcy / insolvency of one of the counterparties (ie any party). The staff notes that that approach is consistent with the principle in the ED and, in the staff's view, most appropriately portrays the entity's financial position.
60. Below is a matrix illustrating the interaction between unconditional / conditional rights of set-off, rights 'enforceable in normal course of business, bankruptcy, default and insolvency or only in some circumstances', the offsetting requirements in IAS 32 and the staff recommendations for clarifications to application guidance in paragraph 59.

		<b>(b) Legally enforceable</b>	
		<b>In normal course of business and in the event of bankruptcy/default/insolvency</b>	<b>Only in some circumstances (eg only in the normal course of business)</b>
<b>(a) Right of set-off</b>	<b>Unconditional (not contingent on a future event)</b>	Offsetting would be required on the statement of financial position	While the entity has the right to offset in some circumstances, offsetting on the statement of financial position would not be permitted.
	<b>Conditional (contingent on a future event)</b>	Offsetting on the statement of financial position would be required after the occurrence of the contingent event.	Offsetting on the statement of financial position would not be permitted even after the occurrence of the contingent event.
<b>Note:</b> This matrix assumes that the entity has met the intent criterion.			

**Question 1: Application guidance for ‘currently’**

- 1a. Does the Board agree with the staff recommendation in paragraph 58 that no that further clarification or application guidance is needed with respect to the word ‘currently’ in the context of an unconditional right in IAS 32 today?

If not, why not? What do you prefer, and why?

- 1b. Does the Board agree with the staff recommendation in paragraph 59 and 60 include application guidance to confirm that a right of set-off should be:

- a) legally enforceable both in the normal course of business and in the event of default, bankruptcy and insolvency of
- b) one of the counterparties?

If not, why not? What do you prefer, and why?

**B. ‘Simultaneous settlement’*****Background***

61. IAS 32 paragraph 42(b) requires that, in order for an entity to set off its financial assets and financial liabilities in the statement of financial position it must intend either to settle on a net basis, or to realise the asset and settle the liability *simultaneously*<sup>13</sup> *-emphasis added*.
62. IAS 32 paragraph 48 further elaborates on the meaning of simultaneous (as occurring at the same moment):

Simultaneous settlement of two financial instruments may occur through, for example, the operation of a clearing house in an organised financial market or a face-to-face exchange. In these circumstances the

<sup>13</sup> Assumed for purposes of this paper that the other offsetting criteria are met.

cash flows are, in effect, equivalent to a single net amount and there is no exposure to credit or liquidity risk. In other circumstances, an entity may settle two instruments by receiving and paying separate amounts, becoming exposed to credit risk for the full amount of the asset or liquidity risk for the full amount of the liability. Such risk exposures may be significant even though relatively brief. *Accordingly, realisation of a financial asset and settlement of a financial liability are treated as simultaneous only when the transactions occur at the same moment.*<sup>14</sup> – emphasis added

63. The ED proposed that an entity offset a recognised financial asset and a recognised financial liability when the entity 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*.<sup>15</sup> – emphasis added

64. The ED defined simultaneous settlement as follows:

C11 *Realisation of a financial asset and settlement of a financial liability are simultaneous only if settlements take place at the same moment (ie there is exposure to only the net or reduced amount).* When this condition is met, the cash flows are, in effect, equivalent to a single net amount and the net amount also reflects the entity's expected cash flows from settling the separate financial instruments. Thus, if settlements take place over a period (even though during this period there is no potential for any change in the value of the financial asset and financial liability, and the period between settlements of the instruments is brief), it is not simultaneous settlement because settlement is not at the same moment. Similarly, realisation and settlement of an asset and a liability at the same stated time but in different time zones is not simultaneous settlement. – emphasis added

C12 Simultaneous settlement of two financial instruments *may occur* through, for example, the operation of a clearing house in an organised financial market or a face-to-face exchange. For example, in some centrally cleared financial markets with a central counterparty or in face-to-face exchanges, the rules of

<sup>14</sup> IAS 32 paragraph 48

<sup>15</sup> Assuming the other criteria for offsetting are met.

the exchange or clearing house may grant both the clearing house or the exchange and the members (or participants) a right to set off amounts due and payable to either party. The procedures of the clearing house or exchange may, in addition, provide that the amount to be paid or received for different products be settled gross. *However, such payments may be made simultaneously. Hence, even though the parties may make payment or receive payment separately for different product types, settlements occur at the same moment or there is exposure only to the net amount.- emphasis added*

***Feedback received /current practice***

65. Many respondents to the ED argued that simultaneous settlement is interpreted in various ways in practice today. They argue that the ‘at same moment’ requirement is inconsistent with settlement practices.
66. For example, many preparers and accounting firms have interpreted IAS 32 to mean that settlement through a clearinghouse always meets the simultaneous settlement criterion. In addition, settlement of two positions by exchanging gross cash flows at exactly the same moment (simultaneously) rarely occurs in practice today.
67. Others currently analogise to the guidance in FASB Accounting Standards Codification (ASC) Topic 210 Balance Sheet paragraph 20-45-11<sup>16</sup> to interpret and apply the simultaneous settlement criterion in IAS 32. Those respondents view the criteria in ASC Topic 210-20-45-11 as resulting in the functional equivalent of net settlement, and as consistent with what they perceive to be the rationale for the simultaneous settlement criterion in IAS 32.
68. The fundamental requirement in IAS 32 is that an entity must have a legally enforceable right of set-off and the intention to settle net to present a recognised financial asset and financial liability net in the statement of financial position.

<sup>16</sup> 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)*

69. However, entities may have an unconditional and legally enforceable right and desire to settle net, but may not have the operational capabilities to effect net settlement. These entities would settle the positions gross in a manner such that the outcome is not distinguishable from net settlement.
70. As a result the Board included simultaneous settlement as a practical exception to net settlement. Simultaneous settlement was intended to capture payments that were essentially equivalent to actual net settlement.
71. The ED reiterated the requirement in IAS 32 that simultaneous is ‘at the same moment’. The ED also discusses the use of a clearinghouse only as one example of a settlement system that may meet the simultaneous criterion.
72. However, some constituents believe that the proposed simultaneous settlement requirement is more restrictive than the similar IAS 32 requirement. This belief seems to arise from the order of the wording in IAS 32 paragraph 48 versus the clarification of the definition in the ED including separation of the application guidance and referral to the use of clearinghouses into two separate paragraphs. They also argue that ‘simultaneous’ is not operational and ignores settlement systems that are established to achieve what is economically considered to be net exposure and currently considered to meet the requirements in IAS 32, without being ‘at the same moment.’
73. Many constituents believe that settlements through some central clearing parties (or CCPs) effectively equate to net settlement. Their rationale is that once the settlement process commences, the entity is not exposed to counterparty or liquidity risk over and above the net amount and therefore the process is equivalent to net settlement. Respondents therefore requested that the boards reinstate the wording in IAS 32 paragraph 48, or broaden the definition of simultaneous settlement to cover such settlement processes.

#### ***Staff analysis and recommendation***

74. Agenda Paper 6C from the July 2011 IASB-only meeting (Appendix B) details various gross and net settlement systems that exist today. Based on this the staff identified the key characteristics of some settlement mechanisms, which even if technically do not have payments being made at the same moment,



effectively result in a similar net exposure as in net settlement or settlement at the same moment. These mechanisms also satisfied the criteria for offsetting in US GAAP ASC Topic 210-20-45-11.

75. The distinguishing factors in these systems are:
- (a) Financial assets and financial liabilities that meet the right of offset criterion are submitted for processing at exactly the same point [= intent and same settlement date];
  - (b) Once submitted for processing, the transactions cannot be cancelled or altered [=no liquidity or credit risk];
  - (c) There is no potential for the cash flows arising from the assets and liabilities to change once they have been submitted for processing unless the processing fails [=no potential change in cash flows];
  - (d) If the processing of one asset or liability that is offset against another fails, then the processing of the related security used as collateral also fails [= always net exposure /similar to a securities transfer system or delivery versus payment (DvP)];
  - (e) Processing is carried out through the same settlement depository [=DvP or same depository account] and
  - (f) There is a high likelihood that an intraday credit facility is available and would be honoured until the settlement process is complete [=no settlement (liquidity/credit) risk].
76. The staff recommends that the Board clarify the definition of net 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 process<sup>17</sup> that is effectively akin to net settlement.

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<sup>17</sup> A single settlement process provides for both the settlement of the underlying contracts and payment of variation margin in a single payment. See further discussion in Agenda Paper 1B/Memo 14B -May 2011.

77. In the staff's view, this is also consistent with the language in paragraph 48 of IAS 32 today that simultaneous settlement results in 'no exposure to credit or liquidity risk'.
78. This would also be consistent with IFRS presentation of payables and receivables arising from repurchase and reverse repurchase transactions today (cash flows that are, in effect, equivalent to a single net amount and there is no exposure to credit or liquidity risk—ie a practical interpretation of 'at the same moment') and would be consistent with the practice of presenting payables and receivables from repurchase and reverse repurchase agreements net when using a settlement mechanism that meets the criteria in paragraph 75 and the criteria in ASC Topic 210-20-45-11 (formerly FIN 41) guidance.

#### Question 2: Simultaneous settlement

Does the Board agree with the staff recommendation in paragraph 76, namely, to broaden/clarify the definition of net settlement in the application guidance of IAS 32 to include gross settlement mechanisms with features that:

- (a) eliminate or result in insignificant credit and liquidity risk and
- (b) under which processing of receivables and payables occur in a single settlement process?

If no, what would the Board like to include, if anything, for simultaneous or net settlement to address practice issues today?

## C. Collateral

### *Background*

79. The proposals in the ED specifically prohibited offsetting assets pledged as collateral (or the right to reclaim the collateral) or the obligation to return collateral obtained and the associated financial assets and financial liabilities.<sup>18</sup>
80. The application guidance expanded on this requirement:

<sup>18</sup> ED paragraph 9

C14 Many financial instruments, such as interest rate swap contracts, futures contracts and exchange traded written options, require margin accounts. Margin accounts are a form of collateral for the counterparty or clearing house and may take the form of cash, securities or other specified assets (typically liquid assets). Margin accounts are assets or liabilities that are accounted for separately. Similarly, if an entity sells collateral pledged to it and thus recognises an obligation to return the collateral sold, that obligation is a separate liability that is accounted for separately. An entity shall not offset in the statement of financial position recognised financial assets and financial liabilities with assets pledged as collateral or the right to reclaim collateral pledged or the obligation to return collateral sold.

***Feedback received /current practice***

81. A number of respondents, mainly financial institutions, disagreed with the proposed treatment of collateral/margin in the ED. They noted that the proposed guidance on offsetting collateral is more restrictive than IAS 32 today.
82. For example, some clearinghouses may require their members to provide or receive cash (variation margin) on a daily basis in response to changes in the fair value, for the effect of discounting and settlement of the underlying contracts based on the net position in specific asset classes or products (and currencies). This is intended not only to ensure that the net position is always cash-collateralised, but to cover any payments due on that day so that the positions are never settled separately. These payments often met the offsetting criteria in IAS 32 today.
83. Respondents therefore objected to a general prohibition on offsetting collateral against recognised financial assets or financial liabilities. They indicated that financial assets or liabilities arising from collateral or margin should not be precluded from the scope of offsetting in all cases as drafted in the ED since in some situations offsetting the collateral and the related assets and liabilities may meet the proposed offsetting criteria.

*Staff analysis/recommendation*

84. Agenda Paper 6B from the July 2011 IASB-only meeting (Appendix C) further discusses the proposed prohibition on offsetting collateral and the related financial asset or financial liability and staff recommendations for amending the ED.
85. However, as this wording is not currently in IAS 32, the staff analysed practice today with respect to amounts referred to as collateral. Practice today indicated that where items defined as collateral (for example variation margin in certain situations) were set off, they met the offsetting criteria as defined in IAS 32 today. No particular practice concerns or inconsistencies in the treatment of collateral have been brought to our attention.
86. IAS 32 allows collateral that meets the offsetting criteria to be offset against recognised financial assets or financial liabilities (ie there is no special consideration given to items referred to as ‘collateral’). The staff believes that this practice should be allowed to continue. When recognised financial assets and financial liabilities meet the criteria for offsetting in IAS 32 offsetting should not be prohibited for such items even if they are legally referred to as ‘collateral’. Therefore the staff does not recommend that the Board include any additional guidance for treatment of collateral in IAS 32.

**Question 3: Collateral**

Does the Board agree with the staff’s recommendation in paragraph 86, namely, that the Board need not add any application guidance to IAS 32 regarding the treatment of collateral obtained or pledged in respect of recognised financial assets and financial liabilities?

If not, why not? What would the Board prefer to do and why?

## D. Unit of account

### *Background*

87. Paragraph 6 of the ED requires an entity to offset a *recognised financial asset and a recognised financial liability* if they meet the proposed offsetting criteria.<sup>19</sup>
88. The ED further defines offsetting as the ‘presentation of *one or more financial assets and financial liabilities* as a single net amount in the statement of financial position’. It also defines a right of set-off as the right to 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.”<sup>20</sup> – *emphasis added*
89. IAS 32 paragraph 42 requires an entity to offset *a recognised financial asset and a recognised financial liability* if they meet the proposed criteria. IAS 32 paragraph 45 also 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* an amount due from the creditor. – *emphasis added*
90. Neither the ED nor IAS 32 specifies the unit of account to which offsetting should be applied.

### *Feedback received /current practice*

91. As the ED does not specify the unit of account to which offsetting should be applied (and appears to suggest at least three possible units of account) many respondents requested clarification on the unit of account for offsetting (and whether the unit of account – the instrument –should be broken into smaller pieces, or pierced, when applying payment netting). They have also asked

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<sup>19</sup> ED paragraph 6

<sup>20</sup> ED paragraph 10 (a) and (b)

whether netting can be done on a portfolio basis (when payment netting is elected and/or a variation margin mechanism is present).

92. Respondents indicated various ways that they thought the offsetting requirements could be applied. These included:
  - (a) identifiable cash flows of financial assets and liabilities (a portion of a financial asset and a portion of a financial liability) or
  - (b) individual financial assets and financial liabilities (ie including offsetting a portion of a financial asset against an entire financial liability and vice versa).<sup>21</sup>
93. The issue of unit of account is more complex in the context of financial instruments with multiple cash flows. This issue is not only pertinent in the derivatives market. It applies to all instruments with multiple cash flows (eg plain vanilla debt instruments with a multi-period amortising principal profile).
94. Diversity in practice in the unit of account used as a basis for offsetting has become apparent in the feedback received. Some industries (eg energy producers and traders) apply the offsetting criteria to identifiable cash flows to reflect the way they do business and achieve offsetting in accordance with IFRSs today. Others apply the offsetting criteria to entire financial assets and financial liabilities. For those entities (eg banks), applying the offsetting criteria to individual identifiable cash flows (portions of financial assets and financial liabilities) within contracts would be impractical and burdensome and would not necessarily reflect the way they do business.
95. Some believe that if the focus of the offsetting model is the entity's cash flow exposure, then netting based on the individual cash flows of the financial instruments is conceptually pure.
96. However, they acknowledge that offsetting individual cash flows can be impractical at times. Hence, they recommend that offsetting individual cash flows should be made mandatory except where it is impractical to do so (and

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<sup>21</sup> See Appendix C for a reproduction of Agenda Paper 6B from the 22 July 2011 IASB-only meeting which discusses the feedback received and an analysis of the unit of account for applying the offsetting criteria.

then it can be applied at the instrument or portfolio level if the offsetting criteria are met in that respect).

*Staff analysis/recommendation*

97. Agenda Paper 6B from the July IASB-only meeting, attached as Appendix C further analyses how the Board might address the concerns raised about the unit of account for applying the proposed offsetting criteria.
98. The staff believes that there is no conceptual reason why the offsetting criteria cannot or should not be applied to individual cash flows (a portion of a financial asset and a portion of financial liability) and in most cases will yield a more representative amount of the future cash flows of an entity.
99. However, identifying the individual cash flows for many entities creates operational issues and may result in less meaningful amounts on the statement of financial position because individual cash flows within financial assets and liabilities would be offset. Piercing the unit of account to permit or require offsetting for portions of an entity's financial assets and financial liabilities would also override other guidance in IAS 39 and may create measurement issues when determining the amounts or portions of assets and liabilities to be offset or not offset.
100. It is also noted that entities that would face the greatest operational challenges (such as large financial institutions with large derivative books) are those for whom the offsetting requirements are most relevant in terms of the amounts of their financial assets and financial liabilities that are affected. This is important to consider because under IAS 32 offsetting is mandatory if the offsetting criteria are met.
101. Some argue that an entity's operational capabilities to offset cash flows as they arise indicate its intention (or lack of intention) to settle net or simultaneously. The staff notes that in practice, while these entities often do intend to settle net or simultaneously (eg by selecting payment netting in their master netting agreements), and ultimately do so when offsetting cash flows arise, they do not have the operational ability to track these settlements on an individual cash flow basis in advance of settlement. In order to offset on the basis of

individual cash flows it would be necessary to determine which cash flows could be offset in advance which creates a major systems challenge.

102. If the application of the offsetting guidance to individual cash flows is prohibited, entities in some industries (eg utilities and energy companies) that report in accordance with IFRSs and currently apply the guidance to individual cash flows of financial instruments and achieve offset on that basis today would no longer be permitted to do so even if this is a conceptually correct way of applying the offsetting criteria.
103. However, if the offsetting guidance was clarified to apply to individual cash flows of financial instruments, the staff believes that the board would need to allow an exemption for entities from this requirement on the basis of the level of operational complexity that would result for the reporting entity due to the concerns set out above. The staff does not believe that it would be feasible to require all entities to apply offsetting on the basis of individual cash flows. Hence the offsetting requirements would apply differently as a result of operational differences between entities.
104. In summary, the staff notes that while there is diversity in practice today with respect to the unit of account at which the offsetting criteria are applied, the diversity does not result in offsetting that contradicts the offsetting requirements today. Nor does the staff believe that the application is inconsistent with the offsetting criteria the Board has supported in the ED. The staff thinks that if the unit of account were clarified, conceptually, set-off on the basis of individual cash flows should still be allowed but practically, offsetting on the basis of entire financial assets and financial liabilities should also be accommodated. This approach would essentially result in the same application as for IAS 32 today.
105. Therefore, the staff does not believe that application guidance to clarify the unit of account for applying the offsetting criteria in IAS 32 is necessary.



**Question 4: Unit of Account**

Does the Board agree with the staff's recommendation in paragraph 105, namely, that application guidance to clarify the unit of account in IAS 32 is not necessary?

If not, why not? What would the Board propose instead?

**E. Location of offsetting requirements in IFRSs**

106. Currently IAS 32 contains the criteria for offsetting recognised financial assets and financial liabilities. It also contains requirements with respect to liability and equity classification, compound financial instruments, treasury shares, and presentation of interest, dividends, gains and losses.
107. Some respondents suggested that the offsetting requirements should be included in IFRS 9 *Financial Instruments*, to ensure all requirements for financial instruments are contained in a single standard.
108. Although some might favour presenting all information related to financial instruments in a single IFRS, the staff does not believe that this is necessary or appropriate. IFRS 9 is a replacement of IAS 39 *Financial Instruments: Recognition and Measurement* and deals both with recognition and measurement of financial instruments. IAS 32 contains requirements on presentation of financial instruments. Because offsetting is a presentation issue, the staff believes that the current offsetting requirements and any additions to the application guidance should continue to be included in IAS 32.
109. Therefore, the staff believes that any amendments as a result of this project should be placed in IAS 32.
110. In addition, at the July 2011 joint meeting the boards agreed on converged disclosure requirements related to offsetting to assist users in comparing financial statements prepared in accordance with IFRSs and US GAAP.

111. As all financial instruments disclosures are located in IFRS 7 *Financial Instruments: Disclosures*, the staff believes that the offsetting disclosures should be placed in IFRS 7.

**Question 5: Location of offsetting requirements**

Does the Board agree with the staff's recommendations in paragraphs 109 and 111, that:

- a) the offsetting criteria and amendments to the offsetting application guidance to IAS 32 should remain in IAS 32 and
- b) the offsetting disclosures should be placed in IFRS 7?

If not, why not? What would the Board propose instead?

## **F. Effective date and transition**

### ***Transition***

112. The ED proposed retrospective application of the offsetting requirements for all comparative periods presented for the statement of financial position. The boards noted that retrospective transition would maximise consistency of financial information between periods, and would facilitate analysis and understanding of comparative accounting data.
113. Many respondents supported the boards' view that retrospective application enhances consistency and comparability.
114. In Agenda Paper 8C *Effective Date and Transition-Disclosures* the staff also recommends retrospective application for the converged offsetting disclosures.

### ***Staff recommendation***

115. Retrospective application is crucial to providing comparable converged disclosure information. The proposed amendments to the offsetting application

guidance are intended to clarify the Board's intentions with respect to the current offsetting criteria rather than change practice today.

116. Based on this and paragraphs 112-114, the staff recommends that the Board require retrospective application of the amendments to the offsetting application guidance.

#### Question 6: Transition

Does the Board agree with the staff recommendation in paragraph 116, namely, to require retrospective application of the amendments to the offsetting application guidance?

If not, why not? What would you propose instead?

#### *Effective date*

117. The ED did not propose an effective date. Some respondents suggested that the offsetting proposals should have the same effective date as the other components of the IASB's financial instruments project (ie IFRS 9). Some thought it could be sooner. Others asked the boards to consider any operational or other burdens when determining the appropriate effective date.
118. The staff noted that the proposed converged offsetting disclosure requirements are less complex and have a narrower scope than those proposed in the ED. As a result an early effective date would no longer be a substantial burden to preparers. The effective date should therefore be as early as possible so that users can benefit from the additional information and increased comparability sooner rather than later.
119. In AP8C the staff recommends that the revised disclosure requirements should be effective for annual and interim reporting periods beginning on or after 1 January 2013. This date will provide entities with time to compile the disclosure information while providing users with comparable information in a timely manner.

*Staff recommendation*

120. The amendments to the offsetting application guidance in this paper (AP 8A) are not intended to change the offsetting in accordance with IAS 32 today. As a result, an earlier effective date is not expected to create a burden for preparers.
121. Based on this, and for consistency with the proposed effective date for the disclosure requirements (see paragraphs 118 and 119), the staff recommends that the amendments to the application guidance should be effective the same date as the disclosure requirements (ie for annual and interim reporting periods beginning on or after 1 January 2013).

**Question 7: Effective date**

Does the Board agree with the staff recommendation in paragraph 121, namely, that the amendments to the offsetting application guidance should be effective for annual and interim reporting periods beginning on or after 1 January 2013?

If not, why not? What effective date would the Board prefer?