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Dear Sir

Exposure Draft ED/2011/1 Offsetting Financial Assets and Financial Liabilities

We are pleased to comment on the above exposure draft (the ED). Following consultation, this letter summarises the views of the BDO network¹.

Consistent with our comments on other recent proposals, we believe that a key objective of any proposal issued at this time should be the development of converged high quality accounting standards, in particular to avoid the risk of accounting arbitrage as entities look to the (differing) guidance issued by each of the Boards. We therefore support the boards' exposure of identical proposals and strongly encourage the development of fully converged requirements.

We agree that it is appropriate for financial assets and liabilities to be offset under certain specified conditions, in order that an entity's statement of financial position and related cash flows reflect the remaining gross asset and liability positions that reflect its actual exposures. Although some might suggest that, in view of the restrictive approach which has been proposed, offset should simply be prohibited, we do not agree. Such an approach would result in an entity recognising gross amounts that would not reflect its actual exposures and future cash flows. However, while we believe that the proposals largely achieve the objectives set out in the introductory section 'What is the objective of the proposed requirements?', in certain respects we consider that they need to be amended.

We note that, *prima facie*, the ED does not propose significant changes to the current requirements of IAS 32: *Financial Instruments: Presentation*, with more significant changes being made to the equivalent US GAAP requirements. However, there are certain changes that have been proposed which would have a very significant effect on certain financial institutions, such as clearing houses, which report in accordance with IFRS. In particular, it would appear that the proposals would prohibit offset for arrangements in which a large number of financial assets and liabilities, which would otherwise qualify for offset, are processed in batches. This is because the requirements for simultaneous settlement, as articulated in paragraph C11 of the Application Guidance, would not be met; this guidance has been tightened in comparison with the existing guidance in IAS 32. We believe that this is inappropriate, and would result in an entity's actual financial asset and financial liability balances being obscured.

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In the context of changes in approach that may result from the proposals as drafted, we note that the capital adequacy of many financial institutions in a number of jurisdictions is based on the reported amounts of financial assets and financial liabilities in their financial statements. Consequently, an increased level of gross presentation could lead to higher regulatory capital requirements. While it is, of course, for regulatory authorities to set those capital requirements at appropriate levels, and not the role of an accounting standard setter, it may be appropriate for the Boards to discuss the effect of their proposals with relevant regulatory authorities, particularly in the US where the proposals would have a significant effect on some entities.

While we agree that robust disclosures should be required, we believe that the proposals would result in the presentation of certain information that would appear to be inconsistent with the principle of presenting net exposures where these exist. In consequence, we do not support the disclosure of gross amounts of financial assets and liabilities where these assets and liabilities would be required to be offset under the proposals. If the Boards outreach activities have indicated that this information would be useful for users of financial statements, we believe that further justification for this disclosure should be included in the basis for conclusions.

Our responses to the specific questions included in the ED are set out in the attached Appendix.

We hope that our comments and suggestions are helpful. If you would like to discuss any of them, please contact Andrew Buchanan at +44 (0)20 7893 3300.

Yours faithfully

BDO IFR Advisory Limited.

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Appendix A

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?

We agree with the proposed requirement, and note that the language of the proposals, other than the extension to require an unconditional right of set off, is the same as currently set out in IAS 32 *Financial Instruments: Disclosure*.

However, we have significant reservations around, and disagree with, the Application Guidance in its analysis of ‘simultaneous’ and the implications of that guidance for the presentation of financial assets and financial liabilities by clearing houses and other financial institutions. Under the existing guidance, IAS 32.48 notes that:

‘Simultaneous settlement of two financial instruments may occur through, for example, the operation of a clearing house in an organised financial market.....’

In practice, the application of this guidance has been to permit the offset of financial assets and liabilities which meet the criteria in IAS 32.42(a), and are sent for processing at the same precise point. Once sent, these transactions cannot be cancelled and are processed in batches. There is no potential for any change in the cash flows arising from the assets and liabilities once they have been sent for processing. The batch processing can mean that assets and liabilities that have been offset can be processed at slightly different times during a ‘processing window’. However, because the assets and liabilities are all submitted for processing at the same point, cannot be cancelled, and have no potential changes in cash flows, this has been analysed as being sufficient for them to be regarded as being settled simultaneously and, consequently, for them to be required to be offset.

The proposals state at paragraph 10(f) that:

‘Realisation of a financial asset and settlement of a financial liability are treated as simultaneous only when the settlements are executed at the same moment.’

Paragraph C11 of the Application Guidance, which forms an integral part of the proposed IFRS, then clarifies this further in stating that:

‘...if settlements take place over a period (even though during this period there is no potential for any change in the value of the financial asset and the financial liability,

and the period between the settlement of the instruments is brief), it is not simultaneous settlement because settlement is not at the same moment.'

Consequently, under the proposals, many financial assets and financial liabilities which have, to date, been offset by clearing houses and other financial institutions would no longer be capable of being offset. We disagree with this outcome.

We note from the introduction to the proposals that they establish a principle that ensures that a recognised financial asset and a recognised financial liability are offset only when:

- a) on the basis of the rights and obligations associated with the financial asset and financial liability, the entity has, in effect, a right to or obligation for only the net amount (ie the entity has, in effect, a single net financial asset or financial liability); and
- b) the amount, resulting from offsetting the financial asset and financial liability, reflects an entity's expected future cash flows from settling two or more separate financial instruments.

For the purposes of the application of these principles, we believe that the transactions described above should properly qualify (and be required to be) offset and presented as one net exposure. In addition, if these balances did not qualify for offset, we believe that the grossed up information presented in an entity's statement of financial position, which could for some entities be very large amounts, would be likely to obscure its actual asset and liability exposures. We believe that this would not be helpful to users of that financial information as it would not be reflective of the attributes listed in the introduction to the proposals:

- the entity's ability to generate cash flows 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.

We suggest that the proposals are modified to require offset of financial assets and financial liabilities under certain additional conditions. Reference might be made to clearing houses, as these entities clearly demonstrate the issue, with offset being required for financial assets and financial liabilities that will be processed in batches when:

- financial assets and financial liabilities that meet all of the other conditions for offset are submitted for processing at exactly the same point;
- once submitted for processing, the transactions cannot be cancelled or altered;
- there is no potential for the cash flows arising from the assets and liabilities to change once they have been submitted for processing unless the processing fails (please see the next bullet point);
- if the processing of one asset or liability that is offset against another fails, then the processing of the related (offset) asset or liability also fails; and
- processing is carried out through the same settlement depository.

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 (i.e. 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?

We agree that, if the criteria for offset are met, that the inclusion of a net amount in an entity's financial statements should be required and not made optional. The presentation of gross amounts for financial assets and liabilities that will, in fact, be settled net could misrepresent the cash flows and financial position of an entity.

We also support the extension (in comparison with IAS 32) of the requirements to include an unconditional right of set-off, meaning that the ability to offset financial assets and liabilities would need to survive the insolvency of one or more of the parties.

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?

We agree.

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?

While we agree that robust disclosures are appropriate, we do not necessarily agree that all of the proposed disclosure requirements are appropriate.

12(a) and 12(b)

We question the rationale for, and potential use of, the gross amounts required by paragraph 12 (a) and (b). Net amounts are presented in the financial statements because they represent the actual (net) exposures and cash flows related to the gross assets and liabilities. It would appear inappropriate for the note disclosures to suggest that there is anything other than a net position.

We also note that the offsetting requirements may require entities to obtain legal advice. Even if there were value to the disclosure of the underlying gross amounts (which we question), it is not clear how that disclosure is justified in the context of entities having incurred potentially significant costs to enable the underlying financial assets and financial liabilities to qualify for offset in the statement of financial position.

We therefore suggest that this part of the disclosure requirements is deleted. However, we note that the Boards' outreach indicated that users found both gross and net information helpful, irrespective of the principle used to determine whether netting is appropriate in the statement of financial position. If that is the case, we believe that the Boards need to set out more clearly, in the basis for conclusions, reasons why users need the information that would be provided by 12(a) and 12(b).

12(c) and 12(d)

We agree with the proposals set out in paragraph 12 (c) and (d), as we believe that this would provide useful additional information to users of the financial statements.

However, we are not convinced that the disclosure of the further net amount, as contemplated by paragraph 12(e), would provide useful additional information. While it might be argued that the inclusion of further netting of amounts that fall within paragraph 12(c) would be helpful, as this would show the extent to which the entity would be capable of further netting its assets and liabilities, the value of also adjusting for conditional rights of set off (paragraph 12(d)) is less apparent. For example, if a right of set off only arises on insolvency, then to disclose a net position that includes that right of set off would appear inconsistent with the principle that an entity's financial statements are prepared on the basis that it is a going concern.

Paragraph 14

We note that this paragraph anticipates that certain of the information that would be required by paragraphs 11-13 may be disclosed elsewhere in an entity's financial statements. If the intention is to acknowledge existing disclosure requirements, whether from an IFRS or US GAAP perspective, we suggest that this should be made more explicit together with a cross reference from the offsetting disclosure requirements to those set out in other accounting standards. This may be the case, for example, in respect of the fair value information that would be required by paragraphs 12(b)(ii) and 12(f)(ii).

Question 5—Effective date and transition

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

We agree with the proposed transition arrangements in Appendix A, with retrospective application being required.

We assume that the mandatory effective date will be aligned with the effective dates of other components of the Boards' financial instruments projects.