

INTERNATIONAL FINANCIAL REPORTING BULLETIN 2011/05

OFFSETTING FINANCIAL ASSETS AND FINANCIAL LIABILITIES



Background

The International Accounting Standards Board (IASB) and the US Financial Accounting Board (FASB) have published a joint proposal to establish a common approach to offsetting financial assets and financial liabilities in the statement of financial position (balance sheet).

Currently, applying the offsetting rules under IFRS and US GAAP yields different results for the same assets and liabilities, giving rise to very large quantitative differences in amounts presented in statements of financial position. The proposals set out in the exposure draft aim to improve, and potentially converge, the requirements for offsetting financial assets and financial liabilities under IFRS and US GAAP.

Offsetting is particularly important to banks and other financial institutions as they often enter into transactions with the same counter parties for both financial assets and financial liabilities, in particular repo transactions and derivative positions, some of which are mirror images of each other and which are settled at the same time.

Proposals

It is proposed that offsetting would be required when the right of set-off of a financial asset and a financial liability is enforceable at all times (including in the event of default and in bankruptcy), the ability to exercise that right is unconditional (and therefore does not depend on a future event), and the parties intend to settle net or settle the gross amounts simultaneously.

The proposals would apply to both bilateral and multilateral (ie between three or more parties) arrangements.

Scope

The draft IFRS proposes guidance for all instruments within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*.

Unconditional right of set-off

An unconditional right to set off means that an entity has an unconditional and legally enforceable right to settle an amount payable and an amount receivable at the net amount, without the exchange of the gross amounts concerned or where the settlement of gross amounts occurs simultaneously.

The right to settle net must not be dependent on a future event, such as default. In cases where the right of set off is dependent on a contingent event, the right to settle net does not meet the unconditional criterion, meaning that the related assets and liabilities cannot be presented net on the face of the statement of financial position.

As an example, an entity might enter into a 'master netting agreement' with a counterparty, which provides for a single net settlement in the event of default on, or termination of, any one contract. This net settlement right is a conditional right of set off and therefore the related assets and liabilities would not qualify for offset under the proposals.

STATUS

Exposure Draft

EFFECTIVE DATE

To be confirmed

ACCOUNTING IMPACT

Changes proposed to the netting criteria for, and consequent presentation of, financial assets and financial liabilities.

Intention to settle net

It is necessary to demonstrate not only an unconditional right, but also the intention, to settle net or to realise the asset and settle the liability simultaneously. Factors which determine whether an entity can demonstrate this intention include:

- Past practice of offsetting amounts and either paying or receiving a net amount;
- Past practice of settling gross amounts simultaneously; and
- Documented risk management policies.

Net settlement might occur via the operation of a clearing house in an organised financial market or face-to-face exchange. In an organised market or a clearing house the amounts due and payable may be to different parties, and may be received and paid separately for different product types; however, when the settlement of these (or a number of these) occurs at precisely the same time and there is only exposure to a single net amount (or a number of net amounts), the presentation in the statement of financial position would be net amount only.

The proposals are tightly drafted, with 'simultaneous settlement' meaning precisely that and no more. Consequently, for a financial institution where transactions are processed in batches over a period of hours, it would appear that the related assets and liabilities would not qualify for offset.

Additional guidance introduced

The proposals include application guidance as an appendix. This guidance includes assistance in determining which transactions would meet the criteria for offsetting; for example, it is noted that bilateral and multilateral set-off arrangements might exist even in cases where the parties to the financial assets and liabilities are not mutually indebted to one another (this could arise in cases of bankruptcy). The application guidance also includes consideration of margin accounts or other collateral obtained or pledged in respect of financial assets and financial liabilities, including circumstances where collateral and associated assets and liabilities would not qualify for offset.

Disclosure

Disclosure would be required of information that would enable users to understand the effects of rights of set off and related arrangements on an entity's financial position. An illustrative example is provided, setting out quantitative disclosures in tabular form.

For each class of financial assets and financial liabilities, gross amounts would be disclosed before taking into account any amounts that are offset in the statement of financial position and any adjustments for credit risk of each of the counter parties or the entity itself. These gross amounts would be reconciled to the net amounts presented in the statement of financial position.

Disclosure would also be required of any amounts where there is an unconditional and legally enforceable right of offset, but where the entity does not intend to settle net or simultaneously, and of financial assets and financial liabilities where there is a conditional right of set off.


Where collateral has been obtained or pledged in respect of an entity's financial assets and financial liabilities, disclosure would be required of the amounts and the fair value of that collateral (excluding any amounts that are in excess of any related net amount included in the statement of financial position).

Effective date and transition

The effective date and transition will be confirmed at a later stage, and may be affected by the outcome of the Boards' Request for Views: Effective Dates and Transition Methods. The offsetting exposure draft proposes retrospective application for all comparative periods presented.

Comment period

The IASB and the FASB have requested the submission of comments on their proposals by 28 April 2011.



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