



19 April 2011

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Your ref: ED/2011/1

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

Dear Sir David

ED/2011/1 *Offsetting Financial Assets and Financial Liabilities*

ICAEW is pleased to respond to your request for comments on the exposure draft *Offsetting Financial Assets and Financial Liabilities*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

Eddy James ACA
Technical Manager
Financial Reporting Faculty

T +44 (0)20 7920 8701
E Eddy.James@icaew.com



ED/2011/1 *OFFSETTING FINANCIAL ASSETS AND FINANCIAL LIABILITIES*

Memorandum of comment submitted in April 2011 by ICAEW, in response to the IASB's Exposure Draft *Offsetting Financial Assets and Financial Liabilities* published in January 2011.

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the exposure draft *Offsetting Financial Assets and Financial Liabilities* published by the International Accounting Standards Board (IASB).

WHO WE ARE

2. ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 136,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance, which has over 775,000 members worldwide.
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. We ensure that these skills are constantly developed, recognised and valued.

MAJOR POINTS

Welcome for the exposure draft

4. We welcome the publication of the exposure draft and the Boards' efforts to develop a converged approach to offsetting financial assets and financial liabilities. Agreeing upon a common approach is critical if meaningful international comparisons are to be drawn, especially when considering banks and other financial sector entities.

Aim should be consistency of presentation

5. The proposals will result in disclosure of both gross and net positions and we understand both positions are of interest to users. Therefore the main question is whether the statement of financial position should be presented on a net or gross basis. There are different views on which provides the most useful information and which is most consistent with the statement of principles. However, it is our understanding that the key point for users is that there is consistency in presentation between IFRS and US reporters and that, uniquely, this is more important than whether gross or net amounts are included in the statement of financial position. Normally we would not see international comparability as being the deciding factor but in this instance, which is simply a matter of balance sheet presentation, we agree that consistency should take priority.
6. Therefore, if after consulting their respective constituents both the IASB and the FASB are still supportive of the exposure draft, we would concur with taking these proposals forward, with some improvements, into the final standard.
7. We can accept the proposed offsetting requirements which are based on the existing principles contained within IAS 32 *Financial Instruments: Presentation* as these requirements are based on a clear principle with no exceptions or choices and result in comparable presentation across different entities. Nevertheless, we are of the view that this does not provide the most useful information in the primary financial statements in all circumstances.
8. In our view a principles based approach which results in a similar outcome to US GAAP would provide more relevant information about potential future cash flows for instruments such as derivatives than these proposals. However, we would not support importing the US GAAP requirements into IFRS since they include exceptions and choices for preparers which potentially reduce comparability. We would suggest that the IASB and FASB work together to

develop an approach which results in offsetting with an outcome more similar to US GAAP but based on a clearer principle. Should the Boards fail to agree on the proposals in the current exposure draft, we would encourage the Boards to pursue this alternative.

9. On the other hand, if no agreement can be ultimately reached between the IASB and the FASB, we see no reason to change existing practice and would therefore encourage the IASB to continue to use IAS 32 in its current form. In our view, the effort of making changes to IFRS would only be of benefit to achieve consistent presentation with US GAAP.

Disclosures

10. We are supportive of some of the enhanced disclosures requirements proposed, including the requirements to disclose additional information about rights of set-off and related arrangements. However, we are concerned that the proposals will require significantly more detailed information than is currently the case and that this may result in a disproportionate level of detail as compared with disclosure requirements in other areas.
11. We believe that the proposed disclosure requirements should be reconsidered in order to make them less onerous and to ensure consistency with the requirements of IFRS 7 *Financial Instruments: Disclosures*.

Unintended consequences

12. We understand that the proposals are intended to better articulate the existing requirements of IAS 32, rather than to make substantial changes to practice. Where the proposals would change existing practice, for example, where offsetting under IAS 32 can no longer be achieved because the settlement cannot be demonstrated to be conducted at exactly the same time, we hope that the Boards will reconsider the wording of the final standard, particularly where the actual method of settlement introduces no additional risks.

Effective date

13. We refer you to our submission in response to your *Request for Views on Effective Dates and Transition Methods*.
14. If the IASB continues with the approach in the ED, we note that, given the limited nature of the change for many IFRS preparers, it may be possible for them to adopt a revised standard with little lead time. However, we would not require changes before the required adoption of the revised financial instrument standard.

RESPONSES TO SPECIFIC QUESTIONS/POINTS

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?

15. There are different views on offsetting, which reflect differences in opinion on what the statement of financial position should represent. In our view, an approach which resulted in offsetting more similar to that in US GAAP would provide more relevant information for the statement of financial position, with gross positions being disclosed in the notes. Nevertheless, we understand that users are more interested in consistency between IFRS and US reporters than whether gross or net amounts are included in the statement of financial position. Therefore, if it would achieve consistency with US GAAP, we can accept the proposed offsetting requirements. However, as set out in paragraphs 7-9 above, if this approach will not result in consistent presentation with US GAAP, then we suggest that the Boards reconsider or, ultimately, that the IASB maintain IAS 32.
16. If the principles in IAS 32 are to be maintained we believe that they could be better articulated, in particular by removing the notion of 'intent'. It is difficult to understand how intentions can be demonstrated by the operation of the rules of a particular clearing house as explained in paragraph C9 or influenced or restricted by other external factors as explained in paragraph C7. Whether contracts are settled on a net basis in these circumstances seems more a matter of fact than intent. It is also not clear why the detailed mechanics of a clearing system should have such an impact on presentation. This is accounting based on the legal form rather than the economic substance which we do not support. Similarly, we believe the focus on simultaneous settlement being at the same time, as set out in paragraph C11, is not only impractical but places undue emphasis on a relatively minor point. Provided there is no credit or liquidity risk as a settlement mechanism operates, we do not see why the exact timing of settlement should have such an impact on presentation.
17. We note that the exposure draft includes application guidance on periodic reassessment of the right of set-off. We are supportive of this guidance.

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?

18. Provided the IASB continues with this approach, we agree that this clarifies that offsetting should only occur where the right of set-off is enforceable in all circumstances. While we do not disagree that this clarifies the underlying principle, we are concerned that there could be consequences where existing practice is changed. If these changes are unintended, the IASB will need to further refine the drafting or return to the existing drafting in IAS 32.
19. Many master netting agreements used by financial institutions would fail to meet the offsetting criteria as they usually only permit offsetting in the case of default ie, they are conditional. This

would mean that financial assets and financial liabilities held under such arrangements would be presented gross. We acknowledge that in such situations some users will be interested in the net position, which better reflects the credit risk, and hence we support the additional disclosures in this area. We also accept that the outcome may be inconsistent with the requirements of the Basel Framework for prudential regulation. Nonetheless, we believe that this is a reasonable accounting result consistent with an underlying principle.

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?

20. We agree that the scope of the requirements should continue to include both bilateral and multilateral set-off arrangements. Although multilateral offsetting arrangements are unlikely to be common, we see no basis for excluding them and agree that offset would be appropriate provided all the relevant criteria are met.

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?

21. We agree with the proposals to require entities to disclose enhanced information about rights of set-off and related arrangements. As demonstrated by the Boards' outreach activities, users are interested in the position before and after arrangements to mitigate credit risk. Such disclosures will help users understand a more complete picture of an entity's financial position. However, we do not agree that entities should disclose the gross positions before the offsetting required by the standard. Where positions are offset, the result represents an asset or liability in accordance with the *Conceptual Framework*, as set out in paragraph BC 17, and this should be sufficient information.
22. We believe that the proposed tabular format will aid user understanding.
23. However, we are concerned that the proposals will require significantly more detailed information than is currently the case and that this may result in a disproportionate level of detail as compared with disclosure requirements in other areas. Therefore, we believe that the gross positions before the offsetting required by the standard should not be an additional disclosure requirement.
24. In addition, we believe that the interaction between these proposed disclosures and the existing requirements of IFRS 7 *Financial Instruments: Disclosures* need to be carefully considered and any duplication eradicated.

Question 5 - Effective date and transition

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

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

25. We agree with the proposed retrospective application of these proposals.
26. We note that the ED does not provide an effective date. See our separate representation letter in response to your *Request for Views on Effective Dates and Transition Methods* for our overall views on effective dates.

27. While it may be possible for IFRS preparers to adopt a revised standard with little lead time, given the limited nature of the change for them, and therefore early adopt these proposals in isolation, we would not require changes before the required adoption of the revised financial instrument standard. In any case, US preparers may require additional lead time.

E Eddy.James@icaew.com

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