April 28, 2011

Ms. Susan M. Cosper, Technical Director Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk, CT 06856-5116

Re: Exposure Draft, Offsetting Financial Assets and Financial Liabilities. File Reference Number: 2011-100

Dear Ms. Cosper:

The Association for Financial Professionals (AFP) <sup>1</sup> appreciates the opportunity to comment on the Financial Accounting Standards Board's (FASB) Exposure Draft (ED) titled, *Offsetting Financial Assets and Financial Liabilities*, issued in January 2011.

We acknowledge that converging the two offsetting (netting) standards is greatly needed. Overall, our members would prefer that the International Accounting Standards Board (IASB) adopt the FASB's model for offsetting financial assets and financial liabilities. We are not convinced that the proposed offsetting principles will result in an overall improvement to either U.S. Generally Accepted Accounting Principles (U.S. GAAP) or International Financial Reporting Standards (IFRS). However, AFP recognizes that compromise is necessary for both sides to achieve this overarching convergence objective.

As you stated in the ED, the differences in the offsetting requirements, when reporting under the IFRS and U.S. GAAP, account for the single largest quantitative difference in amounts presented in statements of financial position. Applying a single uniform set of accounting standards will provide more consistency and comparability in financial reporting for similar entities irrespective

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<sup>&</sup>lt;sup>1</sup> AFP represents approximately 16,000 finance and treasury professionals from over 5,000 corporations, including the Fortune 1,000 and the largest of the middle market companies. Our membership includes a significant number of U.S and Canadian corporate treasurers who are responsible for the protection and management of corporate cash, cash flow requirements and corporate investments; and controllers and CFOs who are responsible for their corporate accounting, financial reporting and regulatory compliance.

their geographic location, which will give companies an equal playing field in the global capital markets. Thus, we commend the FASB for making an attempt to bridge this gap while offering the following comments for the Board to consider in its due process effort.

# Offsetting Contracts under a Master Netting Arrangement

This proposed standard takes a more stringent approach by eliminating companies' ability to offset some derivative sale and repurchase contracts when the right of setoff is conditional, there is no intention to set off, or such intention is conditional. The concern is that companies' will no longer be able to net financial assets and financial liabilities commonly covered under master netting agreements, which is currently allowed per ASC 815-10-45-5, which states:

a reporting entity may offset fair value amounts recognized for derivative instruments and fair value amounts recognized in the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) arising from derivative instrument(s) recognized at fair value executed with the same counterparty under a master netting arrangement.

As a result, we believe that the proposed approach would undoubtedly inflate both the balance sheet asset and liabilities totals significantly. While the financial assets and financial liabilities held under a master netting agreement do not conform technically to the proposed criteria for netting, risk of default is significantly reduced for these assets nevertheless. Therefore, we propose that the Board consider our current practice as the standard, and the IASB adopt the FASB's guidance, rather than the reverse.

Additionally, net presentation is a better depiction of a company's actual liquidity risk. Liquidity risk for secured or collateralized derivatives executed under a master netting arrangement is driven by the cash collateral and ongoing margin requirements, which are typically calculated on a net basis, not a gross basis. Thus, gross presentation may not facilitate a user's ability to predict cash flows and understand liquidity as the proposal suggests because it does not capture the nominal inter-day liquidity risk associated with a related financial asset and financial liability.

If the FASB moves forward with the proposed gross up method for financial assets and financial liabilities commonly covered under a master netting agreement, it should consider adopting a linked presentation approach for presenting these financial assets and financial liabilities so that users of the financial statement can clearly identify the relationship that exists with these financial assets and financial liabilities.

### Simultaneous Settlement Criteria

The recent passage of the Dodd Frank Act imposes a comprehensive and far-reaching regulatory regime on derivatives and market participants. The most significant provisions of the derivative

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regulation include mandatory clearing of certain derivative instruments through regulated clearing organizations and mandatory trading of certain derivative instruments on regulated exchanges or swap execution facilities. Just by the passage of this legislation, derivative contracts will be better regulated, companies' exposure to settlement risk for centrally cleared contracts will be greatly reduced, and more importantly, those that invest in these companies better protected.

AFP is concerned with the potential interpretation of the criteria for simultaneously net settling the eligible asset and eligible liability in this ED, if a company has met the other requirements, for those derivative contracts that are cleared though a regulated clearinghouse. More specifically, it is unclear from the proposal if a company would be required to obtain any additional information to determine simultaneous settlement actually occurred at the clearinghouse level or can a company who uses a clearinghouse assume simultaneous settlement?

### Paragraph C12 of the ED states,

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. For example, in some centrally cleared financial markets with a central counterparty or in face-to-face exchanges, the rules of the markets with a central counterparty may grant both the clearing house or the exchange and the members a right to set off amounts due and payable to either party. The procedures of the clearinghouse or exchange may, in addition provide that the amounts to be paid or received for different products be settled gross. However such payments may be made simultaneously. Therefore, even though the parties may make payment or receive payment separately for different product types, settlements occur at the same moment and there is only exposure to the net amount.

Based on this passage, and similar language found in par. 48 of IAS 32, AFP's interpretation is that transactions settled on an exchange or through a clearinghouse will always meet the simultaneous settlement criterion (even though there may be some period of time between settlement payments due to the mechanics of the exchange or clearing house). However this is not clear in the ED. Additionally, it is not clear whether settlement of financial instruments via an exchange or clearinghouse which settles multiple transactions in batches could meet the simultaneous settlement requirement. We ask the FASB to provide more guidance in this area.

It would be extremely burdensome, counterintuitive and expensive if our members could not assume that the criteria for simultaneous settlement were met for contracts settled through a clearinghouse. As a result, they will be required to incur additional costs to perform due diligence on the regulated clearinghouses. The reason companies use a clearinghouse is to remove the settlement risk (credit and liquidity) from the equation.

Moreover, clearinghouses transact large volumes of contracts throughout the day. Simultaneous settlement to the letter of the standard may seem unrealistic and compliance with this standard

could pose systematic problems. Thus, we propose that settlement through regulated clearinghouses should automatically meet the definition of simultaneous settlement so long as the settlement occurs within the same day.

# **Conclusion**

Overall, AFP supports the efforts of the FASB to steward the development of high quality converged accounting standards. Thank you for the opportunity to comment on this Exposure Draft. Please feel free to contact Salome J. Tinker, AFP's Director of Accounting Policy and Financial Reporting for any additional information and questions at (301) 961-8871 or <a href="mailto:style="signature">style="signature

Sincerely,

June M. Johnson, CPA, CTP

Chair of the AFP Financial Accounting and

**Investor Relations Task Force** 

Joseph C. Meek, CTP

Chair of the AFP Government

**Relations Committee** 

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### **Question 1**

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?

# **AFP's Response:**

AFP agrees with this requirement. However, we believe that the Boards should reconsider its decision to exclude those contracts held under a master netting agreement.

### **Question 2**

Under the proposals, eligible assets and eligible liabilities must offset, if and only if, they are subject to an unconditional and legally enforceable right to setoff. The proposals specify that an unconditional and legally enforceable right of setoff is enforceable in all circumstances (that is, if it 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 the proposed requirement? 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?

# **AFP's Response:**

This proposed standard takes a more stringent approach by eliminating the ability for companies to net financial assets and financial liabilities under a master netting agreements per ASC 815-10-45-5, which states:

a reporting entity may offset fair value amounts recognized for derivative instruments and fair value amounts recognized in the right to reclaim cash collateral (a receivable) or the obligation to return cash collateral (a payable) arising from derivative instrument(s) recognized at fair value executed with the same counterparty under a master netting arrangement.

As a result, we believe that the proposed approach would inflate both the balance sheet asset and liabilities totals significantly. We are not sure if the benefit derived for users of the financial statements will be that significant.

### **Question 3**

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 comment situations in which a multilateral right of setoff may be present?

## **AFP's Response:**

We agree that the proposal should be applied to both bilateral and multilateral setoff arrangements.

#### **Ouestion 4**

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?

### **AFP's Response:**

We agree with the disclosure requirements in paragraphs 11-15. However, many of the proposed disclosures required under paragraph 12 seem repetitive and are already required under existing U.S. GAAP.

### **Question 5**

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?

### **AFP's Response:**

We agree with the transition requirements in Appendix A. Presently, most companies' reporting system is able to compute the gross position and is currently disclosing this information in the notes of their financial statements. Thus, an extended transition time should not be needed.