

## Investor Perspectives

### **Patricia McConnell: Gross or net? That is the question**



The comment period on the exposure draft *Offsetting Financial Assets and Financial Liabilities* ended on 28 April, and reconsideration of the proposals will begin shortly. During our outreach activities we found there was no consensus among investors on the usefulness of presenting information about financial assets and financial liabilities on a gross basis or net basis in the balance sheet. In addition, there was no consensus on what 'net' should reflect if financial instruments are presented in that way in the balance sheet. The lack of a clear investor consensus on these issues highlights the dilemma that we face in trying to meet investor needs. Consequently, it would be helpful if you would let us know your views on the proposals as soon as possible, if you have not already done so.

### **Why did the IASB and the FASB undertake this project?**

Although the investors who provided input did not always express a clear preference for gross or net presentation of financial assets and financial liabilities in the balance sheet, there was a consensus that both gross and net information are useful and that both are necessary for analysing financial statements and valuing entities. In addition, most investors urged the IASB and the FASB to develop a common standard on offsetting, particularly for financial institutions, and asked that the standard should be mandatory rather than allowing an accounting policy choice.

Currently, differences between the IASB's and the FASB's offsetting requirements are the cause of the single largest difference in the amounts presented in the balance sheets of financial institutions. US GAAP currently permits far more offsetting of financial assets and financial liabilities in the balance sheet than do IFRSs. Obviously, this impedes global comparability.

Consequently, the exposure draft, which was developed jointly by the IASB and the FASB, proposes a common approach that would replace the current requirements in both IFRSs and US GAAP for offsetting financial assets and financial liabilities.

## **What is offsetting?**

Offsetting, sometimes referred to as netting, is the presentation of one or more financial assets together with one or more financial liabilities as a single net amount in the balance sheet, which is formally referred to as the statement of financial position.

## **What are the main proposals?**

The main proposal in the exposure draft is quite simple. Offsetting is prohibited except when specific offsetting criteria are met. When the offsetting criteria are met, offsetting is required, not merely allowed as an accounting policy choice.

The criteria in the exposure draft state that a financial asset and a financial liability shall be offset when an entity:

- has an unconditional and legally enforceable right to set off the financial asset and financial liability; and
- intends either:
  - to settle the financial asset and financial liability on a net basis, or
  - to realise the financial asset and settle the financial liability simultaneously (ie there is no risk that one side settles but not the other).

The proposals define a right to set off as a debtor's legal right to settle or otherwise eliminate all or a portion of an amount due to its creditor by applying all or a portion of an amount due to it from the creditor against the amount owed. Furthermore, the proposals define an unconditional and legally enforceable right to set off as a right to set off that is enforceable in all circumstances, the exercisability of which is not contingent on a future event such as bankruptcy. In other words, the right must be enforceable at all times (ie in the normal course of business and on the default, insolvency or bankruptcy of a counterparty). Whether an entity's right to set off meets the legally enforceable criterion will depend on the law governing the

contract and the bankruptcy regime that governs the insolvency of the counterparties.

Note that while offsetting is required if these criteria are met, offsetting is really under the control of management. One of the criteria for offsetting is that the entity intends to settle net or simultaneously. The entity can avoid offsetting by simply not exercising its right to settle net or simultaneously.

### **What would companies disclose under the proposal?**

The exposure draft contains a proposal that information should be disclosed that will enable you to understand the effect of the right to set off a financial asset and financial liability and the related credit mitigation arrangements (such as collateral agreements) on an entity's financial position. The specific disclosures proposed are presented in the table below.

### **Table of proposed disclosures**

The following information shall be disclosed separately for each class of financial asset and financial liability recognised at the end of the reporting period in a tabular format unless another format is more appropriate:

1. the gross amounts of financial assets and financial liabilities;
2. the amounts offset as a result of meeting the offsetting criteria;
3. the net amount presented in the balance sheet;
4. the amounts of financial assets and financial liabilities for which the entity has an unconditional and legally enforceable right to set off the financial assets and financial liabilities but that the entity does not intend to settle net or simultaneously;
5. the amount of financial assets and financial liabilities that the entity has a conditional right to set off, separately by each type of conditional right;
6. the net amount of financial assets and financial liabilities after taking into account the items in 1 to 5; and
7. for cash or other financial collateral obtained or pledged in respect of the financial assets and financial liabilities:
  - a. the amount of cash collateral; and
  - b. the fair value of other financial instruments.

An example that illustrates some possible ways to present the required disclosures is at the end of this article.

In addition to the disclosures listed, the exposure draft proposes that an entity should provide a description of each type of conditional right to set off its financial assets and financial liabilities, including the nature of those rights and how management determines each type.

### **How will entities' financial reporting be affected?**

We expect that the proposed offsetting criteria will result in a more significant change to financial statements prepared in accordance with US GAAP than to those that are prepared in accordance with IFRSs. The proposals would eliminate the exceptions for offsetting in US GAAP for arrangements in which the ability to set off is conditional and there is no intention to set off. Consequently, if the proposal is finalised in its current form companies, particularly financial institutions, preparing financial statements using US GAAP are likely to report more financial assets and financial liabilities in their balance sheets. This may affect many financial ratios, including return on assets and leverage ratios. Changes, if any, required in the balance sheets of entities applying IFRSs are expected to be much less dramatic. The proposals modify the offsetting criteria in IFRSs by clarifying that the right to set off should not only be currently enforceable, but also enforceable at all times, including in the event of bankruptcy. The proposals also require disclosures in addition to those currently required in IFRSs and US GAAP.

### **Why did the boards decide to limit offsetting?**

Our view is that the balance sheet should show all the assets and liabilities of an entity. The offsetting that we are requiring arises when, in substance, there is a single net financial asset or net financial liability even though the legal form is of two or more separate contracts.

We concluded that offsetting financial assets and financial liabilities does not, generally, meet the objective of financial reporting as set out in the boards' conceptual frameworks. The objective of general purpose financial reporting, as set out in our Framework, is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources

to the entity. Our Framework explains that these investors need information:

- to help them assess the prospects for future net cash flows to an entity;
- about the nature and amounts of the entity's economic resources (assets) and claims against those resources (liabilities) to identify the reporting entity's financial strengths, weaknesses, liquidity and solvency and its needs for additional financing; and
- about priorities and payment requirements of existing claims to predict how future cash flows will be distributed among those with a claim against the reporting entity.

Our conceptual frameworks identify assets and liabilities as basic elements of the balance sheet—not net credit risk positions. We believe that it is the responsibility of users of financial statements to decide whether they want to offset financial assets and financial liabilities to see the entity's net exposure to particular risks, such as credit risk, or not. We see no justification for singling out credit risk as the sole basis for net balance sheet presentation. Furthermore, we do not see why offsetting credit risk should be appropriate for derivatives but not for other financial assets and financial liabilities in the balance sheet. Presenting these items on a net basis often obscures the existence of some financial assets and financial liabilities, and changes the size of the balance sheet. In turn, this limits the ability of investors to assess the future economic benefits available to, and the obligations of, the entity and hence limits investors' abilities to assess the entity's financial strengths and weaknesses. In other words, offsetting could provide misleading information about an entity's financial position, particularly its leverage and its funding, and could thus misrepresent its overall financial flexibility.

On the other hand, the boards also concluded that offsetting should be required when, and only when, an entity has an unconditional and legally enforceable right to 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. In this circumstance the entity in effect has a right to, or an obligation for, only the net amount. In other words, the entity's exposure to the financial asset and financial liability is no different from having a single net financial asset or financial liability. In addition, by making offsetting a requirement rather than an accounting policy choice, comparability across entities will be enhanced.

## What do you think?

We believe that presenting financial assets and liabilities on a gross basis and requiring offsetting in the balance sheet only when specified criteria are met, and by requiring offsetting to be accompanied by disclosures that enable you to understand the effect of the right to set off and related arrangements (such as collateral agreements), will provide you with the most useful information. We are interested to know what you think. In particular, we would like to know:

1. Do you agree that requiring financial assets and financial liabilities to be presented on a gross basis in the balance sheet with offsetting only required in specified circumstances, accompanied by disclosure of information about offsetting, credit mitigation and collateral agreements, will provide you with information to make financial decisions about an entity? If not, what do you think would be more useful?
2. Do you agree with the specified criteria for required offsetting?
3. Do you agree with the proposed disclosure requirements? Would you amend them in any way?

## Disclosure example

### Financial assets subject to offsetting and related arrangements

(Note: a similar table would be provided for financial liabilities)

CU million

| As at 31 December 20XX                | (i)                    | (ii)                                                                                     | (iii)=(i)-(ii) <sup>a</sup>                                 | (iv)                                                                 | (v)                                                                                                                                                             | (vi)=(iii)-(iv)-(v)                              | (vii) Collateral held |                                                                  | (viii)       |
|---------------------------------------|------------------------|------------------------------------------------------------------------------------------|-------------------------------------------------------------|----------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------|--------------------------------------------------|-----------------------|------------------------------------------------------------------|--------------|
| Description                           | Gross amount of assets | Gross amount of liabilities offset against assets in the statement of financial position | Net amount of assets in the statement of financial position | Gross amount of liabilities subject to conditional rights of set-off | Gross amount of liabilities subject to an unconditional and legally enforceable right of set-off but the entity does not intend to settle net or simultaneously | Net amount of assets before deducting collateral | Cash                  | Fair value of other financial instruments received as collateral | Net exposure |
| Exchange traded financial instruments |                        |                                                                                          |                                                             |                                                                      |                                                                                                                                                                 |                                                  |                       |                                                                  |              |
| OTC derivatives, repurchase and       |                        |                                                                                          |                                                             |                                                                      |                                                                                                                                                                 |                                                  |                       |                                                                  |              |

|                                                            |  |  |  |  |  |  |  |  |  |
|------------------------------------------------------------|--|--|--|--|--|--|--|--|--|
| stock lending agreements and similar financial instruments |  |  |  |  |  |  |  |  |  |
| Other financial instruments                                |  |  |  |  |  |  |  |  |  |
| Financial assets at fair value through profit or loss      |  |  |  |  |  |  |  |  |  |
| Total                                                      |  |  |  |  |  |  |  |  |  |
| Financial assets at amortised cost                         |  |  |  |  |  |  |  |  |  |
| Total                                                      |  |  |  |  |  |  |  |  |  |

<sup>a</sup> Assumes the entity has not made portfolio-level adjustments in the fair value measurement of derivatives.

**Patricia McConnell** is a Board member of the IASB. The views expressed in this article are those of the author as an individual and do not necessarily reflect the views of the International Accounting Standards Board (Board) or the IFRS Foundation (Foundation). The Board and the Foundation encourage members and staff to express their individual views. This article has not undergone the Foundation's due process. The Board takes official positions only after extensive review, in accordance with the Foundation's due process.