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IN THE HEADLINES
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Proposals for common approach to offsetting financial assets and financial liabilities

Introduction

In response to stakeholders' concerns, including those of the Basel Committee on Banking Supervision and the Financial Stability Board, the IASB[1] and the FASB[2] (the Boards) engaged in a joint project on offsetting financial assets and financial liabilities.

On 28 January 2011 the IASB published ED/2011/1 *Offsetting Financial Assets and Financial Liabilities*. The objective of the exposure draft is to establish a common principle and address the differences in the offsetting requirements under IFRSs and US GAAP. These differences may account for the single largest quantitative difference in reported numbers in statements of financial position of financial institutions.

Comments on the exposure draft are due to the IASB by 28 April 2011.

Summary of proposals

Scope and objective

The offsetting requirements would apply to all entities and to all items within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*.

The objective of the exposure draft is to establish a common principle for offsetting financial assets and financial liabilities that provides useful information about an entity's future net cash flows, liquidity and solvency, economic resources and claims against the entity.

The principle would be that a financial asset and a financial liability are offset only when the entity has a right or obligation for the net amount and the amount resulting from offsetting reflects the entity's expected cash flows from settling two or more separate financial instruments.

Key points to note:

- Offsetting required when unconditional and legally enforceable right to set-off, and intention to settle on a net basis or simultaneously; otherwise prohibited.
- Additional disclosures required about rights of set-off, related arrangements and their effect on financial position.

Our forthcoming publication *New on the Horizon: Offsetting financial assets and financial liabilities* will provide more detail about the exposure draft and discuss possible application issues. Speak to your usual KPMG contact if you would like a copy of this publication.

Presentation

The exposure draft proposes offset of a recognised financial asset and a recognised financial liability only 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 the financial liability on a net basis, or to realise the financial asset and settle the financial liability simultaneously.

Offset of financial assets and financial liabilities would not be an accounting policy choice or option; if the criteria are satisfied, then the entity would be required to offset.

The following concepts are defined for the purpose of the exposure draft:

- An *unconditional right of set-off* refers to a right of set-off the exercisability of which is not contingent on the occurrence of a future event.
- A *legally enforceable right of set-off* refers to a right of set-off that is enforceable in all circumstances, i.e. in the normal course of business and on the default, insolvency or bankruptcy of one of the counterparties.
- *Simultaneous settlement* refers to settlements that are executed at the same moment.

Financial assets and financial liabilities that would not be offset include:

- a transferred financial asset and the associated financial liability in the accounting for a transfer that does not qualify for derecongition; and
- assets pledged as collateral, the right to reclaim collateral or an obligation to return collateral received and the associated financial assets and financial liabilities.

The offsetting requirements would apply to both bilateral and multilateral arrangements.

Disclosure

Disclosures about rights of set-off and related arrangements, e.g. collateral, associated with financial assets and financial liabilities and their effect on the entity's financial position would be required.

Under the proposals, an entity would disclose, at a minimum, the following information separately for financial assets and financial liabilities and by class of financial instruments:

a) the gross amounts, excluding portfolio-level fair value measurement adjustments for credit risk;

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

c) the amounts of financial assets and financial liabilities subject to an unconditional right to set-off, but which the entity does not intend to settle net or simultaneously;

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

e) the net amounts of financial assets and financial liabilities after taking into account the effect of the items in a) – d);

f) the amount of cash and the fair value of other financial instruments obtained or pledged as collateral, excluding the amount that exceeds the net carrying amount; and

g) the net amounts after taking into account the effect of items in e) – f).

Effective date and transition

The Boards 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 Boards plan to finalise their proposals by June 2011.

The final requirements would be subject to retrospective application.

Abbreviations

1 IASB: International Accounting Standards Board

2 FASB: US Financial Accounting Standards Board

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