Financial Accounting
Standards Board

Balance Sheet: Offsetting
Roundtable Meeting

Monday, May 9, 2011

9:00 a.m. – 12:00 p.m.

Financial Accounting Standards Board offices:
Boardroom, 401 Merritt 7, Norwalk, CT 06856

AGENDA

Welcome and introductions

We have arranged this roundtable meeting to listen to your views and to develop further our understanding of the issues you raise or alternatives you propose in your comment letters.

We expect to allocate around 20 minutes to cover each of the following topic areas:

- Topic 1: Offsetting criteria
- Topic 2: Unconditional and legally enforceable right of setoff
- Topic 3: Intention to settle net or simultaneously
- Topic 4: Collateral
- Topic 5: Unit of account
- Topic 6: Disclosures
- Topic 7: Transition requirements and effective date.

We intend to allow some time for participants to raise any additional issues they would like to discuss at the end of the session.

PROJECT BACKGROUND

Convergence

- The differences in the offsetting requirements in International Financial Reporting Standards (IFRSs) and U.S. generally accepted accounting principles (GAAP) account for the single largest quantitative difference in amounts presented in the statement of financial position prepared in accordance with IFRSs and U.S. GAAP.
- Regulators, preparers, auditors, and others have called for an improvement to, and convergence of, the requirements for offsetting financial assets and financial liabilities.
- The offsetting project presents an opportunity to both improve and achieve convergence of IFRSs and U.S. GAAP requirements on this topic.

User feedback

- Users asked the International Accounting Standards Board and the Financial Accounting Standards Board (the Boards) to develop a common standard on offsetting to allow international comparability, especially among banks.
- There is no consensus as to whether to present gross or net information in the statement of financial position. However, irrespective of their individual views there was consensus from users that both gross and net information are useful and required for analysing financial statements.
- Users also preferred a mandatory requirement for offsetting if the relevant criteria are met, rather than allowing offsetting as an accounting policy choice, in order to improve comparability between entities.

PROJECT BACKGROUND (continued)

ED proposals-offsetting principle

The Boards concluded that offsetting financial assets and financial liabilities does not, generally, meet the objective of financial reporting and the qualitative characteristics of information presented in financial reports, as set out in the *Conceptual Framework*.

It is a general principle of financial reporting that assets and liabilities are presented separately from each other consistently with their characteristics as resources or obligations of the entity.

However, the Boards concluded that offsetting an eligible asset and an eligible liability in the statement of financial position is consistent with the objective of financial reporting, is appropriate and reflects the financial position of an entity if:

(a) on the basis of the rights and obligations associated with the eligible asset and eligible 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 eligible asset or eligible 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.

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) and

(b) that ability is assured (ie legally enforceable).

The Boards also concluded that 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, if the entity intends to receive or pay a single net amount, or to settle simultaneously.

Topic 1: Offsetting criteria

The proposals would replace the requirements in U.S. GAAP for offsetting in general and the existing exceptions for derivatives and repurchase agreements. A principle would be established that would preclude offsetting, unless specifically required or permitted, similar to the principle that exists in IFRSs. Offsetting, that is, presentation of one or more eligible assets and eligible liabilities as a single net amount in the balance sheet, would be required when an entity meets specific guidance, as outlined below.

The proposals would eliminate the exception that currently exists in U.S. GAAP that allows offsetting for some derivative and sale and repurchase (and reverse sale and repurchase) contracts when the right is conditional, there is no intention to set off, or such intention is conditional. An entity would be required under the proposed guidance to present their derivatives, repurchase agreements and reverse repurchase agreements on a gross basis, unless they meet specific criteria.

Paragraph 6, Proposed Guidance

An entity shall offset a recognised eligible asset and a recognised eligible 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 setoff the eligible asset and eligible liability; and

(b) intends either:

(i) to settle the eligible asset and eligible liability on a net basis, or

(ii) to realise the eligible asset and settle the eligible liability simultaneously.

In all other circumstances, eligible assets and eligible liabilities are presented separately from each other according to their nature as assets or liabilities.

Main discussion points:

- Do you think that the offsetting criteria are operational? If not, why? What would you propose instead, and why?
- *Users:* Do you think that presentation on the face of the balance sheet based on the proposed criteria would result in more decision useful information than information provided under current U.S. GAAP? Why?

Topic 2: Unconditional and legally enforceable right of setoff

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 setoff.

Paragraph 10 (b) – (e), Proposed Guidance

(b) A right of setoff 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 setoff is a right of setoff in which its exercisability is not contingent on the occurrence of a future event.

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

(e) A legally enforceable right of setoff is a right of setoff 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).

Main discussion points:

- Do you agree with the proposed definition of and application guidance for an "unconditional and legally enforceable" right of setoff? If not, why?

Topic 3: Intention to settle net or simultaneously

To offset in the balance sheet, an entity must have an intention to settle net or settle simultaneously the eligible asset and eligible liability.

Paragraph 6(b), Proposed Guidance

An entity intends either:

(a) To settle the eligible asset and eligible liability on a net basis, or

(b) To realise the eligible asset and settle the eligible liability simultaneously.

Paragraph 10(f), Proposed Guidance

Realization of an eligible asset and settlement of an eligible liability are treated as simultaneous only when the settlements are executed at the same moment.

Paragraph C7, Application Guidance (excerpt)

An entity's intention to settle net or settle simultaneously may be demonstrated through its past practice of executing offset or simultaneous settlement in similar situations, its usual operating practices or by reference to the entity's documented risk management policies…

Main discussion points:

- Is the guidance related to what constitutes simultaneous settlement (executed at the same moment) operational? If not, why not?
- If what is meant by simultaneous settlement (executed at the same moment) were to be changed, how should it be defined and how would the resulting effect of the intention to offset (which is actual net settlement) be satisfied?
- Are there any circumstances in which an intention to settle net should not be required? If so, what are those circumstances?

Topic 4: Collateral

The proposals take the position that there is no offsetting related to collateral, regardless of the legal form of collateral.

Paragraph 9, Proposed Guidance

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.

Paragraph C14, Application Guidance

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.

Paragraphs BC 62 and BC 63, Basis for Conclusions

The Boards believe that the collateral for a debt 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 nonexistent 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.

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.

Main discussion points:

- Are there circumstances when offsetting collateral and financial assets or financial liabilities would be consistent with the offsetting principle in the proposed Update?
- Are there other circumstances when offsetting 'collateral' and related financial assets or financial liabilities would not be consistent with the offsetting principle but you believe offsetting should be permitted or required? If so, what are those circumstances and why do you believe offsetting would be appropriate in those circumstances?

Topic 5: Unit of account

The proposed guidance does not provide information on what the unit of account should be for applying the offsetting criteria. Based on outreach conducted by the staff, some industries (e.g. energy producers and traders) would apply offsetting criteria to identifiable cash flows to reflect the way they do business and achieve offsetting today. For other industries (e.g. banks), applying the offsetting criteria to identifiable cash flows would be impractical and burdensome and would not necessarily reflect the way they do business.

Main discussion points:

- If application of the offsetting criteria is mandatory, would it be operational to apply the offsetting criteria to any of the following:
  - identifiable cash flows of eligible assets and liabilities,
  - individual eligible assets and eligible liabilities, and/or
  - a portfolio of eligible assets and eligible liabilities?
- Under what circumstances would application of the offsetting criteria to a portfolio of eligible assets and eligible liabilities be consistent with the offsetting principle and the basis for conclusions?

Topic 6: Disclosures

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. Essentially, the table reconciles a gross carrying amount to what is presented on the balance sheet and additionally requires an entity to show additional offsetting amounts such as amounts subject to conditional rights of offset and cash or other financial instruments held or pledged as collateral as illustrated below:

a.	b.	c.	d.	e.	f.	g.	h.	i.
Gross carrying amounts (before offsetting)	Gross amounts offset	Portfolio-level adjustments	Net amount presented in financial position (after taking into effect a, b and c)	Amounts subject to conditional rights of setoff	Amounts subject to unconditional and legally enforceable rights of setoff (but which the entity does not intend settle net or simultaneously)	Net amounts (after taking into effect d, e and f)	Cash or other financial instruments held or pledged as collateral	Net exposure (after taking into effect g and h)
X	(X)	(X)/X	X	(X)	(X)	X	(X)	X

Paragraphs 11-15, Proposed Guidance

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

To meet the requirements in paragraph 11, an entity shall disclose, at the minimum, the following information separately for eligible assets and eligible liabilities recognized at the end of 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:

    1. The amounts offset in accordance with the criteria in paragraph 6 to determine the net amounts presented in the statement of financial position

    2. 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

   3. The net amount presented in the statement of financial position.

c. The amounts of eligible assets and eligible liabilities that the entity has an unconditional and legally enforceable right to setoff but that the entity does not intend to settle net or simultaneously

d. The amount of eligible assets and eligible liabilities that the entity has a conditional right to setoff, separately be each type of conditional right.

e. The net amount of eligible assets and eligible 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 eligible assets and eligible liabilities:

   1. The amount of cash collateral (excluding the amount of cash collateral in excess of the amount in (b)(3)), and

   2. 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)(3)).

g. The net amount of eligible assets and eligible liabilities (that is, the difference) after taking into account the effect of the items in (e)-(f).

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

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

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.

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

Main discussion points:

- Are the disclosure requirements as proposed operational? If not, why? How would you propose to amend those requirements, and why?
- Scope: Should the proposed disclosures be restricted to derivatives, repurchase agreements and reverse repurchase agreements? Additionally, should the proposed disclosures include nonfinancial collateral?
- Based on feedback received during outreach, some aspects of the disclosure requirements (after amounts presented on balance sheet) are more operational by counterparty as this would reflect how counterparty risk credit risk is managed. Would you agree with this change in the proposed disclosure table in the ED? Why or why not?
- *Users:* Do the disclosures as proposed provide decision useful information? Why or why not?

Topic 7: Effective date and transition requirements

The Boards are seeking information about the time and effort that would be involved in implementing the proposed requirements. The Boards will use that information to determine an appropriate effective date. The proposed Update outlines a retrospective transition.

Paragraph A1, Appendix A

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

Main discussion points:

- Are the proposed transition requirements operational? 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.

Other topics

Specialized industry practices

- The amendments to U.S. GAAP would eliminate the industry practice allowing payables and receivables arising from unsettled regular way trades to be shown net. Is the elimination of this industry based practice operational?