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Project

Offsetting Financial Assets and Liabilities

Topic

Due process considerations

Introduction

1. In March 2011, the IASB and the FASB published an exposure draft ('ED') to replace the offsetting requirements for financial instruments in US GAAP and IFRS and to improve the disclosure requirements relating to the rights of set-off and related arrangements.
2. At the June 2011 meeting the boards decided not to pursue a common offsetting model for financial instruments but would work on common disclosure requirements related to offsetting to assist users comparing financial statements prepared under IFRS and US GAAP.
3. At the July 2011 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.
4. Following the boards' preference for different offsetting approaches and hence the decision not pursue a common offsetting model (at the June 2011 meeting), at the 22 July IASB-only meeting the staff asked the IASB to reconfirm whether they would like to:
 - (a) move forward with the ED, as modified, or
 - (b) retain the current offsetting requirements in IAS 32 *Financial Instruments: Presentation*.

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 an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

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

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5. Eight members supported retaining the existing requirements, with seven supporting completing the ED. However, the Board also noted that during the project inconsistencies in the application of the offsetting requirements in IAS 32 were highlighted. The Board therefore asked the staff to prepare a paper that would consider whether those inconsistencies should be addressed and, if so, how. In the other Agenda Papers for this meeting, the staff recommends making amendments to the application guidance to IAS 32 to address these inconsistencies.

Purpose

6. This paper reviews whether the Board has complied with due process steps, as required in the *IASB Due Process Handbook*, for the offsetting project. Consideration is given both to the disclosure requirements and the potential amendments to the application guidance to IAS 32.

Due process

7. The *IASB Due Process Handbook* includes mandatory and non-mandatory due process steps required to be undertaken before the publication of an exposure draft or the issue of a new IFRS or amendments to existing IFRSs. The Board is required to explain why it has not undertaken any of the non-mandatory steps (ie the 'comply or explain' approach).

Mandatory steps

Publishing an exposure draft, with a basis for conclusions and alternative views if relevant

8. The Board published the exposure draft ED 2011/1 *Offsetting Financial Assets and Financial Liabilities* (the ED) in January 2011. The ED had a comment period ending on 28 April 2011. The ED was approved by all fifteen Board members and included a basis for conclusions.

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Reviewing comments made within a reasonable period on documents published for comment

9. 160 comment letters were received on the ED. A comment letter summary was presented to the Board at the May 2011 meeting. Summary statistics included in that comment letter summary are reproduced as Appendix A to this paper.¹ The Board have also analysed comments in further detail in its redeliberations between May 2011 and July 2011. Redeliberations are ongoing as of the September 2011 meeting.

Consulting the Advisory Council on major projects

10. The offsetting project was included in discussions with the Advisory Council as part of the work plan update. During discussions on the work plan update, the Advisory Council had the opportunity to ask questions or provide commentary about the offsetting project.
11. Although the offsetting project was not the subject of a separate dedicated session at an Advisory Council meeting, as otherwise noted in this paper, the basis for placing the offsetting project on the Board's agenda was clear, and the scope of the project as well as the entities it impacts are relatively limited. Therefore the consultative function was also addressed via the other mandatory and non-mandatory steps.

Non-mandatory steps

Publishing a discussion document (eg a discussion paper)

12. For the offsetting project, the Board has not published a discussion document. Discussion papers are not mandatory and are generally the first publication on any major new topic as a vehicle to explain the issue and solicit early comment from constituents. They typically include a comprehensive overview of the issue, possible approaches in addressing the issue, preliminary views (if any), and an invitation to comment.

¹ Two comment letters were added to the statistics as of 7 September 2011 which had not been received prior to the publication of the May 2011 statistics.

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13. Due to the nature and scope of the offsetting project and the reasons for adding to the Board's agenda, the publication of a discussion document was not considered necessary.
14. The Board began discussing the offsetting of financial assets and financial liabilities in January 2010. Some respondents to the exposure draft *Derecognition* published in March 2009 had urged the IASB and the FASB to address the differences in their offsetting requirements. In addition, due to the market environment stakeholders (including the Basel Committee on Banking Supervision and the Financial Stability Board) asked the boards to find a common solution to offsetting these items.
15. In addition to the derecognition comment letters, the market environment and convergence, some of the other factors the Board considered in developing the proposed approach to offsetting financial assets and financial liabilities in the ED were:
 - (a) *Conceptual framework*—In evaluating whether and when offsetting in the statement of financial position is appropriate or provides useful information, the boards considered whether and when offsetting is consistent with the objective and the qualitative characteristics of financial reporting information as described in their conceptual frameworks.
 - (b) *User feedback and requests*—In their outreach activities, the boards found no consensus among users on the usefulness of presenting gross information or net information about financial assets and financial liabilities in the statement of financial position. There was, however, consensus among users that information about both the gross amounts of financial assets and financial liabilities and the net amount that results from offsetting is useful. Moreover, most users urged the boards to provide a common approach in order to enhance international comparability, especially among banks.
16. The scope of the offsetting project is relatively limited – it affects the financial statement presentation (ie not the recognition and measurement) of financial

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assets and financial liabilities of a limited number of entities. Therefore, in order to meet the objectives of a discussion document, extensive outreach was performed early in the process. Also, through these steps the Board was able to develop proposals that were sufficiently detailed for an ED, rather than a discussion document. The ED, like a discussion document, contained an invitation to comment.

Establishing working groups or other types of specialist advisory groups

17. The Board did not establish a working group or other specialist advisory group for the offsetting project. As noted above, it has been consistently confirmed that a limited number of entities would be affected by this project. Therefore, extensive outreach and public education sessions were performed to meet the objectives that might otherwise be achieved by a working group or other specialist advisory group.

Holding public hearings and undertaking field tests (both in developed countries and in emerging markets)

18. Because of the limited scope of this project, the Board has not considered it necessary to undertake field tests. The Board thinks that it is not necessary because sufficient input has been received through the following channels:
 - (a) Formal feedback through the comment letters on the ED.
 - (b) Extensive outreach activities during the exposure period (discussed further in following sections).
 - (c) Public roundtables held in London (19 participants), Singapore (14 participants), and Norwalk (20 participants) after the end of the exposure period (discussed further in following sections). The boards asked prepared questions to participants, who provided their comments and views. Participants were eligible to participate in the roundtables if they had submitted comment letters to the ED.

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Additional steps taken

19. The staff undertook additional non-mandatory steps, which included:
- (a) Public education sessions with the boards and preparers, industry organisations, clearinghouses and legal experts, both before the issue of the ED and during redeliberations, in the following meetings:
 - (i) February 2010: International Swaps and Dealers' Association (ISDA), international financial lawyers and European and US investment banks
 - (ii) June 2011: ISDA and London clearinghouse group LCH Clearnet
 - (b) An extensive program of outreach activities during the exposure period of the ED. In their outreach activities, the IASB and FASB staff met with users (including asset managers, analysts, rating agencies and regulators), preparers, auditors, standard setters, lawyers and various industry groups in Asia, Africa, North and South America and Europe. A summary of the outreach activity by type and geography of constituent (from the May 2011 feedback summary for the Board) is contained in Appendix B to this paper.
 - (c) A user survey posted on the website which focused on whether and how users of financial statements adjust for offsetting of financial instruments, to help the IASB better understand what information is useful to users. A summary of the user survey (from the May 2011 feedback summary to the Board) is contained in Appendix C to this paper.
20. The staff is satisfied that the Board has been given sufficient feedback and analysis from the consultation steps performed in the offsetting project. Throughout the project, it has been consistently confirmed that offsetting financial assets and financial liabilities affects a relatively limited number of entities, primarily large financial institutions with relatively-sophisticated systems and processes. For those affected, the effect is significant. The staff notes the extensive outreach and education sessions performed with these

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institutions, as well as the clearinghouses that serve as counterparties to many trades.

Summary

21. In the staff’s view, this project has complied with all mandatory steps in the *Due Process Handbook* thus far.
22. The staff also believes that the Board has performed sufficient non-mandatory due process steps. The Basis for Conclusions will state that fact.

Question 1	
Is the Board satisfied that the Board:	
(a)	has performed all mandatory due process steps?
(b)	has performed sufficient non-mandatory due process steps?

Re-exposure

23. Paragraph 47 of the *IASB Due Process Handbook* sets out the following guidance on determining whether re-exposure is necessary:

In considering the need for re-exposure, the IASB

- identifies substantial issues that emerged during the comment period on the exposure draft that it had not previously considered
 - assesses the evidence that it has considered
 - evaluates whether it has sufficiently understood the issues and actively sought the views of constituents
 - considers whether the various viewpoints were aired in the exposure draft and adequately discussed and reviewed in the basis for conclusions on the exposure draft.
24. The Board is required to decide whether to expose its revised proposals for another round of public comments.
 25. Appendix D sets out a summary of the Board’s tentative decisions to date and compares them with the proposals in the ED, highlighting areas where the tentative decisions differ from the proposals in the ED.

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26. The main deviations from the proposals in the ED in the tentative decisions to date (and staff recommendations from this meeting) include:
- (a) To maintain the offsetting criteria in IAS 32 rather than proceeding with the ED criteria;
 - (b) To amend the requirement that a right of set-off must be legally enforceable ‘in all circumstances’ to be legally enforceable ‘both in the normal course of business and upon the default or bankruptcy of the counterparty’, which is consistent with the ED though clarifies the words used;
 - (c) To clarify the meaning of simultaneous settlement ‘at all times’ to settlement that, even if technically not at the same moment, effectively results in a similar net exposure as in net settlement or at the same moment settlement. The distinguishing factors in these systems, which are consistent with practice under IAS 32 today, are clarified in draft application guidance in Agenda Paper 8A from this meeting; and
 - (d) To remove the prohibition on offsetting collateral and state that collateral should be offset with financial assets and liabilities if the offsetting criteria are met, which is consistent with practice under IAS 32 today.
27. The staff notes that clarifying practice issues under IAS 32 rather than the ED approach significantly limits the scope of the proposed amendments, which were identified through comments to the exposure draft and in the substantial outreach already performed as noted above. As noted in the preceding paragraph, although the staff’s draft application guidance has not been exposed in the form of application guidance, in the staff’s view its recommendations for addressing the IAS 32 practice issues identified are either consistent with the ED proposals or maintain IAS 32.
28. The staff further notes that the commenters to the ED were concerned with what they viewed as extensive and costly disclosures with little added benefit to users. The revised disclosures have been pared down significantly from the ED disclosures while still providing the information requested by users.

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Question 2

Does the Board think that any of the amendments require re-exposure?

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Appendix A: Statistical analysis of comment letters

Demographics of the comment letter respondents (as of 05 September 2011)

Respondents by geographic region	Number	%
Africa	2	1%
Asia-Pacific	28	17%
International	16	10%
Nordic	2	1%
North America	58	37%
South America	3	2%
West Europe	51	32%
Total	160	100%

Respondents by type	Number	%
Firms and industry organisations	65	41%
Preparers	50	31%
Standard setters	20	13%
Regulators	13	8%
Individuals/Other	7	4%
Users	5	3%
Total	160	100%

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Appendix B: Statistical analysis of outreach

Demographics of the outreach meeting

All constituents

Meetings by region	Number	%
Americas	56	51%
Asia Pacific	11	10%
Europe & Africa	40	36%
International	3	3%
Total	110	100%

Meetings by type of user	Number	%
Users	42	38%
Preparers	30	27%
Firms and industry organisations	17	15%
Clearinghouses and exchanges	11	10%
Regulators	10	9%
Total	110	100%

User meetings

User meetings by region	Number	%
Asia Pacific	3	5%
Europe	15	29%
International	2	4%
North America	31	60%
South America	1	2%
Total	52	100%

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Meetings by type of user	Number	%
Asset Management	10	19%
Rating agency	2	4%
Regulators		
Prudential regulator	7	13%
Securities regulator	3	6%
<i>Subtotal regulators</i>	<i>10</i>	<i>19%</i>
Users		
General	15	29%
European investment banks	4	8%
US investment banks	3	6%
Valuation firm	1	2%
<i>Subtotal users</i>	<i>23</i>	<i>44%</i>
User group	7	13%
Total	52	100%

Non-user meetings

Non-user meetings by region	Number	%
Africa	3	5%
Americas	24	41%
Asia-Pacific	8	14%
Europe	22	38%
International	1	2%
Total	58	100%

Meetings by type of constituent- non user	Number	%
Clearinghouses and exchanges	11	18%
Firms and industry organisations		
Accounting firm	11	19%
Industry organisation	3	5%
Professional organisation	1	2%
Law firm	1	2%
Standard setter	1	2%
<i>Subtotal firms and industry organisations</i>	<i>17</i>	<i>30%</i>
Preparer	30	52%
Total	58	100%

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Appendix C: Statistical analysis of user survey

Demographics of the survey respondents

Region of respondent	Number	%
Africa	2	6%
Asia	6	17%
Asia-Pacific	10	28%
International	3	8%
Middle-East	2	6%
West Europe	13	36%
Grand Total	36	100%

Type of user	Number	%
Both	12	33%
Equity	19	53%
Fixed Income	1	3%
Regulator	1	3%
not indicated	3	8%
Grand Total	36	100%

Sector	Number	%
Chemicals, Trading	1	3%
Finance Regulator	2	6%
Financial / Investments	3	8%
Financial Services	12	33%
Forestry	1	3%
Generalist	6	17%
Infrastructure	2	6%
Investments	2	6%
not indicated	7	19%
Grand Total	36	100%

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Appendix D: Comparison of ED proposals to tentative decisions in redeliberations

ED offsetting criteria

6 An entity shall offset a recognised financial asset and a recognised financial liability and shall present the net amount in the statement of financial position 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.

In all other circumstances, financial assets and financial liabilities are presented separately from each other according to their nature as assets or liabilities.

IAS 32 offsetting criteria

42 A financial asset and a financial liability shall be offset and the net amount presented in the statement of financial position when, and only when, an entity:

- (a) currently has a legally enforceable right to set off the recognised amounts; and
- (b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

ED proposals:	Tentative decisions in redeliberations (assumes staff recommendations for the application guidance in IAS 32 from this meeting are taken):
<p><u>Offsetting criteria – general</u></p> <ul style="list-style-type: none"> • An unconditional right must be legally enforceable in all circumstances [ED, par. C5 and C6] 	<p><u>Offsetting criteria – general</u></p> <ul style="list-style-type: none"> • Maintain and clarify the offsetting criteria in IAS 32 • A currently legally enforceable right must be enforceable both in the normal course of business and upon the default or bankruptcy of the counterparty

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<p><u>Unit of account</u></p> <ul style="list-style-type: none"> Some respondents commented that the unit of account was unclear 	<p><u>Unit of account</u></p> <ul style="list-style-type: none"> The unit of account will be unchanged from IAS 32. Diversity in practice (ie individual cash flows vs. entire instruments or certain groups of instruments) will exist between different types of entities (eg utilities and banks)
<p><u>Collateral</u></p> <ul style="list-style-type: none"> Collateral may not be offset with related financial assets and liabilities [ED, par. C14] 	<p><u>Collateral</u></p> <ul style="list-style-type: none"> Collateral should be offset with financial assets and liabilities if the offsetting criteria are met, consistent with IAS 32 today
<p><u>Simultaneous settlement</u></p> <ul style="list-style-type: none"> Simultaneous settlement is settlement at the same moment [ED, par. C11] 	<p><u>Simultaneous settlement</u></p> <ul style="list-style-type: none"> Simultaneous settlement is settlement that, even if technically not at the same moment, effectively results in a similar net exposure as net settlement or settlement at the same moment settlement. The distinguishing factors in these systems are clarified in draft application guidance in Agenda Paper 8A from this meeting. The staff does not view this as a change to IAS 32 practice today.