



financial executives  
international

COMMITTEE ON CORPORATE REPORTING

April 28, 2011

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**Re: FASB File Reference No. 2011-100**

**Re: IASB ED/2011/11**

Dear Madam or Sir:

The Committee on Corporate Reporting (“CCR”) of Financial Executives International (“FEI”) wishes to share its views on the proposed Accounting Standards Update on Balance Sheet (Topic 210), *Offsetting*, (the “Proposed ASU”) as issued by the Financial Accounting Standards Board (“FASB”), and the Exposure Draft ED/2011/11, *Offsetting Financial Assets and Financial Liabilities*, as issued by the International Accounting Standards Board (“IASB”) (collectively, the “Exposure Drafts”). FEI is a leading international organization of senior financial executives. CCR is a technical committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. This document represents the views of CCR and not necessarily the views of FEI or its members individually.

We fully support the continued efforts of both the FASB and the IASB (collectively, the “Boards”) to converge the FASB Accounting Standards Codification (“ASC” or “US GAAP”) with International Financial Reporting Standards (“IFRS”), as balance sheet offsetting currently creates a major difference in comparability of financial reporting between the two accounting models. However, we do not believe that the Exposure Drafts will result in an improvement to financial reporting currently applied under US GAAP. As such, a majority of our members would not support the Exposure Drafts and feel strongly that the proposed changes will not improve the quality of information provided to users of financial statements or be cost beneficial to the preparers of such financial statements. Further, we feel that if the Boards diverge on this issue, there will remain a major difference in comparability of balance sheet presentation for firms who use US GAAP versus IFRS as their primary accounting model. The divergence will also create an additional burden for preparers who currently follow IFRS for local reporting requirements, but follow US GAAP for their SEC filings on a consolidated basis. Therefore, we implore both Boards to converge to a model that more closely aligns with the current US GAAP

accounting model. In the attached appendix, we describe in more detail our specific concerns with regard to our position and to the questions posed within the Exposure Drafts.

We appreciate the Boards' consideration of these matters and welcome the opportunity to discuss any and all related matters. If you have questions, please contact Lorraine Malonza at (973) 765-1047 or [lmalonza@financialexecutives.org](mailto:lmalonza@financialexecutives.org).

Sincerely,

A handwritten signature in cursive script that reads "Loretta Cangialosi".

Loretta V. Cangialosi  
Chair, Committee on Corporate Reporting  
Financial Executives International

## Appendix

### ***Question 1 — Offsetting Criteria: Unconditional Right and Intention to Settle Net or Simultaneously***

*The proposals would require an entity to offset a recognized eligible asset and a recognized eligible liability when the entity has an unconditional and legally enforceable right to setoff the eligible asset and eligible liability and intends either:*

- 1. To settle the eligible asset and eligible liability on a net basis,*
- 2. To realize the eligible asset and settle the eligible liability simultaneously.*

*Do you agree with this proposed requirement? If not, why? What criteria would you propose instead and why?*

### **Cash Collateral under Derivative Contracts**

The Exposure Drafts require that an entity shall not offset recognized eligible financial assets and liabilities with assets pledged as collateral or the right to reclaim collateral pledged or the obligation to return collateral sold. One area of concern is the Exposure Drafts' characterization of variation margin posted for exchange-traded and centrally-cleared derivatives. Paragraph C14 specifically refers to margin accounts related to interest rate swap contracts, futures contracts, and exchange-traded written options, and requires that these margin accounts should be accounted as separate assets and liabilities. Margin accounts can take different legal forms, and as such should not be generalized in the accounting guidance.

For example, cash variation margin posted to an exchange for daily-margined futures contracts is deemed to be a legal settlement of the instrument, resulting in the recording of a net receivable or payable to the exchange at the end of the day, which will settle the next morning. The amount recorded on balance sheet is not the full fair value of the futures contract, as the requirement to provide margining on a daily basis and the resulting legal settlement does not result in the build-up of fair value of the instrument. As a result, we find the requirement to separately account for variation margin on exchange-traded instruments that are legally settled on a daily basis to be separating the unit of account of the instrument. We therefore ask the Boards to eliminate the requirement to separate the variation margin from the gross fair value of legally-settled, exchange-traded derivative contracts.

Cash variation margin under certain centrally-cleared derivatives does not always constitute a legal form of settlement of the instrument as described above. However, the substance and intent of the daily variation margin is to settle the net exposure to match the same economic impact of those instruments that are legally settled. The cash variation margin will not be returned to the customer unless there is a favorable change in fair value. The amount posted as variation margin will eventually be used to close out the customer's position on a net basis upon termination or maturity. As discussed above, due to daily posting of cash variation margin, there exists no build up of fair value of the instrument to the customer as cash has already been posted and used to reduce the risk exposure inherent in the instrument. Similarly, cash collateral posted on bilateral

over-the-counter (“OTC”) contracts also have the substance and intent of settling the net exposure, although the variation margin may not be transferred on a daily basis resulting in an uncollateralized portion of the gross exposure. Regardless of the frequency of cash variation margin payments, we feel that recording of gross exposures on the balance sheet with separate accounts for margin does not reflect the true assets and liabilities of an entity, since they will be net settled upon termination of the instrument and/or ultimate bankruptcy of the entity under the rules of the exchange or clearinghouse for centrally-cleared derivatives or under master netting agreements as used in bilateral OTC derivative contracts.

We note the Boards wanted to reflect gross balances of instruments on the face of the balance sheet and did not want to offset only certain risks such as liquidity or credit risk. However, it is our belief that at a reporting date, the balance sheet should reflect assets and liabilities that will be settled on a net basis. In the case of posting cash collateral to reduce the overall exposure of derivative contracts, we do not favor a linked-presentation model, but feel offsetting the cash margin amounts is appropriate within the balance sheet as of the reporting date as the cash margin has reduced the outstanding risks both legally, in the case of futures contracts, and in substance for all other types of derivatives. Risks other than liquidity or credit risk inherent in the instrument cannot be derived from a balance sheet presentation, and can only be fully understood from disclosure in the notes to the financial statements, as currently required on a gross basis by underlying risk and product type under US GAAP. We therefore ask the Boards to allow the offset of cash collateral with the fair value of derivative contracts on the face of the balance sheet and to align the disclosure requirements concerning derivative contracts under both US GAAP and IFRS. See additional comments on disclosures in our response to Question 4.

### **Payment Netting**

We ask the Boards for additional application guidance for the criteria on the intent to settle net, especially for the offset of contracts with various cash flows during their life. If two financial instruments have the legally enforceable right to offset, would all cash flows of those two contracts need to settle net or simultaneously to apply an offset of the asset and liability balance? Similarly, if instruments have differing maturity dates, but the underlying cash flows match during the life of the shorter duration instrument, can the shorter duration instrument be offset with the longer duration instrument during the life of the shorter duration contract? For example, a vanilla interest rate swap derivative contract typically has no payment at maturity since there is a zero fair value at maturity. We contend that as long as the maturity date is the same for a repurchase agreement and a reverse repurchase agreement, offsetting of the principal balances is warranted, if other offsetting criteria are met, even though the periodic interest payments may not match during their lives. Specific examples of cash flows on eligible financial instruments include periodic interest or premium payments, the fixed leg vs. floating leg of an individual swap contract, exchange of payments in different currencies, initial and final payments in different currencies under a single contract such as cross-currency swap, payments at final maturity, etc. It is unclear within the guidance whether all of these cash flows must match to achieve balance sheet offset.

In addition, it is unclear if companies should pierce the unit of account and offset the portion of the asset or liability that relates only to the underlying cash payments that settle net or simultaneously. For example, if one swap contract pays interest quarterly and another swap

contract receives semi-annually, would a portion of the asset and liability balance relating only to those payments that net on a semi-annual basis be able to offset? We ask the Boards to propose a reasonable and operationally efficient manner to analyze payment netting, since current financial reporting systems do not currently allow the matching of all individual payments across instruments. This will require significant system enhancements to achieve matching of all cash flows and/or the offset of partial assets and liabilities if the unit of account is to be pierced.

### **Simultaneous Settlement**

The Exposure Drafts define simultaneous settlement as having to occur at the same moment, i.e., there is exposure to only the net or reduced amount. We find that this requirement is operationally impossible to verify and unreasonably strict. In ASC Subtopic 210-20-45, the FASB reached a determination that the clearing and settlement mechanism described therein constituted the “functional equivalent of net settlement” for repurchase and reverse repurchase agreements. Many preparers under current IFRS also consider this guidance in their application of IAS 32 (as currently interpreted). IAS 32 states that the operation of a clearinghouse leads to the equivalent of net settlement. Current practice under IFRS is to apply simultaneous settlement to transactions that settle through a central clearinghouse in the same account on the same day. Many repurchase agreements reverse repurchase agreements, and securities lending/borrowing agreements settle based on a batch process whereby positions that settle on a given day will be processed at different points during the day based on systematic/administrative limitations. The Exposure Drafts do not reflect how settlement systems in the capital markets operate and would result in a significant change in accounting practice merely based on the “form” of settlement focusing on logistical or immaterial timing differences. The substance of inter-day settlements gives adequate credit and liquidity risk protection, along with the other credit risk mitigators in place at clearinghouses, such as daylight overdraft protection, lines of credit, and excess collateralization.

It is impossible to verify when settlement is performed at the clearinghouse between counterparties as described above. Therefore, we feel that the settlement on the same day with both counterparties significantly reduces both credit and liquidity risk. We strongly recommend that the Boards redeliberate this criterion to align with current practice.

### **Requirement of Offset**

Many of our members who are not financial institutions do not have significant portfolios of eligible financial assets and liabilities that fall within the scope of the Exposure Drafts, specifically derivatives or repurchase agreements. Under US GAAP, presentation of these balances is reported on a gross basis. Although the current criteria in the Exposure Drafts have considerable hurdles to achieve offset on the face of the balance sheet, they would now “require” offsetting of eligible financial assets and liabilities. Some of our members would like the opportunity to report eligible financial assets and liabilities on a gross basis if they do not consider the impact to be material to the balance sheet. We believe that the search for unrecorded netting would be onerous and costly to preparers with little benefit to users. In addition, please see comments on the scope of the disclosure requirements as mentioned in the Question 4.

## **Specific Industry Guidance under US GAAP**

### **Amendments to ASC Subtopic 910-405 – Contractors-Construction**

We noted the Proposed ASU would eliminate the construction contractor industry guidance that allowed offsetting of customer advances against work in process on cost-plus contracts.

However, we also noted the Proposed ASU does not include conforming amendments to the Federal Government contractor industry guidance that permits offsetting customer advances against work in process (ASC paragraph 912-405-45-6). We assume the Proposed ASU did not include these conforming amendments because the Federal Government takes title to and has an unconditional obligation to pay its contractors for work in process. We request the Boards clarify why the construction contractor industry guidance on how customer advances should be presented on the balance sheet would be eliminated while the Federal Government contractor industry guidance would be retained.

Furthermore, the Proposed ASU does not eliminate the Revenue Recognition (ASU Topic 605) guidance on how customer advances on construction and production-type contracts should be presented on the balance sheet (ASC paragraphs 605-35-45-3 to 5). We assume the Proposed ASU does not eliminate this guidance because Revenue Recognition (Topic 605) is expected to be superseded in its entirety by the proposed Accounting Standards Update (*Topic 605*), *Revenue Recognition*, (“Proposed Revenue ASU”). Our interpretation of the Proposed Revenue ASU is that customer advances are required to be offset against unbilled receivables. However, offsetting customer advances against work in process would not be permitted. We believe construction contracts are intended to qualify for continuous transfer of control under the Proposed Revenue ASU and depending on the method chosen for measuring progress and recognizing revenue, the accumulated cost incurred to date would either be captured in unbilled receivables (e.g. cost-to-cost approach) or work in progress (e.g. units of delivery). Therefore, customer advances would be recorded net against unbilled receivables if the cost to cost method is chosen and gross as a liability under a unit of delivery approach. It is unclear as to why there would be differing balance sheet presentation based on the method selected to measure progress. We do not agree with what appears to be the Board’s decision to prohibit offsetting customer advances against work in process when contracts qualify for continuous transfer of control. We believe offsetting customer advances against both unbilled receivables and work in process should be allowed for contracts that meet the continuous transfer criteria.

### ***Question 2 — Unconditional Right of Offset Must Be Enforceable in All Circumstances***

*Under the proposals, eligible assets and eligible liabilities must be offset if, and only if, they are subject to an unconditional and legally enforceable right of setoff. The proposals specify that an unconditional and legally enforceable right of setoff is enforceable in all circumstances (that is, 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 have concerns that the requirement of unconditional right of offset is too strict. We understand that the Boards did not want to reflect the offset of only certain risks on the balance sheet, such as credit risk. However, the offset of financial assets and liabilities under conditional

netting agreements does not make a significant change to the information gathered from the face of the balance sheet. If there is an intention to settle net, contracts with the same counterparty will be offset at termination, maturity, and/or bankruptcy of the counterparty or the reporting entity. This was proven to be effective, even in the recent financial crisis. Financial assets and liabilities under master netting agreements, regardless of their unconditional or conditional rights, would be offset if the counterparty fell into bankruptcy. In some jurisdictions, the gross assets would not be available to other creditors, and therefore, reflecting gross assets and liabilities on the face of the balance sheet would not give faithful and relevant information to a user as those assets and liabilities are inextricably linked. The analysis of gross risks inherent in each of the financial instruments subject to offset can only be derived from disclosure in the notes to the financial statements. We therefore believe that a legally enforceable right of offset regardless of conditionality is sufficient for netting of financial instruments on the face of the balance sheet.

***Question 3 — Multilateral Setoff Arrangements***

*The proposals would require offsetting for both bilateral and multilateral setoff arrangements that meet the offsetting criteria. Do you agree that the offsetting criteria should be applied to both bilateral and multilateral setoff arrangements? If not, why? What would you propose instead, and why? What are some of the common situations in which a multilateral right of setoff may be present?*

We agree that offsetting shall be permitted between multiple parties if the offsetting criteria are met. Multilateral arrangements exist in certain master netting agreements between the counterparty and various affiliates of the reporting entity. Currently, these agreements are conditional in nature, as netting is subject to default of one of the counterparties of the agreement, and would not meet the criteria under the Exposure Drafts. As mentioned in our response under Question 2, we believe that if an unconditional right of offset is not required, netting under multilateral arrangements would be more prevalent under an accounting model based on current US GAAP.

***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?*

We agree that disclosures relating to gross amounts of financial assets and financial liabilities provide valuable information to users of financial statements to understand the inherent risks by product type. Currently, these disclosures are only required for derivative assets and liabilities under FASB ASC Topic 815, *Derivatives and Hedging*, but are not required for other product types or in any disclosures under IFRS. We believe that disclosures of the gross and net balances of eligible financial assets and liabilities should be consistent across all types of financial instruments, but not in the detail as prescribed in the Exposure Drafts. For the detail disclosures as proposed, the benefits for the users of financial statements do not outweigh the efforts and

costs for collecting the data. Not all information required for the proposed disclosures is readily available from current financial reporting systems.

In particular, the requirement to disclose the portfolio-level adjustments for credit risk is a valuation methodology issue and relates to a valuation reserve, i.e., a portion of the fair value of the group of instruments, to reflect an exit price of the portfolio and would be better placed within disclosures on fair value measurement. A valuation reserve is not an offset of gross financial assets and liabilities and may mislead users of the financial statements. In addition, the concept of portfolio-level adjustments is not currently within US GAAP or IFRS as the FASB ASU for Topic 820 and IFRS 13 have not yet been issued. If the guidance for portfolio-level adjustments will be prospective in nature effective in future periods, a retrospective application of the netting disclosures is incongruous. In addition, we do not believe that the breakdown between unconditional and conditional netting that was not achieved within the balance sheet is relevant to users. If for any reason the netting criteria are not met, users will not benefit from the reason why netting was not achieved. Although we do believe, as mentioned above, that the differentiation between unconditional and conditional netting arrangements should not matter for netting within the balance sheet, we also do not believe that the disclosure of that differentiation is relevant to users. The differentiation of the type of netting arrangements by product type will be extremely difficult to collect from financial reporting systems and can be described more effectively in a qualitative nature.

We also ask the Boards for additional clarification on the population of instruments to be considered for inclusion in the proposed disclosures. As the Exposure Drafts require netting for eligible financial assets and liabilities, entities will need to determine where netting might be eligible in certain remote conditions or where there is no intention to settle net. This effort to identify and quantify eligible netting would be necessary to comply with the netting disclosures where the netting criteria are not met within the balance sheet, but would be required to be included in the disclosures. We believe that this search for unrecorded netting would be onerous and costly to preparers with little benefit to users and therefore should be excluded from the proposed disclosures for eligible financial instruments that are not intended to be offset. In addition, there are many instances where instruments may be collateralized by cash or other financial instruments where no netting has been achieved in the past under either US GAAP or IFRS, e.g., loan receivables or issued debt. We do not believe that these types of financial instruments should be included in the scope of the disclosures simply because they do not meet the netting criteria, but are only collateralized vanilla instruments. We believe that disclosure of collateral is best placed within the footnotes of those specific product types and described in a qualitative nature.

***Question 5 — Effective Date and Transition***

*Do you agree with the proposed transition requirements in Appendix A? 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.*

The proposed guidance will cause a significant departure from practice under US GAAP and may affect certain aspects of netting under IFRS. We expect that for our members who have

significant portfolios of derivatives, changes in systems will be required to achieve the level of detail prescribed by the proposed disclosures. In addition, all firms will need to perform an exhaustive search of potential netting relationships that are not identified under current netting guidance and determine how this information will be collected in future reporting periods. Since the transition guidance requires retrospective application to previous reporting periods and a significant change in the reporting systems, we believe that the effective date of the new guidance should be no sooner than reporting periods beginning 1 January 2015. This should coincide with the timeline of implementation for other converged standards, specifically the Boards' project on Financial Instruments.

### ***Other Considerations***

#### **Intercompany Assets and Liabilities**

It is unclear whether the Exposure Drafts intend to include or exclude intercompany assets and liabilities. The Exposure Drafts do not make reference to any changes to International Accounting Standard 27, *Consolidated and Separate Financial Statements*, or to FASB ASC topic 810-10-45, *Consolidation: Other Presentation Matters*, which states:

45-1 In the preparation of consolidated financial statements, intra-entity balances and transactions shall be eliminated. This includes intra-entity open account balances, security holdings, sales and purchases, interest, dividends, and so forth. As consolidated financial statements are based on the assumption that they represent the financial position and operating results of a single economic entity, such statements shall not include gain or loss on transactions among the entities in the consolidated group.<sup>1</sup>

If the intention was to exclude intercompany assets and liabilities, then we recommend that the proposal should contain more specific language for preparers to better understand the scope of the proposal. We contend that the Exposure Drafts should not amend current guidance relating to intercompany assets and liabilities of a consolidated group.

If the intention was to include intercompany assets and liabilities in the scope of the Exposure Drafts, we would strongly oppose such a change. We feel that the current consolidation guidance that permits netting of intercompany assets and liabilities is the preferred reporting, especially in companies where the subsidiary is 100% owned and consolidated by the parent. We do not feel that there is any additional benefit to users by grossing up intercompany assets and liabilities that would otherwise net to zero. Further, grossing up intercompany assets and liabilities would greatly inflate the balance sheets of many corporate entities and distort financial ratios, without providing any further information regarding the true risks and exposures of the consolidated company.

As this issue was not addressed in the Exposure Drafts, it is our hope that the intention of the Boards was to scope intercompany assets and liabilities out of the Balance Sheet Offsetting guidance for consolidated reporting. If the intention was to include intercompany assets and

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<sup>1</sup> Similar guidance is included in paragraphs 20 – 21 of IAS 27 under IFRS.

liabilities, then we recommend that the Boards provide constituents with more time to consider the implications of such a change.

As an additional example, some of our members have cash pooling arrangements that utilize a third party bank (the “pool”) to provide multi-currency cash pooling for their international subsidiaries. Depositing subsidiaries transfer eligible cash amounts to the pool. Withdrawing subsidiaries are then able to borrow money from the pool, with the deposits serving as collateral for these loans. These arrangements also contain a master netting agreement between the parent company and the facilitating bank. Current practice is to show the net amount of cash on the consolidated balance sheet, whereas in individual stand-alone financial statements, gross cash balances are reflected by the depositing subsidiaries and liability balances are reflected by the borrowing subsidiaries. The requirements under the Exposure Drafts would seem to suggest that the deposits made into the pool and the subsidiary borrowings should be shown gross on the face of the consolidated group’s balance sheet. This display would be contrary to the economics of the transaction. The facilitating bank, through the master netting agreement has not taken on any risk of the individual loan and deposit of each subsidiary. It only has a risk relative to the net position of the corporation.

Our view is that gross presentation of this activity on the face of the consolidated balance sheet accompanied by a reconciliation to the net amount in the footnotes would not necessarily provide financial statement users with more useful information with regard to an entity’s overall liquidity position. Investors focus primarily on the entity’s cash management and more specifically the use of excess funds. Gross presentation on the face of the consolidated balance sheet could be misleading to investors as it would misrepresent the true level of excess cash available for activities such as the repurchase of own stock, business acquisitions, debt repayment, etc. Although footnotes would provide a reconciliation of the gross and net balances, investors are more focused on the net balance and therefore we believe that gross presentation on the face of the consolidated balance sheet would present undue prominence of this amount.

We also believe that the level of disclosures would significantly increase as a result of the Exposure Drafts, due to their explicit requirements, but also due to the additional disclosures that we believe would be needed to provide users of the consolidated financial statements with an understanding of the reported cash balance. In addition, the proposals in the Exposure Drafts would necessitate the statement of cash flows to be reconciled to the gross cash balance recorded on the face of the consolidated balance sheet rather than the net balance currently recorded. Consequently, we believe that consideration would need to be given to presentational issues that may arise in respect of deposits into and withdrawals from the pool and their classification within the sections of Operating and Financing Activities. We believe that this would require further additional disclosures to explain the activity within each section. We do not believe that this increased volume of disclosures would necessarily provide more useful information to users.