Frank and Caroline Walker 175 E Delaware Pl #6701, Chicago, IL 60611

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Financial Accounting Standards Board director@fasb.org File Reference No. 2011-100

Proposed Accounting Standards Update: Balance Sheet (Topic 210) Offsetting:

Unconditional Right of Offset Must Be Enforceable in All Circumstances: Question 2

Dear Technical Director:

We applaud the FASB for proposing a legal basis for balance sheet offsetting.

Our comments concern both the realities of implementing the proposals under extreme conditions such as bankruptcy and the going concern analysis underpining normal financial reporting.

In bankruptcy, claimants use available means to assert their rights over others when most creditors and other stake holders will not be made whole. Such proceedings can be incredibly complicated and last for years. Contracts can be renegotiated, modified or rejected by a bankruptcy court. An entity emerging from bankruptcy may be reorganized and under new control. The legal enforceability of a contract cannot be guaranteed.

We believe that --

Financial reporting has limited influence in bankruptcy proceedings.

Bankruptcy should not become the driver of this important financial reporting proposal.

Impairment testing, fair value adjustments and other analysis can support the contintuity of business evaluation.

"Unconditional" is not consistent with professional judgment and cannot be reasonably assured given multiple potential jurisdictions and applicable law.

Sincerely,

Frank Walker

Certified Fraud Examiner

Caroline Walker

Caroling Walker

http://www.linkedin.com/in/carolineannwalker

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Paragraphs that refer to bankruptcy were extracted from the proposal as follows:

- 9 Unconditional Right of Offset Must Be Enforceable in All Circumstances Question 2: 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?
- 12 e. A *legally enforceable right of setoff* is a right of setoff that is enforceable in all circumstances, that is enforceable both in the normal course of business and on the default, insolvency, or bankruptcy of one of the counterparties
- 17 C5. A right of setoff may arise as a result of a provision in law (or a regulation), or it may arise as a result of a contract. Because the right of setoff is a legal right, the conditions supporting the right may vary from one legal jurisdiction to another. Moreover, in particular cases, the laws of a jurisdiction about the right of setoff may provide results different from those normally provided by contract or as a matter of common law. Similarly, the bankruptcy or insolvency laws of a jurisdiction may impose restrictions on or prohibitions against the right of setoff in bankruptcy, insolvency, or similar events in some circumstances.
- 17 C6. Thus, whether an entity's right of setoff meets the legally enforceable right of setoff criterion will depend on the law governing the contract and the bankruptcy regime that govern the insolvency of the counterparties. Therefore, the laws applicable to the relationships between the parties (for example, contractual provisions, the law governing the contract, and the bankruptcy laws of the parties) need to be considered to ascertain whether the right of setoff is enforceable in all circumstances.
- 19 C13. Generally, the right of setoff requires "mutuality" of parties (that is, the parties must be mutually indebted to each other) for it to be enforceable. However, a party may, by contract, no longer require mutuality and allow its asset to be made available to be set off against a third party's liability. For example, A, B, and C agree that A may set off amounts owed by A to B against amounts owed to A by C. Therefore, in unusual circumstances a debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor (that is, a tripartite arrangement). However, not all jurisdictions recognize this type of contractual setoff arrangement, particularly in bankruptcy scenarios. If the arrangement meets the criteria in paragraph 6, an entity shall offset the relevant eligible asset and eligible liability.
- 20 C17 At a minimum, an entity shall distinguish between rights of setoff that are exercisable on default, bankruptcy, or insolvency (or similar events) and rights of setoff that are exercisable in the normal course of business. In determining whether to aggregate the disclosures in paragraph 12(d) for different types of rights of setoff, an entity shall consider the characteristics of those rights and the disclosure requirements in paragraph 12.
- 26 Legally Enforceable Right of Setoff A right of setoff that is legally enforceable in all

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circumstances, that is, enforceable both in the normal course of business and on the default, insolvency, or bankruptcy of one of the counterparties.

36 210-20-55-5 A right of setoff may arise as a result of a provision in law (or a regulation), or it may arise as a result of a contract. Because the right of setoff is a legal right, the conditions supporting the right may vary from one legal jurisdiction to another. Moreover, in particular cases, the laws of a jurisdiction about the right of setoff may provide results different from those normally provided by contract or as a matter of common law. Similarly, the bankruptcy or insolvency laws of a jurisdiction may impose restrictions on or prohibitions against the right of setoff in bankruptcy, insolvency, or similar events in some circumstances.

36 210-20-55-6 Thus, whether an entity's right of setoff meets the legally enforceable right of setoff criterion will depend on the law governing the contract and the bankruptcy regime that governs the insolvency of the counterparties. Therefore, the laws applicable to the relationships between the parties (that is contractual provisions, the law governing the contract, and the bankruptcy laws of the parties) need to be considered to ascertain whether the right of setoff is enforceable in all circumstances.

38 >> Bilateral and Multilateral Setoff Arrangements

210-20-55-13 Generally, the right of setoff requires "mutuality" of parties (that is, the parties must be mutually indebted to each other) for the right of setoff to be enforceable. However, a party, by contract, no longer require mutuality and allow its asset to be made available to be set off against a third party's liability. For example, A, B, and C agree that A may set off amounts owed by A to B against amounts owed to A by C. Therefore, in unusual circumstances a debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor (a tripartite arrangement). However, not all jurisdictions recognize this kind of contractual setoff arrangement, particularly, in bankruptcy scenarios. To the extent that the arrangement meets the conditions in paragraph 210-20-45-5B, an entity should offset the relevant financial or derivative asset and financial or derivative liability.

39 210-20-55-17 Paragraph 210-20-50-2(d) requires disclosure of the portion of the net amount presented in the statement of financial position that is covered by each type of conditional and legally enforceable right of setoff. The disclosures required by paragraph 210-20-50-2(d) may be presented in the aggregate for similar types of rights of setoff if separate disclosure of each type of right of setoff would not provide more useful information to users of financial statements. An entity should disclose the criteria it applies in aggregating similar rights of setoff. At a minimum, an entity should distinguish between rights of setoff that are exercisable on default, bankruptcy, or insolvency (or similar events) and rights of setoff that are exercisable in the normal course of business. In determining whether to aggregate the disclosures in paragraph 210-20-50-2(c) for different types of rights of setoff, an entity should consider the characteristics of those rights and the disclosure requirements in paragraph 210-20-50-2.

51 BC6. The proposals clarify that the offsetting criteria apply whether the right of setoff arises from a bilateral arrangement or from a multilateral arrangement (that is, between three or more parties). The proposals also clarify that a legally enforceable right of setoff must be a right of setoff that is legally enforceable in all circumstances (including the normal course of business and default by, or the bankruptcy of, a counterparty).

51 Outreach Performed BC7. In reaching their conclusions, the Boards conducted extensive outreach

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including meetings with users, legal experts and firms, preparers, regulators, clearing houses, industry groups, and auditors:

- b. Legal experts on financial law provided an overview of (1) the legal meaning, basis, and effect of setoff rights in master netting and other agreements; (2) whether the legal analysis and effect of contracts with or through central counterparties differ; and (3) the interaction of setoff rights with bankruptcy laws and relevant cross-border implications.
- 51-52 Requiring Offset When an Entity Has a Conditional Right of Setoff BC30. The Boards considered whether offset should be required when an entity has a legally enforceable right of setoff but that right is conditional (that is, enforceable or would be triggered only on the occurrence of some future event, usually the default, insolvency, or bankruptcy of the counterparty or other credit-related events). Under this alternative, all eligible assets and eligible liabilities that are executed with the same counterparty that are subject to a legally enforceable master netting agreement, or similar netting arrangement, would be offset, regardless of their other characteristics (for example, maturity, type, or underlying risk). This approach is based on the notion that offsetting is appropriate if counterparty risk is mitigated.
- 52 BC35. The Boards were not convinced that requiring offsetting on the basis of what might or might not happen in the future (that is, an assumption that an entity or its counterparties will default or become bankrupt) would be appropriate.
- 52 BC36. The Boards also concluded that offsetting based on a conditional right of setoff will result in financial statements that depict only entity's exposure to credit risk. The Boards observed that the statement of financial position does not represent an aggregation of the credit risk of an entity; it is not its purpose to set out the rights or the obligations of an entity if counterparties fail or become bankrupt. Thus, the Boards concluded that offsetting on the basis of a conditional right of setoff would not result in financial statements that are representationally faithful.
- 53 BC40. Moreover, the right of the parties to a swap agreement to pay a net amount on settlement is not a conditional right. Hence, the right to pay a net amount in a swap agreement is different from conditional rights of setoff in master netting agreements (close-out netting), which are enforceable only on the occurrence of some future event, usually the default, insolvency, or bankruptcy of the counterparty or other credit-related events.