

International Auditing and Assurance Standards Board

545 Fifth Avenue, 14th Floor, New York, New York 10017 USA
Tel+1 (212) 286-9344 ■ Fax+1 (212) 856-9420 ■ www.iaasb.org

April 25, 2011

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

Dear David,

Re: Comments on IASB's Exposure Draft on Offsetting Financial Assets and Financial Liabilities

The International Auditing and Assurance Standards Board (IAASB) is pleased to provide comments on the IASB's Exposure Draft (ED), *Offsetting Financial Assets and Financial Liabilities*.

In formulating the comment letter, we have established a Working Group to monitor the development of the IASB project on Fair Value and Financial Instruments. The focus of the Working Group is to identify significant aspects of IASB proposals which could pose difficulty in an auditing context and therefore where the IAASB members' expertise can add value to the IASB's deliberations – for example, aspects of proposals where preparers' compliance may not be able to be achieved on the basis of objective evidence or where the basis for their judgments may be difficult to substantiate.

Through our discussion, we have identified several proposed requirements that may be problematic from a verifiability/auditability perspective. The attached Appendix includes the Working Group's views on what are likely to be the most substantive issues from an auditing perspective resulting from changes in the proposed standards from current practice.

Where practicable, the Working Group has offered suggestions for the IASB's consideration as to how language in the standard could be amended to address the issues noted. The IAASB looks forward to continuing to work with the IASB as early as possible in its standard-setting processes. I hope you find the comments in the Appendix valuable and encourage you to engage us in further dialogue if necessary as you finalize these proposed standards.

Yours sincerely,

Prof. Arnold Schilder Chairman, IAASB

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IASB EXPOSURE DRAFT-

OFFSETTING FINANCIAL ASSETS AND FINANCIAL LIABILITIES

Comments of the IAASB's Working Group

OVERALL COMMENTS

The ED proposes that an entity shall offset financial assets and financial liabilities, when certain conditions are met. From an auditing perspective, it is important for the standard to clearly indicate: (i) under what conditions off-setting is permitted or required, and (ii) what support (or basis) is necessary for an entity to be able to demonstrate that all conditions in the requirements have been met. Comments below identify areas where, in the Working Group's view, either the conditions, or the expectations of entities to support their application of off-setting, are not sufficiently clear.

QUESTION 1—Offsetting Criteria: Unconditional Right and Intention to Settle Net or Simultaneously

DEMONSTRATING THE INTENTION OF OFFSETTING

Issue Description

Paragraph 6 of the ED proposes that an entity shall offset a financial asset and liability when an entity meets the following conditions:

- (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.

Paragraph C7 of the ED states that "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." Also, paragraph C10 states that "incidental simultaneous settlement of a financial asset and financial liability does not meet the criterion in paragraph 6."

In the view of the Working Group, the need to be able to demonstrate intent is fundamental to making the standard clear and effective. The requirement in paragraph 6(b) could be strengthened by including a specific reference to the need to demonstrate intent. This would provide a stronger link to the important guidance in paragraphs C7 and C10.

Actions that IASB May Wish to Consider in Addressing the Issue

The Working Group recommends that paragraphs 6 be modified as follows (proposed wording changes are in bold and underlined):

- 6. An entity shall offset a recognised financial asset and recognised financial liability and shall present the net amount in the statement of financial position when the entity:
 - (a) ..
 - (b) can demonstrate that it intends either etc.

SIMULTANAOUS SETTLEMENT

Issue Description

Paragraph 6 of the ED proposes that an entity has to realise the financial asset and settle the financial liability simultaneously in order to be able to offset them.

The Working Group believes that how that condition is to be applied in the situation where settlement takes place through a clearing house could be clarified. Paragraph 48 of IAS 32 states that: "Simultaneous settlement of two financial instruments may occur through, for example, the operation of a clearing house in an organized financial market or a face-to-face exchange. In these circumstances, the cash flows are, in effect, equivalent to a single net amount and there is no exposure to credit or liquidity risk."

Given the recent trend towards more utilization of clearing houses for derivatives transactions (e.g., CDSs), the Working Group thinks that such guidance as amended is helpful.

Actions that IASB May Wish to Consider in Addressing the Issue

The Working Group recommends that paragraphs 48 of the IAS 32 be reinstated, with relevant amendments for clarification.

QUESTION 2—Unconditional Right of Set-off must be Enforceable in All Circumstances

CLARIFICATION OF UNCONDITIONALITY

Issue Description

As stated earlier, paragraph 6 of the ED proposes that offsetting shall be made when clauses (a) and (b) of the paragraph are met.

An assessment of whether a right is "unconditional and legally enforceable" would be judged based on laws and regulations in relevant jurisdictions. In the Working Group's view, it may be useful if the standard were to provide examples of what would be considered a "condition." For example, there could be relatively minor stipulations in an agreement, such as submission of a letter from one party to the other to enact the legal set-off, that might be seen as "conditions," but which seem to focus on form over substance. It is not clear if such stipulations in an agreement are intended to be considered "conditions" for the purposes of the standard.

Actions that IASB May Wish to Consider in Addressing the Issue:

The Working Group recommends that the IASB clarify what is meant by "conditions" in the context of this standard.

QUESTION 3—Multilateral Set-off Arrangements

POTENTIAL DIFFICULTIES FOR MULTINATERAL SET-OFF ARRANGEMENTS

Issue Description

Paragraph C13 of the ED permits off-setting in a multilateral set-off arrangement.

Paragraph 45 of the IAS 32 states "in unusual circumstances, a debtor may have a legal right to apply an amount due from a third party against the amount due to creditor provided that there is an agreement between the three parties that clearly establishes the debtor's right of obligation of set-off." Taking into account that a multiple arrangement may be more complicated than a bilateral arrangement in light of verifiability, the Working Group believes that such guidance would continue to be helpful.

Further, paragraph C13 explains a three-party relationship by using an example where A, B, and C agree that A may set off amounts owed by A to B against amounts owed to A by C. The Working Group understands that entities are required to demonstrate that the condition set out in paragraph 6 (b) (ii) is met for the relationship between A and B as well as A and C. However, it is not clear whether simultaneous settlement is also required for the relationship between B and C and how such settlement could be demonstrated.

Actions that IASB May Wish to Consider in Addressing the Issue:

The Working Group recommends that the IASB reinstate the aforementioned guidance from IAS 32. In addition, the Working Group recommends that the IASB clarify the criteria for off-setting when settlement is planned for multilateral arrangements.

QUESTION 4—Disclosures

OBJECTIVE-BASED DISCLOSURE REQUIREMENT

Issue Description

Paragraph 11 of the ED states that "An entity shall disclose information about rights and set-off and related arrangements (such as collateral arrangements) 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." In addition, paragraph 12 states that "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..."

The Working Group appreciates the inclusion of the phrase "as the minimum", in paragraph 12. It adds clarity that enables an entity and an auditor to easily identify matters that need to be included in the disclosures, while still emphasising that additional disclosures may be required.

The Working Group would, however, like to draw your attention to the IAASB Discussion Paper (DP), *The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications*, published in January 2011. In the DP, the IAASB noted that one of the significant changes in financial reporting is the introduction of objective-based disclosure requirements, which can be open to different interpretations, particularly when minimum expected disclosures are not defined (see paragraphs 29-33 and 70 of the DP).

Actions that IASB May Wish to Consider in Addressing the Issue:

The Working Group recommends that the IASB retain the term "as the minimum" in the final standard.

PRACTICALITY OF THE DISCLOSURE REQUIREMENT

Issue Description

Paragraph 12 of the ED proposes that the reconciliation of gross amounts of financial assets and liabilities to their net amount be presented in a tabular format. A draft illustrative example is provided. However, the ED is not explicit on whether the disclosure requirement applies to particular financial assets and liabilities (such as those arising from derivative and/or repurchase transactions) or to all financial assets and liabilities including loans and deposits of financial institutions. If it applies to *all* financial assets and liabilities, we wonder if it is practicable for management to be able to sort out all positions by customer (or counterparty). In particular, financial institutions have a myriad of transactions with their counterparties, and often transactions are managed by different information systems in the group financial statements.

In addition, paragraph BC 75 of the ED states that "the proposed discussion *would* require the quantitative information to be presented in a tabular format." This appears to indicate that it is the IASB's view that if an entity provides the required information but fails to do so in a tabular format, the disclosure be misstated. This raises an interesting question for auditors regarding whether an entity's failure to disclose the information in a tabular format would be a *material* misstatement requiring qualification of the auditor's opinion. Clarification of the IASB's intention in mandating the tabular format of presentation would be appreciated.

Actions that IASB May Wish to Consider in Addressing the Issue:

The Working Group recommends the IASB address the abovementioned matters in finalizing the standard.