January 2011

Exposure Draft ED/2011/1

Offsetting Financial Assets and Financial Liabilities

Comments to be received by 28 April 2011

IFRS™

Exposure Draft

Offsetting Financial Assets and Financial Liabilities

Comments to be received by 28 April 2011

ED/2011/1

This exposure draft *Offsetting Financial Assets and Financial Liabilities* is published by the International Accounting Standards Board (IASB) for comment only. The proposals may be modified in the light of the comments received before being issued in final form as amendments to International Financial Reporting Standards (IFRSs). Comments on the exposure draft and the accompanying documents should be submitted in writing so as to be received by **28 April 2011.** Respondents are asked to send their comments electronically to the IFRS Foundation website (www.ifrs.org), using the 'Comment on a proposal' page.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

ISBN: 978-1-907877-06-3

Additional copies of this publication may be obtained from:
IFRS Foundation Publications Department,
1st Floor, 30 Cannon Street, London EC4M 6XH, United Kingdom.
Tel: +44 (0)20 7332 2730 Fax: +44 (0)20 7332 2749
Email: publications@ifrs.org Web: www.ifrs.org

CONTENTS

Introduction and invitation to comment

Why are the IASB and the FASB publishing this exposure draft?

Offsetting (netting) assets and liabilities is an important aspect of presentation in financial statements. The differences in the offsetting requirements in International Financial Reporting Standards (IFRSs) and US generally accepted accounting principles (GAAP) account for the single largest quantitative difference in amounts presented in statements of financial position prepared in accordance with IFRSs and those prepared in accordance with US GAAP. This difference reduces the comparability of statements of financial position prepared in accordance with IFRSs or US GAAP. As a result, users of financial statements have requested and the Financial Stability Board has recommended that the differences in the requirements for offsetting be addressed expeditiously.

Some respondents to the exposure draft *Derecognition* published by the International Accounting Standards Board (IASB) in March 2009 also urged the IASB and the US Financial Accounting Standards Board (FASB) to address the differences in their offsetting requirements. The FASB also received requests from its constituents to revisit the US GAAP requirements for offsetting and, in particular, to permit offsetting for some stock lending and stock borrowing transactions. In response to those requests, the IASB and the FASB have developed this joint proposal to improve and potentially bring to convergence the requirements for offsetting financial assets and financial liabilities.

In developing the proposed approach to offsetting financial assets and financial liabilities, the boards considered various factors, including the following:

(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.

(c) *Convergence*—The offsetting project presents an opportunity to improve IFRSs and US GAAP requirements on this topic, and achieve convergence of IFRSs and US GAAP.

(d) *Market environment*—In the light of the recent financial crisis, regulators, preparers, auditors and others have called for an improvement to, and convergence of, the requirements for offsetting financial assets and financial liabilities.

Which entities would be affected by the proposed requirements?

If confirmed, the proposed requirements would affect all entities that hold all types of financial instruments within the scope of IAS 39 *Financial Instruments: Recognition and Measurement.* The proposed requirements would supersede the requirements on offsetting in IAS 32 *Financial Instruments: Presentation*.

What are the main proposals?

Under the proposals, an entity would be required to offset (ie present as a single net amount in the statement of financial position) a recognised financial asset and a recognised financial liability when it has an unconditional and legally enforceable right of set-off and intends either to settle the asset and liability on a net basis or to realise the asset and settle the liability simultaneously (the offsetting criteria).

The proposals clarify that the offsetting criteria apply whether the right of set-off arises from a bilateral arrangement or from a multilateral arrangement (ie between three or more parties). The proposals also clarify that a right of set-off must be legally enforceable in all circumstances (including default by or bankruptcy of a counterparty) and its exercisability must not be contingent on a future event.

The proposals would require an entity to disclose information about offsetting and related arrangements (such as collateral agreements) to enable users of its financial statements to understand the effect of those arrangements on its financial position.

What is the objective of the proposed requirements?

The proposed requirements establish a principle for offsetting financial assets and financial liabilities that ensures that a recognised financial asset and a recognised financial liability are offset only when:

(a) on the basis of the rights and obligations associated with the financial asset and financial liability, the entity has, in effect, a right to or obligation for only the net amount (ie the entity has, in effect, a single net financial asset or financial liability) and

(b) the amount, resulting from offsetting the financial asset and financial liability, reflects an entity's expected future cash flows from settling two or more separate financial instruments.

In all other circumstances, an entity's recognised financial assets and recognised financial liabilities are presented in the statement of financial position separately from each other, according to their nature as assets or liabilities.

Thus financial assets and financial liabilities would be presented in the financial statements in a manner that provides information that is useful for assessing:

(a) the entity's ability to generate cash in the future (the prospects for future net cash flows);

(b) the nature and amounts of the entity's economic resources and claims against the entity; and

(c) the entity's liquidity and solvency.

How would the main proposals affect IFRSs and US GAAP?

The proposals would replace the requirements in IFRSs for offsetting instruments within the scope of IAS 39 and US GAAP offsetting requirements (including the exceptions for derivatives and repurchase agreements) and would establish a common approach for the presentation of such instruments.

In US GAAP, a principle would be established that would preclude offsetting, unless specifically required or permitted by a specific standard, similar to the principle that exists in IFRSs. The proposals would eliminate the exception in US GAAP that allows offsetting for some derivative and sale and repurchase (and reverse sale and repurchase) contracts when the right of set-off is conditional, there is no intention to set off or such intention is conditional. It would also modify the offsetting criteria in IFRSs by clarifying that the right of set-off should not only be currently enforceable. The proposals would enhance disclosures required by IFRSs and US GAAP by requiring improved information about financial assets and financial liabilities subject to set-off and related arrangements (such as collateral agreements), and the effect of those arrangements on an entity's financial position.

The proposals are presented in this exposure draft as a self-contained draft IFRS rather than as draft amendments to an existing IFRS. However, if confirmed, the requirements would be included in existing requirements on the presentation of and disclosures associated with instruments within the scope of IAS 39 (ie the proposed requirements would supersede the requirements on offsetting in IAS 32 and amend the disclosure requirements in IFRS 7 *Financial Instruments: Disclosures*).

When would the proposals be effective?

The boards seek information about the time and effort that would be involved in implementing the proposed requirements. They will use that information to determine an appropriate effective date. In addition, the boards will consider the responses to their Request for Views, *Effective Dates and Transition Methods,* as well as the implementation plan for other planned new accounting and reporting standards, in order to facilitate management of the pace and cost of change.

Invitation to comment

The boards invite comments on all matters in this exposure draft, in particular on the questions set out in the paragraphs below. Comments are most helpful if they:

(a) respond to the questions as stated.

(b) indicate the specific paragraph(s) to which they relate.

(c) contain a clear rationale.

(d) if applicable, provide a suggestion for alternative wording that the boards should consider.

The boards are not seeking comments on other aspects of the accounting for financial instruments through this exposure draft.

Comments should be submitted in writing so as to be received no later than **28 April 2011**. Respondents should submit one comment letter to either the IASB or the FASB. The boards will share and jointly consider all comment letters received.

Question 1—Offsetting criteria: unconditional right and intention to settle net or simultaneously

The proposals would require an entity to offset a recognised financial asset and a recognised financial liability when the entity has an unconditional and legally enforceable right to set off the financial asset and financial liability and intends either:

(a) to settle the financial asset and financial liability on a net basis or

(b) to realise the financial asset and settle the financial liability simultaneously.

Do you agree with this proposed requirement? If not, why? What criteria would you propose instead, and why?

Question 2—Unconditional right of set-off must be enforceable in all circumstances

It is proposed that financial assets and financial liabilities must be offset if, and only if, they are subject to an unconditional and legally enforceable right of set-off. The proposals specify that an unconditional and legally enforceable right of set-off is enforceable in all circumstances (ie it is enforceable in the normal course of business and on the default, insolvency or bankruptcy of a counterparty) and its exercisability is not contingent on a future event. Do you agree with this proposed requirement? If not, why? What would you propose instead, and why?

Question 3—Multilateral set-off arrangements

The proposals would require offsetting for both bilateral and multilateral set-off arrangements that meet the offsetting criteria. Do you agree that the offsetting criteria should be applied to both bilateral and multilateral set-off arrangements? If not, why? What would you propose instead, and why? What are some of the common situations in which a multilateral right of set-off may be present?

Question 4—Disclosures

Do you agree with the proposed disclosure requirements in paragraphs 11–15? If not, why? How would you propose to amend those requirements, and why?

Question 5—Effective date and transition

(a) Do you agree with the proposed transition requirements in Appendix A? If not, why? How would you propose to amend those requirements, and why?

(b) Please provide an estimate of how long an entity would reasonably require to implement the proposed requirements.

[Draft] International Financial Reporting Standard X *Offsetting Financial Assets and Financial Liabilities* ([draft] IFRS X) is set out in paragraphs 1–15 and Appendices A–C. All the paragraphs have equal authority. Paragraphs in **bold type** state the main principles. Definitions of terms are given in the Glossary for International Financial Reporting Standards. [Draft] IFRS X should be read in the context of its objective and the Basis for Conclusions, the *Preface to International Financial Reporting Standards* and the *Conceptual Framework for Financial Reporting*. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

[Draft] International Financial Reporting Standard X *Offsetting Financial Assets and Financial Liabilities*

[FASB only] Background

1 [This paragraph in the FASB exposure draft is not used in the IASB exposure draft.]

Overview and background

2 This [draft] IFRS establishes principles for offsetting financial assets and financial liabilities in the statement of financial position.

Scope

3 This [draft] IFRS shall be applied by all entities to all items within the scope of IAS 39 *Financial Instruments: Recognition and Measurement.*

Objective

4 This [draft] IFRS establishes a principle for offsetting financial assets and financial liabilities, namely, an entity shall offset a recognised financial asset and recognised financial liability only when:

(a) on the basis of the rights and obligations associated with the financial asset and financial liability, the entity has a right to or obligation for only the net amount (ie the entity has, in effect, a single net financial asset or financial liability) and

(b) the amount, resulting from offsetting the financial asset and financial liability, reflects an entity's expected cash flows from settling two or more separate financial instruments.

5 In all other circumstances, an entity presents recognised financial assets and recognised financial liabilities in the statement of financial position separately from each other, according to their nature as assets or liabilities. Financial assets and financial liabilities would thus be presented in the financial statements in a manner that provides information that is useful for assessing:

(a) the entity's ability to generate cash in the future (the prospects for future net cash flows);

(b) **the nature and amounts of the entity's economic resources and claims against the entity; and**

(c) **the entity's liquidity and solvency.**

Presentation

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.

7 In accounting for a transfer of a financial asset that does not qualify for derecognition, the entity shall not offset the transferred asset and the associated liability.

8 An entity that undertakes a number of financial instrument transactions with a single counterparty may enter into a 'master netting agreement' with that counterparty. Such an agreement may provide for a single net settlement of all financial instruments covered by the agreement in the event of default on, or termination of, any one contract. Such a right is a conditional right of set-off and does not meet the criterion in paragraph 6(a). Hence an entity shall not offset in the statement of financial position financial assets, financial liabilities and amounts recognised as accrued receivables or payables, in respect of those assets and liabilities, on the basis of such rights of set-off.

9 An entity shall not offset, in the statement of financial position, 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.

10 For the purposes of this [draft] IFRS:

(a) Offsetting is the presentation of one or more financial assets and financial liabilities as a single net amount in the statement of financial position.

(b) A right of set-off is a debtor's legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount all or a portion of an amount due from the creditor or a third party.

(c) 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.

(d) A conditional right of set-off is a right of set-off that can be exercised only on the occurrence of a future event.

(e) A legally enforceable right of set-off is a right of set-off that is enforceable in all circumstances (ie enforceable both in the normal course of business and on the default, insolvency or bankruptcy of one of the counterparties).

(f) Realisation of a financial asset and settlement of a financial liability are treated as simultaneous only when the settlements are executed at the same moment.

Disclosure

11 An entity shall disclose information about rights of set-off and related arrangements (such as collateral agreements) associated with the entity's financial assets and financial liabilities to enable users of its financial statements to understand the effect of those rights and arrangements on the entity's financial position.

12 To meet the requirements in paragraph 11, an entity shall disclose, as the minimum, the following information separately for financial assets and financial liabilities recognised at the end of the reporting period by class of financial instruments:

(a) the gross amounts (before taking into account amounts offset in the statement of financial position and portfolio-level adjustments for the credit risk of each of the counterparties or the counterparties' net exposure to the credit risk of the entity).

(b) showing separately,

(i) the amounts offset in accordance with the criteria in paragraph 6 to determine the net amounts presented in the statement of financial position;

(ii) the portfolio-level adjustments made in the fair value measurement to reflect the effect of the entity's net exposure to the credit risk of counterparties or the counterparties' net exposure to the credit risk of the entity; and

(iii) the net amount presented in the statement of financial position.

(c) the amounts of financial assets and financial liabilities that the entity has an unconditional and legally enforceable right to set off but that the entity does not intend to settle net or simultaneously.

(d) 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.

(e) the net amount of financial assets and financial liabilities after taking into account the effect of the items in (a)–(d).

(f) for cash or other financial instrument collateral obtained or pledged in respect of the entity's financial assets and financial liabilities:

(i) the amount of cash collateral (excluding the amount of cash collateral in excess of the amount in (b)(iii)), and

(ii) the fair value of other financial instruments (excluding the portion of the fair value of such collateral that is in excess of the amount in (b)(iii)).

(g) the net amount of financial assets and financial liabilities (ie the difference) after taking into account the effect of the items in (e) and (f).

The information required by this paragraph shall be presented in a tabular format, unless another format is more appropriate.

13 An entity shall provide a description of each type of conditional right of set-off separately disclosed in accordance with paragraph 12(d), including the nature of those rights and how management determines each type.

14 If the information required by paragraphs 11–13 is disclosed in more than a single note to the financial statements, an entity shall cross-reference from the note in which the information in paragraph 12 is disclosed to the notes in which the information required by paragraphs 11 and 13 is disclosed.

15 An entity need not provide the information required by paragraphs 11–14 if the entity has no financial assets and financial liabilities at the reporting date that are subject to a right of set-off and the entity has neither obtained nor pledged cash or other financial instruments as collateral in respect of recognised financial assets and recognised financial liabilities.

Appendix A
Effective date and transition

This appendix is an integral part of [draft] IFRS X.

A1 An entity shall apply this [draft] IFRS for annual and interim periods beginning on or after [date to be inserted after exposure]. The [draft] IFRS shall be applied retrospectively for all comparative periods presented.

Appendix B
[Draft] Amendments to other IFRSs

B1 This [draft] IFRS supersedes the offsetting requirements in IAS 32 *Financial Instruments: Presentation*.

B2 The disclosures required by paragraphs 11–15 will be added to IFRS 7 *Financial Instruments: Disclosures*.

Appendix C
Application guidance

This appendix is an integral part of [draft] IFRS X.

Offsetting financial assets and financial liabilities: criteria (paragraph 6)

C1 The offsetting criteria in paragraph 6 include two requirements:

(a) an unconditional and legally enforceable right to set off the financial asset and financial liability; and

(b) the intention 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.

An arrangement does not qualify for offset if it lacks one of the requirements in paragraph 6, for example, when an entity has an unconditional and a legally enforceable right of set-off, but does not intend to settle the financial asset and financial liability net or to realise the asset and settle the liability simultaneously, or vice versa.

Unconditional and legally enforceable right of set-off (paragraph 6(a))

C2 A right of set-off is a debtor's legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount all or a portion of an amount due from the creditor or a third party. It is the right that one party has against another to use its asset (amount owed to it by a creditor or another party) in full or partial payment (or satisfaction) of what it owes the creditor.

C3 The right of set-off may be unconditional or conditional. Similarly, a right of set-off may be enforceable only in some circumstances or may be enforceable in all circumstances. However, 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.

C4 A conditional right of set-off is a right of set-off that can be exercised only on the occurrence of a future event. For example, an entity may have a right to set off recognised amounts, such as in a master netting agreement or in some forms of non-recourse debt, but such a right may be enforceable or triggered only on the occurrence of some future event, usually the default of the counterparties or other credit-related events or on termination of the contracts. In some cases, an entity may have a right of set-off that is exercisable on changes to particular legislation or a change in control of the counterparties. Conditional rights of set-off such as these do not meet the offsetting criteria and, hence, the financial asset and financial liability subject to such rights of set-off shall not be offset.

C5 A right of set-off may arise as a result of a provision in law (or a regulation) or it may arise as a result of a contract. Because the right of set-off is a legal right, the conditions supporting the right may vary from one legal jurisdiction to another. Moreover, in particular cases, the laws of a jurisdiction about the right of set-off may provide results different from those normally provided by contract or as a matter of common law. Similarly, the bankruptcy or insolvency laws of a jurisdiction may impose restrictions on or prohibitions against the right of set-off in bankruptcy, insolvency or similar events in some circumstances.

C6 Thus, whether an entity's right of set-off meets the legally enforceable right of set-off criterion will depend on the law governing the contract and the bankruptcy regime that governs the insolvency of the counterparties. Therefore, the laws applicable to the relationships between the parties (eg contractual provisions, the law governing the contract, and the bankruptcy laws of the parties) need to be considered to ascertain whether the right of set-off is enforceable in all circumstances.

Intention to settle on a net basis (paragraph 6(b)(i))

C7 To offset a financial asset and a financial liability in the statement of financial position, an entity must have an intention to settle net or settle simultaneously the financial asset and financial liability. An entity's intention to settle net or settle simultaneously may be demonstrated through its past practice of executing set-off or simultaneous settlement in similar situations, its usual operating practices or by reference to the entity's documented risk management policies. An entity's intentions with respect to settlement of particular assets and liabilities may, however, be influenced or restricted by its usual operating practices, industry practice, the requirements of the financial markets, and other circumstances that may affect the ability to settle net or to settle simultaneously. The requirement for an intention to settle net or to settle simultaneously is assessed from the reporting entity's perspective.

C8 In practice, even though an entity has the right to settle net, it may settle gross either because of lack of appropriate arrangements or systems to effect net settlement or to facilitate operations. If this is the case, the entity presents such assets and liabilities separately (ie it shall not offset the asset and liability) in the statement of financial position (except when the entity intends to settle the asset and the liability simultaneously).

C9 Some contracts and master netting agreements provide for automatic set-off of payments due to or from the parties if they occur on the same day and are in the same currency. Also, in a centrally cleared financial market with a central counterparty, the rules of the clearing house typically provide for automatic netting and cancellation of offsetting contracts. For such contractual arrangements, the entity's intention is considered to have been demonstrated at the date of entering into the contracts.

Intention to realise the financial asset and settle the financial liability simultaneously (paragraph 6(b)(ii))

C10 An entity's intention to settle simultaneously must be demonstrated, for example, through its past practice of executing simultaneous settlement in similar situations, by its normal operating practices or by reference to the entity's documented risk management policies. Thus, incidental simultaneous settlement of a financial asset and financial liability does not meet the criterion in paragraph 6.

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.

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 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 and there is exposure only to the net amount.

Bilateral and multilateral set-off arrangements (paragraph 6)

C13 Generally, the right of set-off requires 'mutuality' of parties (ie the parties must be mutually indebted to each other) for it to be enforceable. However, a party may contract out of the requirement of mutuality and allow its asset to be made available to be set off against a third party's liability. For example, A, B and C agree that A may set off amounts owed by A to B against amounts owed to A by C. Hence, in unusual circumstances a debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor (ie a tripartite arrangement). However, not all jurisdictions recognise this type of contractual set-off arrangement, particularly in bankruptcy scenarios. If the arrangement meets the criteria in paragraph 6, an entity shall offset the relevant financial asset and financial liability.

Collateral obtained or pledged in respect of financial assets and financial liabilities

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.

Reassessment of right of set-off (paragraph 6)

C15 A right of set-off that does not meet the unconditional right of set-off criterion would subsequently qualify as an unconditional right of set-off if the contingent event(s) occurs and that right of set-off no longer meets the definition of a conditional right of set-off in paragraph 10. However, a right of set-off that may be removed by a future event does not meet the unconditional right of set-off criterion in paragraph 6. Similarly, if the right to set off a recognised financial asset and financial liability is exercisable only before a specific date, that right of set-off does not qualify as an unconditional right of set-off.

Disclosures (paragraphs 11–15)

C16 Paragraph 12 requires an entity to disclose the required information by class of financial instruments. An entity shall group financial assets and financial liabilities (separately) into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial instruments and the applicable rights of set-off.

C17 Paragraph 12(d) requires disclosure of the portion of the net amount presented in the statement of financial position that is covered by each type of conditional and legally enforceable right of set-off. The disclosures required by paragraph 12(d) may be presented in the aggregate for similar types of rights of set-off if separate disclosure of each type of right of set-off would not provide more useful information to users of financial statements. An entity shall disclose the criteria it applies in aggregating similar rights of set-off. At a minimum, an entity shall distinguish between rights of set-off that are exercisable on default, bankruptcy or insolvency (or similar events) and rights of set-off that are exercisable in the normal course of business. In determining whether to aggregate the disclosures in paragraph 12(d) for different types of rights of set-off, an entity shall consider the characteristics of those rights and the disclosure requirements in paragraph 12.

C18 Paragraph 12(f) restricts the amount of cash or other financial instrument collateral to be disclosed in respect of the entity's financial assets and financial liabilities to the amounts of the financial asset or financial liability, as presented in the statement of financial position. An aggregate disclosure of the amount of cash or the fair value of other financial instrument collateral would not provide meaningful information about the effect of collateral arrangements on the entity's financial position if account is not taken of over-collateralisation of financial assets or under-collateralisation of financial liabilities and vice versa.

C19 The specific disclosures required by paragraphs 12 and 13 are minimum requirements and an entity may need to supplement them depending on the nature of the rights of set-off and related arrangements and their effect on the entity's financial position. Disclosures required by other IFRSs may be considered in determining whether additional information needs to be disclosed to meet the requirements in paragraph 11.

C20 An entity shall present the disclosures in a manner that clearly and fully explains to users of the financial statements the nature of rights of set-off and related arrangements and their effect on the entity's financial assets and financial liabilities. An entity shall determine how much detail it must provide to satisfy the disclosure requirements of this [draft] IFRS. The entity must strike a balance between obscuring important information as a result of too much aggregation and excessive detail that may not help users of financial statements to understand the entity's financial position. For example, an entity shall not disclose information that is so aggregated that it obscures important differences between the different types of rights of set-off or related arrangements.

[Draft] Illustrative examples

This guidance accompanies, but is not part of, the [draft] IFRS.

Disclosures (paragraph 12)

IE1 The following examples illustrate some possible ways to meet the quantitative disclosure requirements in paragraph 12. However, these illustrations do not address all possible ways of applying the disclosure requirements of the [draft] IFRS.

Financial assets subject to offsetting and related arrangements

CU million

As at 31 December 20XX	(i)	(ii)	(iii)=(i)-(ii)[a]	(iv)	(v)	(vi)=(iii)-(iv)-(v)	(vii)		(viii)
							Collateral held		
	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
Description									
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									

(a) Assumes the entity has not made portfolio-level adjustments in the fair value measurement of derivatives.

Financial liabilities subject to offsetting and related arrangements

CU million									
As at 31 December 20XX	(i)	(ii)	(iii)=(i)-(ii)[a]	(iv)	(v)	(vi)=(iii)-(iv)-(v)	(vii) Collateral pledged		(viii)
	Gross amount of liabilities	Gross amount of assets offset against liabilities in the statement of financial position	Net amount of liabilities in the statement of financial position	Gross amount of assets subject to conditional rights of set-off	Gross amount of assets 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 liabilities before deducting collateral	Cash	Fair value of other financial instruments pledged as collateral	Net exposure
Description									
Exchange traded financial instruments									
OTC derivatives, repurchase and stock borrowing agreements and similar financial instruments									
Other financial instruments									
Financial liabilities at fair value through profit or loss									
Total									
Financial liabilities at amortised cost									
Total									

(a) Assumes the entity has not made portfolio-level adjustments in the fair value measurement of derivatives.

Approval by the Board of *Offsetting Financial Assets and Financial Liabilities* published in January 2011

The exposure draft *Offsetting Financial Assets and Financial Liabilities* was approved for publication by the fifteen members of the International Accounting Standards Board.

Sir David Tweedie	Chairman
Stephen Cooper	
Philippe Danjou	
Jan Engström	
Patrick Finnegan	
Amaro Luiz de Oliveira Gomes	
Prabhakar Kalavacherla	
Elke König	
Patricia McConnell	
Warren J McGregor	
Paul Pacter	
Darrel Scott	
John T Smith	
Tatsumi Yamada	
Wei-Guo Zhang	

Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, the draft IFRS.

Introduction

BC1 This Basis for Conclusions summarises the considerations of the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) in reaching the conclusions in the exposure draft *Offsetting Financial Assets and Financial Liabilities*. Individual Board members gave greater weight to some factors than others.

BC2 Following requests from users of financial statements and the recommendations of the Financial Stability Board, the IASB and the FASB added a project to their respective agendas to improve and potentially bring to convergence the requirements for offsetting financial assets and financial liabilities. The boards made this decision because the differences in their requirements for offsetting financial assets and financial liabilities are the cause of the single largest difference in amounts presented in statements of financial position between those prepared in accordance with International Financial Reporting Standards (IFRSs) and those prepared in accordance with US generally accepted accounting principles (GAAP).

Proposed requirements

BC3 The proposed requirements would replace the requirements in IFRSs and US GAAP for offsetting financial assets and financial liabilities and would establish a common approach.

BC4 Under the proposed requirements, an entity would be required to offset a recognised financial asset and a recognised financial liability if, and only if, it has an unconditional and legally enforceable right of set-off and intends either to settle the asset and liability on a net basis or to realise the asset and settle the liability simultaneously.

BC5 The proposals would eliminate the exceptions in US GAAP for offset in some arrangements in which the ability to set off is conditional and there is no intention to set off or such intention is conditional. The proposals would enhance disclosures required by IFRSs and US GAAP by requiring improved information about financial assets and financial liabilities subject to set-off rights and related arrangements (such as collateral agreements), and the effect of those rights and arrangements on an entity's financial position.

BC6 The proposals clarify that the offsetting criteria apply whether the right of set-off arises from a bilateral arrangement or from a multilateral arrangement (ie between three or more parties). The proposals also clarify that a legally enforceable right of set-off must be a right of set-off that is enforceable in all circumstances (including the normal course of business and default by, or the bankruptcy of, a counterparty).

Outreach performed

BC7 In reaching their conclusions the boards conducted extensive outreach—including meetings with users, legal experts and firms, preparers, regulators, clearing houses, industry groups and auditors:

(a) **Representatives from the banking sector** provided an overview of their organisation’s netting policies and practices and also industry practice with respect to netting.

(b) **Legal experts on financial law** provided an overview of (i) the legal meaning, basis and effect of set-off rights in master netting and other agreements; (ii) whether the legal analysis and effect of contracts with or through central counterparties differ; and (iii) the interaction of set-off rights with bankruptcy laws and relevant cross-border implications.

(c) **The International Swaps and Derivatives Association and representatives of clearing houses** provided a general overview of the master netting agreement framework, how the various aspects (ie confirmations, schedules, the master agreement and the other documents) of the framework relate to each other, how the framework is intended to work and the workings and rules of clearing houses and exchanges.

(d) **Auditors:** The staff also sent a ‘Request for Information’ to some accounting firms. Most of the firms consulted asked the boards to establish a principle for what the statement of financial position is intended to communicate to users and said that offsetting in the statement of financial position should follow that principle.

(e) **Users:** The staff and the boards met users of financial statements, including analysts from asset management firms, investment banks, user groups and rating agencies to discuss their views on offsetting. The staff also invited users to respond to an online survey on the question. There was no consensus from those users about the usefulness of providing gross or net information in the statement of financial position. Responses varied depending on the geographical location of users and company as well as the type of user (ie whether they were buy side or sell side analysts and whether they were equity or credit analysts). However, irrespective of their views there was consensus that both gross and net information is useful and both are required for analysing financial statements. They asked the boards to develop a common standard to allow international comparability, especially among banks. They also preferred a mandatory requirement to offset if the criteria are met (if the boards decide to allow offsetting), rather than allowing offset as an accounting policy choice, in order to improve comparability between entities.

Principle underlying the proposed approach for offsetting financial assets and financial liabilities

BC8 It is a general principle of financial reporting that (a) assets and liabilities are presented separately from each other consistently with their characteristics as resources or obligations of the entity and (b) offsetting recognised assets and recognised liabilities detracts from the ability of users both to understand the transactions, other events and conditions that have occurred and to assess the entity's future cash flows.

BC9 The boards decided that offsetting financial assets and financial liabilities is appropriate and reflects the financial position of an entity only if:

(a) on the basis of the rights and obligations associated with the financial asset and financial liability, the entity has, in effect, a right to or an obligation for only the net amount (ie the entity has, in effect, a single net financial asset or financial liability), and

(b) the amount resulting from offsetting the asset and liability reflects an entity's expected future cash flows from settling two or more separate financial instruments.

In all other circumstances, recognised financial assets and recognised financial liabilities of an entity are presented in the statement of financial position separately from each other, according to their nature as assets or liabilities.

BC10 Thus financial assets and financial liabilities would be presented in the financial statements in a manner that provides information that is useful for assessing:

(a) the entity's ability to generate cash in the future (the prospects for future net cash flows);

(b) the nature and amounts of the entity's economic resources and claims against the entity; and

(c) the entity's liquidity and solvency.

BC11 The boards concluded that the net amount represents the entity's right or obligation if (a) the entity has the ability to insist on a net settlement or enforce net settlement in all situations (ie the exercise of that right is not contingent on a future event), (b) that ability is assured, and (c) the entity intends to receive or pay a single net amount, or to settle simultaneously.

Conceptual Framework for Financial Reporting

BC12 In evaluating whether and when offsetting in the statement of financial position is appropriate or provides useful information, the boards considered whether offsetting is consistent with the objective and the qualitative characteristics of financial reporting information as described in the *Conceptual Framework for Financial Reporting*.

BC13 The boards' *Conceptual Framework* specifies that the objective of general purpose financial reporting 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. It explains that existing and potential investors, lenders and other creditors need information:

(a) to help them assess the prospects for future net cash flows to an entity;

(b) about the nature and amounts of a reporting entity's economic resources and claims against the entity to identify the reporting entity's financial strengths, weaknesses, liquidity and solvency and its needs for additional financing; and

(c) 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.

BC14 Thus, the objective of financial reporting necessitates provision of information in the statement of financial position about the economic resources of the entity (its assets) and the claims on those resources (its liabilities and equity).

BC15 Generally, presenting assets and liabilities net limits the ability of users of financial statements to assess the future economic benefits available to, and obligations of, the entity and hence their ability to assess the entity's financial strengths and weaknesses. Offsetting obscures the existence of some assets and liabilities and thereby reduces users' ability either to assess the entity's liquidity and solvency and its needs for additional financing or to predict how future cash flows will be distributed among those with a claim against the entity.

BC16 The boards therefore concluded that offsetting financial assets and financial liabilities does not, generally, meet the objective of financial reporting, as set out in the *Conceptual Framework,* and that financial assets and financial liabilities should therefore, generally, be presented gross in the statement of financial position.

BC17 The boards believe that offsetting a financial asset and a financial liability in the statement of financial position is consistent with the objective of financial reporting only if, on the basis of the rights and obligations associated with a financial asset and a financial liability, the entity has, in effect, a right to or obligation for only the net amount (ie the entity has, in effect, a single net financial asset or financial liability).

BC18 The boards believe that the net amount represents the entity's right or obligation if (a) the entity has the ability to insist on a net settlement or enforce net settlement in all situations (ie the exercise of that right is not contingent on a future event), (b) that ability is assured, and (c) the entity intends to receive or pay a single net amount, or to settle the asset and liability simultaneously.

BC19 The *Conceptual Framework* states that the qualitative characteristics of information in financial reports are the attributes that make information in financial statements useful to users of financial statements. For financial information to be useful, it must be relevant and faithfully represent what it purports to represent.

BC20 The *Conceptual Framework* defines relevant financial information as information that is capable of making a difference in the decisions made by users. Financial information has that capability if it has predictive value, confirmatory value or both.

BC21 The boards believe that, generally, the presentation of gross amounts of assets and of liabilities provides more relevant information than a net presentation. In particular, the boards believe that gross amounts of derivative assets and liabilities are more relevant to users of financial statements than net amounts for assessing the liquidity or solvency of an entity. A derivative can generally be settled or sold at any time for an amount equal to its fair value. Thus the boards believe that gross amounts generally provide better information about the entity's derivatives portfolio and its exposure to risk.

BC22 Gross presentation of derivative assets and liabilities also depicts a market assessment of the present value of the net future cash flows directly or indirectly embodied in those assets and liabilities, discounted to reflect both current interest rates and the market's assessment of the risk that the cash flows will not occur. Periodic information about the gross fair value of an entity's derivative portfolio (under current conditions and expectations), for example, should help users both in making their own predictions and in confirming or correcting their earlier expectations.

BC23 Thus the boards concluded that the gross presentation of such assets and liabilities generally provides relevant information and is more useful to investors, creditors and other users of financial statements than a net presentation.

BC24 However, the boards concluded that when the proposed offset criteria are met, offsetting meets the relevance criteria as doing so reflects that the entity has, in effect, a right to or obligation for only the net amount (ie the entity has, in effect, a single net financial asset or financial liability). Hence in these circumstances offsetting should be required.

BC25 The *Conceptual Framework* explains that for financial information to be useful, it must not only provide relevant information, it must also faithfully represent the phenomena that it purports to represent.

BC26 Offsetting generally obscures the existence of some assets and liabilities in the statement of financial position and it changes the size of the statement of financial position. Thus, the boards believe that a net presentation of assets and liabilities in the statement of financial position generally does not provide a complete depiction of the assets and liabilities of an entity.

BC27 Offsetting is conceptually different from the derecognition of financial instruments. Although conceptually different, offset that results in a net amount of zero and derecognition resulting in no gain or loss are indistinguishable in their effect in the statement of financial position. Likewise, not recognising assets and liabilities of the same amount in financial statements achieves similar reported results. Hence the boards believe that offsetting could provide misleading information about an entity's financial position.

BC28 The boards concluded that when, on the basis of the rights and obligations associated with the financial asset and financial liability, the entity has, in effect, a right to or obligation for only the net amount (ie the entity has, in effect, a single net financial asset or financial liability), offsetting faithfully represents the economic resources of and claims against an entity. The boards concluded that this is the case if 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), the ability to insist on a net settlement is assured, and the entity intends to receive or pay a single net amount, or to settle simultaneously.

Alternative approaches

BC29 The boards considered other approaches for determining when offsetting a recognised financial asset and a recognised financial liability would provide more useful information to users of financial statements. The boards rejected those approaches for the reasons set out below.

Requiring offset when an entity has a conditional right of set-off

BC30 The boards considered whether offset should be required when an entity has a legally enforceable right of set-off but that right is conditional (ie enforceable or would be triggered only on the occurrence of some future event, usually the default, insolvency or bankruptcy of the counterparty or other credit-related events). Under this alternative, all financial assets and financial liabilities that are executed with the same counterparty and are subject to a legally enforceable master netting agreement, or similar netting arrangement, would be offset, regardless of their other characteristics (for example, maturity, type or underlying risk). This approach is based on the notion that offsetting is appropriate if counterparty risk is mitigated.

BC31 Under existing and proposed requirements, when an entity enters into a contract that hedges its exposure to a particular risk, it is not required or permitted to present the asset and the liability in that hedge relationship net in the statement of financial position (although the arrangement may even result in complete mitigation of the entity's exposure to a particular market risk). The boards could not identify a reason why net presentation should be allowed or required solely because a master netting agreement reduces an entity's credit exposure (one type of risk) on financial contracts.

BC32 Conditional rights of set-off are present in many arrangements, for example, non-recourse debt arrangements and banker and customer relationships, and offset is not allowed for any of those arrangements. The boards were unable to identify any conceptual or practical reason for singling out contracts governed by a master netting agreement and cash collateral for offset in accounting.

BC33 The boards believe that net presentation (of the gross amounts of the assets and the liabilities) in the statement of financial position, under this approach, reduces users' ability to understand the implied economic leverage position of an entity. Leverage is of concern to users because of two effects: (a) it creates and increases the risk of default and (b) it increases the potential for rapid deleveraging.

BC34 The boards believe that zero gross exposure is different from zero net exposure (if offset is on the basis of a conditional right of set-off), because the latter may have significant counterparty, operational or other risks. For example, a bank that has a large amount of derivative contracts outstanding but without any significant net exposure could still make very large losses if prices change significantly or important counterparties fail and netting arrangements do not work.

BC35 The boards were not convinced that requiring offsetting on the basis of what might or might not happen in the future (ie an assumption that an entity or its counterparties will default or become bankrupt) would be appropriate.

BC36 The boards also concluded that offsetting based on a conditional right of set-off will result in financial statements that depict only the entity's exposure to credit risk. The boards observed that the statement of financial position does not represent an aggregation of the credit risk of an entity: it is not its purpose to set out the rights or the obligations of an entity if counterparties fail or become bankrupt. Thus the boards concluded that offsetting on the basis of a conditional right of set-off would not result in financial statements that are representationally faithful.

BC37 The boards evaluated the similarities in and differences between offsetting a financial asset and financial liability under this approach and netting of payments underlying a swap agreement. The accounting treatment of a swap agreement is that of a single financial arrangement (ie a swap is a single financial instrument and it is accounted for as such).

BC38 There is some similarity between offsetting and some payment arrangements in a swap contract. Typically, the contractual payments underlying the swap contract are netted before payment is made (but this is not always the case). A swap contract that is structured so that the settlement dates for the pay leg and receive leg are the same and requires or provides that amounts payable and receivable must be settled net (ie the difference between the pay leg and the receive leg) would be consistent with the proposed offset criteria as the contract would typically provide an unconditional and legally enforceable right of set-off and the entity can demonstrate intention to settle net.

BC39 However, not all swap contracts are structured in the manner set out in paragraph BC38. Irrespective of the settlement provisions, the accounting treatment of a swap agreement is that of a single financial arrangement (ie a swap is a single financial instrument and it is accounted for as such). The offsetting criteria are not relevant when there is only a single financial instrument. Offsetting is applicable only when an entity has both a financial asset and a financial liability and the conditions for offsetting are met. Thus the boards believe that offsetting under this approach is different from net presentation of the different rights and obligations in a single derivative instrument (eg the payment obligations and right to receive cash under an interest rate swap agreement).

BC40 Moreover, the right of the parties to a swap agreement to pay a net amount on settlement is not a conditional right. Hence the right to pay a net amount in a swap agreement is different from conditional rights of set-off in master netting agreements (close-out netting), which are enforceable only on the occurrence of some future event, usually the default, insolvency or bankruptcy of the counterparty or other credit-related events.

BC41 The boards considered the argument that offsetting positions under contracts governed by a master netting agreement with conditional set-off rights do not impair the representational faithfulness of the financial statements because a master netting agreement consolidates the master agreement and all transactions covered by it into a single agreement.

BC42 One general issue relating to the master netting framework (irrespective of whether the right of set-off provided by the arrangement is conditional or unconditional) is whether the separate parts of the framework constitute a single contract or a number of separate contracts. There is scope for different views on this issue, and it may be that the terms of the individual transaction, case law and the laws of a particular jurisdiction might favour one view over the other. However, the main issue is the effect of such provisions: is it a derecognition/recognition issue, an offsetting issue or a question of measurement?

BC43 If the entire master netting agreement is to be treated as a single contract (and hence a single financial instrument for accounting purposes), it would raise issues of recognition and derecognition. The question would be when to recognise such an agreement as an asset or a liability and subsequently how to treat any new transaction (ie whether subsequent transactions are modifications of the contract or change the nature of the asset or liability previously recognised in such a way that the previously recognised asset or liability should be derecognised).

BC44 Under existing requirements, each of the transactions covered by a master netting agreement is recognised separately as an asset or a liability as the case may be. The boards concluded that:

(a) each trade or transaction is exposed to risks that may differ from the risks to which the other trades or transactions are exposed;

(b) the pricing of the individual transactions is independent;

(c) each transaction is typically negotiated as a separate trade with a different commercial objective;

(d) each of the individual transactions represents a transaction with its own terms and conditions and is not meant to be performed concurrently or consecutively with other transactions; and

(e) an entity has separate performance obligations and rights for each of such transactions and each may be transferred or settled separately.

BC45 Hence, the boards concluded that, irrespective of whether all the transactions constitute a single contract at law, consistently with current requirements, each of those arrangements (transactions) should be recognised and presented separately as an asset or liability, as the case may be.

BC46 The boards believe that counterparty risk is a matter of measurement rather than presentation and thus mitigation of credit risk per se should not be the basis for offsetting. Hence, the FASB's proposed Accounting Standards Update: *Fair Value Measurements and Disclosures (Topic 820): Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*, published on 29 June 2010, proposes that the effect of master netting agreements should be used as the basis for determining credit valuation adjustments when there is a legally enforceable right to set off one or more financial assets and financial liabilities with the counterparty in the event of default (for example, because the reporting entity has entered into an enforceable master netting agreement with that counterparty).

BC47 The boards believe that for presentation purposes net amounts are also important but should be disclosed in the notes. Financial statements contain notes, schedules and other information that supplement the information in the primary financial statements. For example, they may contain additional information that is relevant to the needs of users about the items in the statement of financial position and the statement of comprehensive income, such as disclosures about the risks and uncertainties affecting the entity, information about geographical and industry segments and the effect on the entity of changing prices. Similarly, the boards concluded that information about the effect on credit risk of conditional set-off arrangements is best provided by the disclosure of the nature, effect and extent of such arrangements.

Requiring offset when an entity has a conditional right of set-off and the contracts have the same or primary underlying risks

BC48 Another approach the boards considered was to allow offsetting if an entity has a conditional and legally enforceable right of set-off and the contracts have the same risks or same primary risks.

BC49 This alternative is based on the notion that it is not appropriate to offset financial assets and financial liabilities unless the following risks are eliminated: (a) counterparty risk in the event of default and (b) underlying market risk, because doing so would not faithfully represent the types of risks to which an entity is exposed or the timing of its cash flows.

BC50 This approach, arguably, is consistent with how contracts are handled or aggregated on exchanges and in clearing systems. In such scenarios net positions are determined instrument by instrument (ie are based on risk type). In general, exchanges either (a) set off positions in a particular product (by book entry) or (b) net by novating outstanding contracts into a single contract at the end of a trading date or period, if the contracts are of the same type (eg risk, duration, currency). This approach is also seen, partly, to be consistent with how financial institutions manage risks. Financial institutions manage not only credit risk but also market risk with the objective of maintaining both types of risk at an acceptable level.

BC51 The boards concluded that implementing this approach would raise practical problems as it would be difficult to identify a single primary underlying risk: financial instruments, especially derivatives, are usually exposed to several different types of risk. For example, a forward contract for equity securities often has both share price and foreign currency exchange risk. This may cause operational difficulties for entities because they would have to determine the primary or predominant risk of every financial asset and financial liability to determine which items should be offset in the statement of financial position. Moreover, offsetting on the basis of the same primary risk ignores the other risks that may be present in financial assets and financial liabilities.

Requiring offset only when the financial asset and financial liability are settled on the same date or the asset is settled before the liability

BC52 The boards considered whether two instruments should be required to be offset if the instruments have the same contractual maturity or the asset settles before the liability. This criterion is aimed at preventing a situation in which an entity makes the required payment (for a liability) but is unable to obtain payment from the counterparty for its asset at a later time.

BC53 The boards noted that this criterion is useful but the requirement for an entity to demonstrate its intention to settle net or settle simultaneously to qualify for offsetting addresses that concern. Hence the boards regard this requirement as redundant.

Requiring only an unconditional right of set-off

BC54 Some reason that an unconditional and legally enforceable right of set-off is of itself a sufficient condition for offsetting a financial asset and a financial liability. They argue that if an unconditional right of set-off is enforceable, the financial asset and financial liability together form a single asset or liability regardless of how the parties intend to settle the two positions. They also reason that an intention to settle net is subjective and difficult to substantiate.

BC55 The boards believe that the existence of an unconditional right of set-off, by itself, is not a sufficient basis for offsetting. In the absence of an intention to exercise the unconditional right of set-off or to settle the financial asset and financial liability simultaneously, the amount and timing of an entity's future net cash flows are not affected. Also, an intention by one or both parties to settle on a net basis without an unconditional and legally enforceable right to do so is not a sufficient basis for offsetting because the rights and obligations constitute separate financial assets and financial liabilities and should be presented separately from each other in accordance with their characteristics as rights or obligations.

BC56 The boards concluded that the existence of the unconditional and legally enforceable right of set-off, by itself, is not a sufficient basis for offsetting because the amount and timing of an entity's future cash flows may not be affected and providing information on a net basis would not assist users in assessing future cash flows. Hence the boards concluded that in the absence of an intention to exercise the unconditional right of set-off (to settle net), presentation of the asset and liability on a net basis would be inappropriate.

Other considerations

BC57 The boards also took the following issues into account in reaching their conclusions.

Multilateral set-off arrangements

BC58 The boards evaluated whether to limit offsetting only to the case when an entity has an asset and a liability with the same counterparty (bilateral) or to require offsetting for arrangements in which more than two parties are involved (multilateral).

BC59 Traditionally, offsetting is allowed for arrangements between two parties. However, IAS 32 *Financial Instruments: Presentation* points out that 'In unusual circumstances, a debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor provided that there is an agreement between the three parties that clearly establishes the debtor's right of set-off.'

BC60 Some reason that it is difficult to satisfy all the other conditions, including having a legally enforceable right of set-off, under multilateral arrangements. They reason that, as stated in IAS 32, there may be cases in which a multilateral agreement meets the criteria of intention and ability to set off, but those cases are 'unusual circumstances'. Hence they believe that requiring offsetting for multilateral arrangements would not be appropriate.

BC61 The boards concluded that although multilateral offsetting is likely to be unusual there is no basis for explicitly excluding multilateral netting arrangements from the scope of offsetting if all the other criteria, including legal enforceability, are met for the transaction.

Collateral obtained or pledged in respect of financial assets and financial liabilities

BC62 The boards believe that the collateral for an amount owed is irrelevant to the question of whether assets and liabilities should be presented separately or offset in the statement of financial position. The credit risk that an entity faces in relation to settling a liability may be negligible or non-existent because of the collateral for the debt, but this is not a sufficient reason to require offsetting in the statement of financial position. The boards note that users are interested in information about an entity's performance and financial position rather than simply credit risk.

BC63 The boards concluded that offsetting the payables and receivables related to cash collateral would make it difficult to analyse the relationship between the carrying amount of financial instruments and the associated gains or losses reported in the statement of comprehensive income. They therefore concluded that cash and other financial instrument collateral should not be offset against recognised financial assets and financial liabilities.

Consistency with Basel Framework requirements

BC64 Some users and constituents requested that the offsetting guidance should be aligned with the Basel II requirements on netting. The boards reviewed the Basel guidance on netting for purposes of capital adequacy calculations (in the Basel II Accord). The boards noted that there are significant differences between the Basel II netting guidance and the offsetting requirements.

BC65 The boards noted that aligning the offsetting requirements with the Basel II netting requirements would be difficult to achieve because the differences are significant. The Basel Framework permits netting in a wider range of circumstances than is permitted under IFRSs and US GAAP. The boards also believe that the objective of financial statements and hence the goal of offsetting may not necessarily be congruent with that of prudential regulation. Thus the offsetting and netting requirements will inevitably be different. The Basel Framework is intended to reflect the exposure in the event of default of an entity's counterparties, which is seen as an appropriate measure for capital adequacy purposes. But such an approach does not result in financial statements that are consistent with the objective of financial reporting.

Should offset be required or permitted if the offset criteria are met?

BC66 At present, when the offsetting criteria are met, IFRSs require entities to offset financial assets and financial liabilities, whereas US GAAP permits, but does not require, offsetting when the specified criteria are met.

BC67 As noted in paragraph BC7, although there was no consensus regarding the usefulness of gross versus net information, there was consensus for a common solution. Users argued for a common standard to be developed to allow for international comparability. The boards concluded that a common solution (and consistent approach and application of the proposed requirements) would enhance comparability across entities.

BC68 The boards note that financial statements provide useful information if they enable users to identify similarities and differences between entities. Information about an entity is more useful if it can be compared with similar information about other entities. Thus the boards concluded that offsetting should be required if the offsetting criteria are met.

Disclosure

BC69 The proposals would require an entity to provide information about rights of set-off and related arrangements (such as collateral agreements) and the effect of those arrangements on the entity's financial position.

BC70 The boards noted that faithful representation requires provision of all relevant information that is necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations. Hence the boards decided to require improved information about financial assets and financial liabilities subject to rights of set-off, and related arrangements (such as collateral agreements), and the effect of those rights and arrangements on an entity's financial position.

BC71 In developing the disclosure requirements, the boards took into account the disclosure requirements in IFRSs, US GAAP and the Basel Framework and what the boards perceive to be gaps in the current disclosure requirements in IFRSs and US GAAP.

BC72 The boards' outreach showed that users unanimously support robust disclosures, regardless of the offsetting criteria. The boards took into account the views of users and market participants in developing the proposed disclosure requirements.

Cross-referencing

BC73 The boards propose to require cross-referencing to other notes in which information about rights of set-off and related arrangements is disclosed, to the extent that the information required is disclosed in more than a single note. Users have consistently criticised the presentation of disclosures about financial instruments (in particular derivatives) as being difficult to understand and follow. The boards noted that disclosing the required information in a single note could provide the desired information about rights of set-off and related arrangements. Furthermore, the boards believe that disclosing the required information in a single note could enhance the understandability of information about rights of set-off and related arrangements.

BC74 The boards also noted that some of the information proposed to be required may already be required by other IFRSs and US GAAP. The boards therefore decided that transparency would be best enhanced by requiring cross-referencing of the rights of set-off and related arrangements note to the other notes that include disclosures about rights of set-off and other related arrangements. The boards also concluded that it would not be appropriate for the boards to prescribe the organisation of note disclosures. This is because the boards believe that management should be able to determine the most appropriate presentation of the note disclosures.

Tabular information

BC75 The proposed disclosures would require the quantitative information to be presented in a tabular format, unless another format is more appropriate. The boards believe that a tabular format would best convey an overall understanding of an entity's financial position and the effect of any rights of set-off and other related arrangements. The boards believe that using tables would improve the transparency of information about rights of set-off and related arrangements and their effect on an entity's financial position.

Netting arrangements

BC76 The boards note that rights of set-off can reduce the credit risk exposures of market participants, relative to what the exposures would be were the same parties liable for their gross exposures on the same set of underlying contracts. This can be the case irrespective of whether the proposed offsetting criteria are satisfied. Hence the boards believe that disclosures about the existence, nature and effect of such rights would be useful to users of financial statements.

Collateral arrangements

BC77 In most cases collateral posted or obtained against financial liabilities and financial assets may be liquidated immediately upon an 'event of default'. As such, collateral mitigates counterparty risk. Consequently, disclosing the value of collateral posted or obtained provides useful information in understanding the net exposure of an entity. The boards note that margin payments in the form of cash are just one way of posting or obtaining collateral. In many cases, other financial assets are used as collateral. Hence the boards concluded that an entity should disclose information about both cash and other financial instrument collateral and the effect of such arrangements on the entity's financial position.

Transition requirements

BC78 The boards identified two transition approaches, namely, prospective and retrospective.

BC79 Prospective transition would require an entity to apply the relevant provisions only on a prospective basis. Prospective transition is generally appropriate only in situations where it is not practicable to apply a standard to all prior periods and/or the standard applies to discrete non-recurring events or transactions. The boards do not believe that this is the case with the proposed requirements. The boards believe that prospective application would decrease comparability and might be misleading to users of financial statements.

BC80 Retrospective transition would require an entity to apply the new requirements to all periods presented. This would maximise consistency of financial information between periods. Retrospective transition would also facilitate analysis and understanding of comparative accounting data. This consideration is more significant under US GAAP as there will be considerable change in the numbers in the statement of financial position (as a result of eliminating the exceptions for conditional rights of set-off). Therefore the boards decided to require retrospective application whereby all comparative periods would be presented to reflect the revised offsetting requirements for consistency and comparability.