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IFRS

New on the Horizon: Offsetting financial assets and financial liabilities

February 2011

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Contents

Joint proposals on offsetting financial assets and financial liabilities

On 28 January 2011 the IASB and the FASB (the Boards) issued joint proposals on offsetting financial assets and financial liabilities in the statement of financial position. Although offsetting does not affect reported earnings, offsetting, or not offsetting, can have an enormous impact on reported assets and liabilities and significantly affect leverage and gearing ratios calculated from an entity's financial statements. Offsetting is an issue particularly for banks and other financial sector entities. The Boards report that offsetting requirements account for the single largest quantitative difference between statements of financial position prepared under IFRS and under US GAAP.

Under the proposals entities would offset a financial asset and a financial liability only when there is both an unconditional right and an intention to settle net. This would represent a major change from current US GAAP requirements that allow companies to offset derivative, as well as related collateral, and certain repo balances subject to master netting agreements when net settlement is conditional on default or is not intended. As a result, many US financial institutions might see a big increase in reported assets and leverage. Banks reporting under IFRS also may be impacted as a result of the more detailed criteria and guidance contained in the proposals, including those related to derivatives and cash collateral. Therefore, financial institutions will need to get to grips with how the proposals might affect the treatment of complex settlement and margining arrangements with financial market counterparties and clearing houses and any possible interaction with regulatory capital requirements.

It is good to see the IASB and the FASB working closely together. We welcome the prospect of convergence in this area. Sir David Tweedie, the Chairman of the IASB, has called the effect of the current differences between US GAAP and IFRS "not acceptable in global capital markets." However, there is still a debate to be had about whether the proposals of the IASB and the FASB offer the best possible converged solution. We hope that this publication will provide helpful insight into the proposals and encourage you to contribute to that debate.

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1. Highlights

The guidance in the IASB's ED/2011/1 *Offsetting Financial Assets and Financial Liabilities* (the exposure draft) and the FASB's Proposed Accounting Standards Update *Offsetting Financial Assets and Financial Liabilities* proposes convergence of the offsetting requirements for financial assets and financial liabilities between IFRSs and US GAAP. The proposed requirements may affect all entities that hold financial instruments within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*.

The proposed offsetting criteria would be similar to those that currently exist in IAS 32 *Financial Instruments: Presentation*. Therefore, the proposals would be more likely to have a significant impact on entities that report under US GAAP. The proposals would eliminate the exception under US GAAP that allows offsetting for some arrangements in which the ability to offset is conditional and there is no intention to offset or the intention is conditional. However, the proposals would amend IAS 32 by clarifying that, in order to enable offsetting, a right of set-off must be both unconditional and legally enforceable in *all* circumstances as opposed to the present requirement that an entity currently have a right to set-off. The proposals also contain additional detail with respect to derivatives and collateral. Therefore, it is unclear whether the proposals could have a significant impact on entities reporting under IFRSs, depending on their circumstances, how they have applied the existing guidance in IAS 32 and how the guidance in the proposals is meant to be interpreted and applied.

As well as its potential effects on financial statement presentation, the exposure draft also proposes additional disclosure requirements about offsetting and related arrangements.

Main proposals

- Offset of a recognised financial asset and a recognised financial liability would be required when the entity:
  - has an unconditional and legally enforceable right of set-off; and
  - intends either to settle the asset and the liability on a net basis or to realise the asset and settle the liability simultaneously.

  In all other cases, offsetting would be prohibited.
- A right of set-off would be unconditional if its exercisability is not contingent on the occurrence of a future event.
- A right of set-off would be considered legally enforceable if it is enforceable in all circumstances.
- The offsetting criteria would apply to both bilateral and multilateral arrangements.
- Disclosures would be enhanced through improved information about financial assets and financial liabilities subject to set-off and related arrangements, and the effect of those arrangements on the entity's financial position.

Impact of the proposals	
Sectors affected	Offsetting of financial assets and financial liabilities is particularly an issue for banks and other financial sector entities. Financial institutions hold large amounts of financial assets and financial liabilities. They may engage in multiple derivative and other transactions with financial market counterparties and clearing houses that include complex settlement and margining arrangements. Offsetting, or not offsetting, can have an enormous impact on reported assets and liabilities and significantly affect leverage and gearing ratios calculated from an entity's financial statements.
Regulatory capital requirements	Under the international Basel frameworks for banks, many asset measures used in calculating regulatory capital requirements are based on the entity's financial statements. However, there is a tendency to more use of specific regulatory parameters that reflect the different objectives of prudential regulation and general purpose financial reporting. These include specific regulatory rules for offsetting. For example, for the purposes of the maximum leverage ratio requirement to be introduced under Basel III, derivatives and repos would be subject to netting in accordance with certain of the Basel II principles. However, financial institutions may be subject to additional national requirements or requirements applying to non-banks, e.g. insurance companies and securities brokers. Although these requirements may not generally be affected by changes in principles for offsetting under IFRSs, entities should evaluate the impact in light of their own particular circumstances and the specific requirements to which they are subject.
Taxes and other levies	Some jurisdictions have implemented or are considering imposing taxes or other levies on financial institutions based on their assets or liabilities. Depending on how relevant legislation is framed, the tax or levies due may be impacted by a change in requirements for offsetting under IFRSs.
Management and employee remuneration	Some bonus schemes may have targets based on returns on assets that are calculated from IFRS measures. Also, some management remuneration schemes may be based on reducing asset amounts in the statement of financial position or leverage calculated from IFRS financial statements.
Compliance with debt covenants	Debt agreements may impose limits on the amount of total debt or on the leverage or gearing of a borrower. These limits may be based on IFRS amounts. Borrowers subject to such covenants should consider how the proposals might impact them.

Impact of the proposals	
Knowledge	In order to apply the proposals or understand their impact, an entity needs to understand the terms of relevant financial instruments, including settlement and margin arrangements, and their legal effect. Whether an entity's right of set-off would meet the legally enforceable criterion depends on the law governing the contract and the bankruptcy regime that governs the insolvency of the reporting entity and the counterparties. Therefore, further input from legal specialists may be necessary to understand whether the criteria would be met.
System and process impacts	Possible impacts to systems and processes include: • tracking the gross financial assets and financial liabilities that qualify for offsetting under the proposals; and • aligning systems with the other proposed disclosure requirements of the exposure draft.

2. Background

The Boards report that the differences between the offsetting requirements under IFRSs and US GAAP account for the single largest quantitative difference in reported numbers in statements of financial position prepared in accordance with their respective frameworks. Users of financial statements, including the Financial Stability Board, requested the Boards to address these differences between IFRSs and US GAAP. In response, the Boards decided to issue jointly proposed changes to their standards on offsetting financial assets and financial liabilities.

In developing their proposed approach to offsetting financial assets and financial liabilities, the Boards considered amongst others the following factors:

- Conceptual framework – whether and when offsetting is consistent with the objectives and the qualitative characteristics of financial reporting as described in their conceptual frameworks.
- Convergence – the opportunity to achieve convergence between IFRSs and US GAAP.
- User feedback and requests – although there was no consensus with regard to the usefulness of offsetting, most wanted information as to both gross and net amounts for financial assets and financial liabilities and urged the Boards to provide a high quality common approach in order to improve international comparability.
- Market environment – the requests for improvement and convergence of offsetting requirements by regulators.

3. Scope and objective

3.1 Scope

ED 3

The proposed requirements would be applicable to all entities and to all items within the scope of IAS 39.

3.2 Objective

ED 2, 4, BC3, BC12

The objective of the exposure draft is to establish a common principle under IFRSs and US GAAP for offsetting financial assets and financial liabilities that provides useful information consistent with the *Conceptual Framework for Financial Reporting 2010*.

ED 4, BC9, BC17, BC24

Under the proposed principle an entity would offset a recognised financial asset and a recognised financial liability only when:

- the entity has a right to or obligation for the net amount, i.e. an entity has, in effect, a single net financial asset or financial liability; and
- the amounts resulting from offsetting reflect the entity's expected cash flows.

Observation – Comparison of proposed principle with IAS 32 and derecognition

ED BC17, BC24, BC27, IAS 32.42

The formulation of the proposed principle is very similar to what is contained in IAS 32.

However, although there may be in effect a single net asset or liability, the Boards distinguish carefully between the concept of offsetting, being a matter of presentation, and the concept of derecognition.

Offsetting does not involve derecognition of the amounts that were offset or a remeasurement of the net amount. By contrast, derecognition implies the surrender or extinguishment of existing assets or liabilities together with their removal from the statement of financial position and their replacement by new assets or liabilities. Derecognition may entail recording a gain or loss and a new measurement approach to the new assets or liabilities.

ED 5

In all other cases, recognised financial assets and recognised financial liabilities would be presented separately.

ED 5, BC10, BC14

The proposed offsetting principle aims to help users assess:

- the entity's ability to generate cash in the future;
- the nature and amounts of the entity's economic resources and claims against the entity; and
- the entity's liquidity and solvency.

4. Presentation

4.1 Offsetting criteria

ED 6, C1, C3, BC4

Under the proposed principle, an entity would 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 the financial liability; and
- intends either to settle the financial asset and financial liability net or to realise the financial asset and settle the financial liability simultaneously.

ED 6, BC66-BC68

Offset of financial assets and financial liabilities is not an accounting policy choice. If, and only if, the offsetting criteria are satisfied, then the entity would be required to offset the financial assets and financial liabilities.

ED 7, IAS 32.42, 39.36

The proposals would retain the current prohibition in IAS 32 and IAS 39 against offsetting a transferred financial asset that does not qualify for derecognition against the associated liability.

4.2 Change in offsetting criteria from IAS 32

IAS 32.42

Under paragraph 42 of IAS 32 offset is required when, and only when, an entity *currently* has a legally enforceable right to set-off and intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

In the exposure draft, the word 'currently' has not been retained and the term 'unconditional' has been added. The offsetting guidance in IAS 32 does not discuss the future enforceability of a current enforceable right to set-off beyond the requirement to consider the entity's intent to settle net.

ED 6, C15

However, under the proposals, it is explicit that offsetting would not be permitted if a legally enforceable right of set-off is currently exercisable but its exercisability may be removed by the occurrence of a future event, or as a result of the passage of time.

IASB webcast

In a webcast hosted by the IASB on 31 January 2011, it was stated that the IASB's intention in drafting the exposure draft had been that the only change with respect to the offsetting criteria, compared to IAS 32, was to replace the notion of a current enforceable right with that of an unconditional and legally enforceable right.

4.3 Unit of account

ED 6

Although the exposure draft addresses offsetting of recognised financial assets and recognised financial liabilities, the Boards make a number of observations about the 'unit of account' to which the offsetting criteria should be applied. The Boards make these observations in their discussions on alternative approaches to the proposed offsetting principle in the Basis for Conclusions to the exposure draft.

IAS 32.11, 39.9, 14, 17, 39

IAS 32 refers variously to a financial asset or financial liability as representing a 'contract' or 'contractual right' or 'obligation'. Individual derivative transactions generally are thought of as financial instruments or contracts.

4.3.1 Master netting agreements

ED BC41-BC43

The first observations with regard to the unit of account relate to master netting agreements. An entity that enters into multiple financial instrument transactions with a counterparty may do so under a master netting agreement. These arrangements are used commonly by financial institutions to provide protection against circumstances that result in a counterparty being unable to meet its obligations. A master netting agreement usually is an umbrella agreement that allows a conditional or unconditional right of set-off with respect to all the individual contracts it governs. More generally, a master agreement establishes a contractual framework under which the parties may enter into individual financial instrument transactions. Some might argue that the master agreement itself constitutes one single contract that encompasses all individual transactions within its scope. There may or may not be legal support for this view, depending on the circumstances. Possibly, if such a view were applied also for financial reporting purposes, then the entire master agreement, encompassing all the individual transactions, could be seen as one single financial instrument. In this case, each individual transaction entered into under the master agreement would not itself represent a distinct financial instrument to be accounted for separately.

Adoption of such an approach would have potentially far-reaching consequences. As the Boards note, entering into or terminating individual transactions would represent a modification or novation of the single financial instrument represented by the master agreement, and give rise to issues around derecognition and recognition. Additionally, under this approach, challenging issues would arise around whether or how individual transactions under the master agreement could be subject to different measurement classifications or could be designated as hedging instruments.

ED BC44, BC45

The Boards rejected such an approach and note that "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." Notwithstanding the debate about the legal status of the master agreement, the Boards believe this reflects the fact that each transaction under the master agreement has its own risks, commercial objective and performance rights and obligations that are capable of separate transfer or settlement, and typically is priced and negotiated separately. Based on this approach, individual transactions under a master netting agreement are separate financial assets and financial liabilities that can be offset only if they meet the offsetting criteria.

4.3.2 Derivatives

ED BC37-BC39

The Boards also evaluated the similarities in and differences between offsetting a financial asset and a financial liability and netting of payments underlying a swap agreement. An individual transaction, such as an interest rate swap, may itself represent a bundle of expected contractual cash flows, some being inflows and others being outflows, each occurring at different points in time. Notwithstanding this, the derivative is presented either as an asset or a liability at a single net fair value amount. The Boards believe that a swap is a single financial instrument and is accounted for as such. Therefore, it is not necessary to consider whether the individual cash inflows and outflows of the swap meet the offsetting criteria.

4.4 Defined concepts

4.4.1 Right of set-off

ED 10, C2

Under the proposals, a right of set-off is a debtor's legal right to settle or eliminate an amount due to a creditor by applying against it an amount due from the creditor or a third party.

4.4.2 Unconditional right of set-off

ED 10, C4, C15

A right of set-off is unconditional if its exercisability is not contingent on the occurrence of a future event. Conversely, a conditional right of set-off is one that is exercisable on the occurrence of a future event and thus cannot qualify for offsetting. For example, a right of set-off that would be triggered on the default of a counterparty, termination of the contract, changes in legislation or a change in control would be considered conditional and would not qualify for offsetting. Similarly, an existing right of set-off that might be removed by a future event or that is exercisable only before a specific date also would be considered conditional and would not qualify for offsetting.

A right that is conditional may become unconditional as a result of the event that triggers its exercisability occurring and may qualify for offsetting thereafter.

Observation – Application of 'unconditional' to derivatives

ED BC37-BC40

Derivatives sometimes are described as 'conditional contracts' in the sense that the future cash flows depend on future changes in an underlying. For example, no future cash flows may arise on an option if it expires out of the money, and the future cash payments or receipts on an interest rate swap will vary depending on movements in the reference interest rate index. Therefore, the ability of an entity to exercise a right of set-off under a derivative contract, even if it is not conditional on any other event, might be argued to be conditional on there actually being future amounts payable and receivable that can be set-off. This issue is not explicitly addressed in the proposals.

Although there are references in the Basis for Conclusions to the exposure draft to the gross presentation of derivative assets and liabilities generally providing more relevant and better information about cash flows and exposure to risk, the only explicit statements as to the failure of derivative assets and liabilities to qualify for offsetting is in the context of master netting agreements in which the right to off-set is conditional on default or termination.

Observation – Right of set-off that expires on a specific date

ED C15

A right of set-off that is exercisable only before a specific date would not be considered unconditional and would not qualify for offsetting. The exposure draft does not explain why this is the case or how it is consistent with the defined concept of an unconditional right of set-off. The reason for this requirement may be that the occurrence of the date on which the right expires is considered an event and that its exercisability is contingent on that date not occurring. However, it is unusual to consider the passage of time to be either an event or contingent.

It is possible that the statement is intended to capture only situations in which the entity may not be able to exercise the right of set-off in practice. For example:

- if the right of set-off is only capable of exercise on the date of settlement, but it expires before the scheduled settlement date; or
- if the right of set-off is only capable of exercise at the time of settlement, but settlement may be delayed.

In other cases, the right to set-off, e.g. to apply the amount due to another entity as a reduction in the amount due from the same entity, might be freely and immediately exercisable prior to the actual or scheduled settlement date.

Observation – Right of set-off that is exercisable upon termination of a contract

ED 10, C4

Under the proposals, a right of set-off that is exercisable upon termination of a contract appears to be identified as an example of a conditional right of set-off that would not qualify for offsetting.

In many cases, termination of the contract may be contingent on an event that is outside of the entity's control, e.g. the counterparty's default or bankruptcy. In this case the right of set-off is clearly conditional. However, in some cases, termination of a contract may be a free choice of the entity and is therefore within the entity's control. It is not discussed in the proposals whether events that are within the entity's control would be considered contingent on the occurrence of a future event. Therefore, it is not clear whether such rights of set-off should be considered conditional or unconditional rights of set-off.

4.4.3 Legally enforceable right of set-off

ED 10, C2, C5, C6

A right of set-off would be considered legally enforceable only if it is enforceable in all circumstances, i.e. enforceable both in the normal course of business and on the default, insolvency or bankruptcy of one of the counterparties. The right of set-off may arise from the terms of the contract or from the application of general laws and regulations. The nature of the rights of set-off that are present, their effect and their enforceability vary from jurisdiction to jurisdiction. In particular, laws governing insolvency may limit their enforceability in those circumstances. The laws applicable to the relationships between the parties need to be considered to ascertain whether the right of set-off is enforceable in all circumstances.

Observation – Enforceability on insolvency of the (reporting) entity

ED 10, Snapshot

The requirement of legal enforceability extends to all circumstances and this is specifically mentioned as including insolvency or bankruptcy of one of the counterparties, as opposed to insolvency or bankruptcy of the counterparty with whom the entity transacts. Therefore, it appears that offsetting would be precluded unless the right of off-set is enforceable even in the event of the entity's own insolvency. This reading is supported by an example included in the *Snapshot* prepared by staff of the IASB, which was published at the same time as the exposure draft.

4.4.4 Intention to settle net or simultaneously

ED 6, C7-C9

An entity's intention to settle a financial asset and financial liability net may be demonstrated through its past practice, its usual operating practices, its documented risk management policies or by contracts it engages in that provide for automatic set-off of payments. Some contractual arrangements may provide for automatic netting of payments due on the same day in the same currency. Also, the rules of centrally cleared financial markets often involve automatic netting and cancellation of offsetting contracts. Under the proposals, the entity's intention would be considered to have been met upon entering into such contracts. However, in some cases, even if an entity has a right to settle net, it may in practice settle on a non-simultaneous gross basis because of operational or system constraints. In this case, the entity would not offset in the statement of financial position.

ED 10, C10-C12

Simultaneous realisation of a financial asset and settlement of a financial liability would be limited to cases when the settlements are executed at the same moment such that there is only exposure to the net amount. An entity's intention to settle simultaneously must be demonstrated by policies or practice; incidental simultaneous settlements or settlements that take place over a brief period would not qualify for offsetting.

Illustrative example – Simultaneous settlement

ED C12

The rules of a clearing house grant both the clearing house and the participants a right to set-off amounts due and payable to either party. The procedures of the clearing house, in addition, provide that the amount to be paid or received for different products be settled gross. However, such payments are made simultaneously. Hence, even though the parties 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.

Observation – Effect of automatic netting arrangements

ED C9

Under some master netting agreements, all cash payments and receipts due on the same day in the same currency may be unconditionally subject to set-off. As discussed above, the exposure draft indicates that such an arrangement would demonstrate the entity's intention to settle on a net basis.

However, it is not discussed whether that intention is demonstrated only if, or to the extent that, cash flows are due on the same day in the same currency, or if it extends to the entirety of financial instruments subject to the agreement. If there are some cash flows under the financial instruments that are in different currencies or are due on different days, then there might not be an unconditional right to set-off those cash flows. This raises a further interesting question as to contracts that involve multiple payments on different dates, some of which coincide and some of which do not, and whether some form of partial offsetting should be considered. Similar questions may arise with respect to the exposure draft's reference to rules of clearing houses that provide for automatic netting and cancellation of offsetting contracts. The complexity of these issues is compounded by the fact that these agreements may cover many hundreds of contracts with cash flows spreading out many years into the future.

4.5 Collateral

ED 9, C14, BC62, BC63

An entity would not be allowed to offset assets pledged as collateral or the right to reclaim collateral, or the obligation to return collateral obtained and the associated financial assets and financial liabilities.

ED C14, BC77

Under the proposals, margin accounts related to derivative contracts are described as a form of collateral for the counterparty or clearing house that may comprise cash, securities or other liquid assets. Margin accounts are assets and liabilities that would be accounted for separately.

4.5.1 Master netting agreements and cash margin

ED 8, BC41-BC45, IAS 32.42, 50, 39.36, 37, IGB.10

Much of the analysis on master netting agreements and collateral in the exposure draft is similar to IAS 32 and IAS 39, including:

- Under the proposals, master netting agreements, in which the right to set-off is exercisable only following default, are conditional and therefore do not qualify for offsetting.
- Under IAS 32, the same conclusion is reached in a discussion of whether a right to set-off is currently enforceable.
- Under IAS 39, a margin account is considered a separate asset, but it is not discussed whether it might be eligible for offsetting.
- Under the guidance in IAS 39 on transfers of non-cash collateral and the guidance in IAS 32 on offsetting, netting of non-cash collateral against associated assets or liabilities is not envisaged.

Observation – Cash collateral and margin

ED 9, C14, BC63, BC77

It is not entirely clear whether and, if so, why the exposure draft's proposal to prohibit offsetting of assets pledged as collateral or the obligation to return collateral would extend to all cash margin arrangements. The Basis for Conclusions to the exposure draft states that the Boards "concluded that cash collateral should not be offset against recognised payables and receivables."

It is possible that the prohibition is intended only to apply to cash collateral that does not meet the general offsetting criteria. Perhaps the Boards' intent is to reserve the term 'collateral' to amounts that are used for settlement only in the event of default. However, cash margin accounts may in certain cases operate as cash deposit accounts with or from the counterparty that are used in the normal course of events to settle payments or receipts under derivatives or other transactions within the scope of the same master agreement. In these cases, there is a right of set-off between the amount receivable (or payable) in respect of the deposit against the amount payable (or receivable) in respect of the financial instrument to which it relates, and there is an intention to settle net.

An example of an arrangement that combines many of the issues raised above with respect to derivatives, master agreements, cash margin and automatic netting, may be an entity that is a member of a clearing house. Transactions entered into with other members of the clearing house are novated such that the clearing house is the legal counterparty to the entity for all those transactions. Cash margin is payable or receivable between the entity and the clearing house based on the fair value of outstanding transactions. Only one net cash payment or receipt, which covers final settlement of maturing transactions, periodic payments on existing transactions and net payment or receipt of cash margin, occurs each day between the entity and the clearing house. This net settlement mechanism is part of the contractual terms and is considered to be legally enforceable. It is not yet clear how such an arrangement should be considered in terms of the exposure draft. Given the large volume and value of financial instruments transacted under similar arrangements with clearing houses, this may be a significant issue for some entities.

ED C13, BC6, BC57-BC61

The offsetting criteria would apply to both bilateral and multilateral arrangements, e.g. A has a right to set-off an amount owed by A to B against an amount owed by C to A. However, the Boards noted that not all jurisdictions may recognise multilateral rights of set-off as enforceable.

Observation – Multilateral set-off arrangements

Even when a multilateral right to set-off is legally enforceable, in many cases the requirements that the right be unconditional and that the asset and the liability are intended to be settled net or simultaneously will not be met. For example, in many cases, the right of set-off may be conditional on default. Also, in many cases, the intention may be that the different payable and receivable balances will be settled separately on a gross basis and not simultaneously. Therefore, there may be relatively few multilateral arrangements that in practice would qualify for offsetting.

4.6 Alternative approaches

ED BC29

During its deliberations the Boards also considered – and rejected – alternatives to the proposed principle.

4.6.1 Conditional right of set-off

ED BC30-BC47

One alternative approach would be to require offset when an entity has a conditional right of set-off that is legally enforceable. As a consequence, all financial assets and financial liabilities subject to such a right of set-off that are executed with the same counterparty would be offset regardless of their other characteristics. This approach would be based on the notion that offsetting should reflect mitigation of counterparty credit risk. The Boards rejected this alternative because they believe that mitigation of counterparty credit risk is a matter of measurement and disclosure rather than presentation and therefore should not be the basis for offsetting. The Boards also noted that financial instruments, especially derivatives, may contain many risks other than just credit risk.

4.6.2 Conditional right of set-off and same primary risks

ED BC48-BC51

Another alternative approach would be to require offset when:

- an entity has a conditional and legally enforceable right of set-off; and
- the contracts have the same or primary underlying risks.

This approach would be based on the notion that it is not appropriate to offset financial assets and financial liabilities unless both credit risk and the underlying market risks are eliminated. The Boards rejected this alternative because it would be difficult to identify a single primary underlying risk as instruments usually are exposed to several types of risks and it would be inappropriate to ignore the other risks. In practice, financial institutions manage risks with the objective of managing them within acceptable limits rather than eliminating them.

4.6.3 Settlement of asset before or simultaneously with liability

ED BC52, BC53

A third alternative considered was to require offset if the financial asset and the financial liability are settled on the same date or the asset is settled before the liability. The Boards rejected this approach because this criterion is already addressed by the requirement for an entity to demonstrate the intention to settle net or simultaneously.

4.6.4 Unconditional right of set-off only

ED BC54-BC56

The last alternative considered was to require offset based only on there being an unconditional and legally enforceable right of set-off. This would be similar to the approach proposed in the exposure draft except that there would be no need for an entity to have an intention to settle net or simultaneously. The Boards rejected this alternative because, without such an intention, offsetting would not reflect an entity's future cash flows.

5. Disclosures

ED 11, C19, C20, BC69, BC70

An entity would disclose information about rights of set-off and related arrangements, e.g. collateral agreements, associated with its financial assets and financial liabilities. The objective would be to enable users to understand the effect on the entity's financial position.

ED 14, BC73, BC74

If the information required by the exposure draft is disclosed in more than one note to the financial statements, then cross referencing between the different elements would be required.

ED 12, C16, BC76, BC77

At a minimum, an entity would disclose the following information separately for financial assets and financial liabilities and by class of financial instruments at the end of the reporting period:

a) the gross amounts, before any adjustments under (b);

b) the amounts offset in accordance with the requirements in the exposure draft, the portfolio-level adjustments to fair value measurements for counterparty and own credit risk, and the resulting net amounts presented in the statement of financial position;

c) the amounts subject to an unconditional right of set-off that the entity does not intend to settle net or simultaneously;

d) the amounts subject to a conditional right of set-off, separately for each type of conditional right;

e) the net amounts after taking account of (a) to (d);

f) the amount of cash and the fair value of other financial instruments obtained or pledged as collateral, excluding any excess over the net amount in the statement of financial position; and

g) the net amounts after taking account of (e) and (f).

ED 12, BC75

The above amounts would be presented in a tabular format unless another format would be more appropriate.

Observation – Portfolio-level adjustments

ED 12, BC46

Under the proposals, the amounts of recognised financial assets and recognised financial liabilities would be disclosed before portfolio-level adjustments for counterparty and own credit risk. The amount of those adjustments would be disclosed separately. A draft of the forthcoming fair value measurement standard that was prepared by the staff of the IASB and the FASB and posted to the IASB's website on 19 August 2010 states that an entity may measure the fair value of a group of financial assets or liabilities based on the net exposure to credit risk or market risk if certain conditions are met. These conditions include that the entity manages the risk on a net basis and, in the case of credit risk, that it has a legally enforceable right to set-off in the event of default.

The staff draft of the fair value measurement standard did not indicate that disclosure of the amount of the portfolio-level adjustments was required and neither that draft nor the exposure draft discuss how the adjustments should be attributed to individual assets and liabilities. It is possible that these issues will be addressed in the final fair value measurement standard. The exposure draft also is silent as to how portfolio-level adjustments for market risk under the new fair value measurement standard might be reflected in the proposed disclosures.

Another issue not discussed in the exposure draft is how the concept of portfolio-level credit risk adjustments interrelates with the fair value measurement guidance under IAS 39.

ED 13, C17, C20

Furthermore, for each type of conditional right of set-off for which separate disclosure under (d) as mentioned above is given, the entity would disclose the nature of those rights and how management determines each type.

It would be allowed to disclose similar types of conditional rights of set-off in aggregate if disclosing each type separately would not provide more useful information. At a minimum, an entity would distinguish between those conditional set-off rights that are exercisable on default, bankruptcy or insolvency and those that are exercisable in the normal course of business.

ED 12, C18 The amount of cash and the fair value of other financial instruments obtained or pledged as collateral disclosed under (f) as mentioned above is restricted to the net carrying amounts of the collateralised financial asset or liability as reported in the statement of financial position. The Boards' intention is that the meaningfulness of the information reported is not distorted by reporting the total amounts of collateral in cases of overcollateralisation.

ED 15 An entity would not be required to make any of the above disclosures if it is has no financial assets or financial liabilities subject to rights of set-off and it has neither pledged nor obtained any financial instruments as collateral.

6. Effective date and transition

ED A1, BC78-BC80

The Boards currently seek information about the time and effort that would be involved in implementing the proposed requirements. This information will be used to determine an appropriate effective date. Furthermore, the Boards will consider the feedback from their Request for Views on *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.

The final requirements would be subject to retrospective application to any comparative periods presented.

7. Project timeline

ED B1, B2

The comment deadline is 28 April 2011. The final requirements would be included in the existing standards on the presentation of and disclosures associated with financial instruments within the scope of IAS 39. The Boards aim to finalise the revised requirements by June 2011.

About this publication

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited).

Content

Our *New on the Horizon* publications are prepared upon the release of a new proposed IFRS or proposed amendment(s) to the requirements of existing IFRSs. They include a discussion of the key elements of the new proposals and highlight areas that may result in a change of practice.

This edition of *New on the Horizon* considers the proposed requirements of ED/2011/1 *Offsetting Financial Assets and Financial Liabilities*.

The text of this publication is referenced to the exposure draft and if applicable to selected other current IFRSs in issue at 28 January 2011. References in the left-hand margin identify the relevant paragraphs.

Further analysis and interpretation will be needed in order for an entity to consider the potential impact of this ED in light of the entity's own facts, circumstances and individual transactions. The information contained in this publication is based on initial observations developed by the KPMG International Standards Group, and these observations may change.

Abbreviations

IASB: International Accounting Standards Board

FASB: US Financial Accounting Standards Board

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Acknowledgements

We would like to acknowledge the efforts of the principal authors of this publication. The authors include Silvie Koppes and Chris Spall of the KPMG International Standards Group.

We would also like to thank the contributions made by other reviewers, who include other members of the Financial Instruments Topic Team:

Marco Andre Almeida	KPMG in Brazil
Ewa Bialkowska	KPMG in the UK
Ana Cortez	KPMG in Hong Kong
Jean-François Dandé	KPMG in France
Terry Harding	KPMG in the UK
Gale Kelly	KPMG in Canada
Agnes Lutukai	KPMG in South Africa
Marina Malyutina	KPMG in Russia
Patricia Stebbens	KPMG in Australia
Enrique Tejerina	KPMG in the US
Andrew Vials	KPMG in the UK
Venkataramanan Vishwanath	KPMG in India
Danny Vitan	KPMG in Israel

Publication name: *New on the Horizon: Offsetting financial assets and financial liabilities*

Publication number: 314588

Publication date: February 2011

KPMG International Standards Group is part of KPMG IFRG Limited.