April 29, 2011

Ms. Leslie Seidman, Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

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

Re: Proposed Accounting Standards Update, Balance Sheet (Topic 210): Offset (File Reference No. 2011-100) and Exposure Draft, Offset (File Reference ED/2011/1)

Dear Leslie and Sir David:

The Financial Reporting Committee of the Institute of Management Accountants ("FRC") is writing to provide its views on the Proposed Accounting Standards Update, Balance Sheet (Topic 210): Offset and the Exposure Draft, Offset (together the Proposed Update). We support the Boards’ efforts to develop a joint proposal to converge the requirements for offsetting, and we share the Boards’ goal of providing users of financial statements with meaningful financial information and disclosure. We also acknowledge that existing differences in the offsetting requirements in International Financial Reporting Standards (IFRS) and U.S. generally accepted accounting principles (U.S. GAAP) result in significant quantitative differences in the statement of financial position of the respective preparers. Accordingly, we believe convergence of offsetting standards would improve the comparability of such financial statements. However, it has been brought to our attention by our user members that the most significant issue in this area is the lack of disclosure under IFRS, which makes it impossible for them to adjust the amounts reported in those financial statements to a net basis, if they so choose. We further observe that the proposed changes will be costly and disruptive to affected parties without the benefit of an improvement in the presentation of this information for investors.

The FRC includes preparers of financial statements for some of the largest companies in the world, representatives from the world’s largest accounting firms, valuation experts, accounting consultants, academics and analysts¹. The FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations.

¹ Additional information about the IMA Financial Reporting Committee can be found at www.imafrc.org.
Existing US GAAP Literature is Sound

The core issues that the Boards are addressing in this project were thoroughly considered as part of the deliberations leading up to issuance of FASB Interpretation 39, *Offsetting of Amounts Related to Certain Contracts* (FIN 39). At that time, the FASB reached a completely different conclusion from the Proposed Update—that net amounts for derivatives would provide better information to investors than gross amounts. The nature and fundamental structures of these netting arrangements are unchanged from what existed at the date of issuance of FIN 39. While we understand the desire for convergence, it is unclear that the proposed approach is superior to an enhanced IFRS disclosure alternative. Certainly the original conclusions would support net presentation of derivatives subject to master netting arrangements as appropriate.

The reasoning and views set forth in Paragraphs 20 and 21 of the *Background Information and Basis for Conclusions* of FIN 39 are as appropriate and supportable today as they were at the time the original Interpretation was issued. Those paragraphs state:

20. FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, paragraph 37, states that "... financial reporting should provide information to help investors, creditors, and others assess the amounts, timing, and uncertainty of prospective net cash inflows to the related enterprise" (footnote reference omitted). The amount of credit risk exposure—the amount of accounting loss the entity would incur if the counterparties to forward, interest rate swap, currency swap, option, or other conditional or exchange contracts failed to perform in accordance with the terms of those contracts—is one indicator of the uncertainty of future cash flows from those instruments.

21. The Board decided to permit offsetting of the fair value recognized for forward, interest rate swap, currency swap, option, and other conditional or exchange contracts if they are executed with the same counterparty under a master netting arrangement. That arrangement effectively consolidates individual contracts into a single agreement between the parties. The failure to make one payment under the master netting arrangement would entitle the other party to terminate the entire arrangement and to demand the net settlement of all contracts. The Board believes that an exception to the requirement of paragraph 5(c) of this Interpretation, which states that "the reporting party intends to set off", is justified when a master netting arrangement exists because the net presentation discloses the amount of credit risk exposure under that arrangement. The Board decided that, given a master netting arrangement, presentation of the aggregate fair values of the individual contracts executed under that arrangement would not provide more information about the uncertainty of future cash flows from those contracts than net amounts would.”

The FRC believes that these existing requirements for offsetting provide a superior framework for reporting. The current offsetting guidance provides meaningful, well understood information in the statement of financial position and, supported by the required disclosures, meets the primary requirements of users of financial statements. In addition, the current presentation reflects the way that different preparers manage risk exposure, particularly for derivative instruments. We believe that this framework, with additional disclosures as required (e.g., the disclosure of secured financing counterparty netting discussed below) will meet the needs of users, preparers and the market.

Net Presentation is More Relevant

We believe that the general principles set forth by the Boards to achieve such convergence sacrifice relevance. For example, an entity does not have credit exposure equal to the amount of gross derivative assets, nor does
an entity have liquidity risk equal to the amount of gross derivative liabilities. These gross balances do not reflect the impact of widely used credit and liquidity risk management tools such as collateral requirements and master netting arrangements (MNAs). For preparers with significant derivative activities or risk management activities executed through the use of derivative instruments, the proposed changes would greatly increase the size and volatility of balance sheets in ways that would not reflect the economic condition or risk profile of the relevant institutions. In addition, we are concerned that the resulting reporting of extremely large derivative balances will reduce the visibility of all other assets and liabilities, which will have their quantitative significance reduced or perhaps even cause them to be not separately reported in the statement of financial position based on changes in line item materiality.

We consider the Proposed Update to be at odds with the Boards' shared goal to better align the accounting treatment and presentation with the risk management strategies of the reporting entity.

We are most concerned with the treatment of derivative instruments and secured financing arrangements.

- *Derivative instruments* – We do not agree that the proposed gross presentation would provide useful information about an entity’s future ability to generate cash and an entity’s liquidity and solvency. When taking into consideration the combination of the counterparty MNAs under which derivatives are transacted, collateral requirements, and the ranking in bankruptcy of these instruments, the net position more clearly represents the future cash flow requirements (additional detail is provided in Appendix A).

- *Secured financing arrangements*– We believe that the proposed simultaneous settlement requirement for offsetting secured financing arrangements (e.g., repurchase agreements) would result in significantly different balance sheet presentation based solely on inconsequential differences in the timing of cash flows. Current settlement practices have been established to facilitate movement of cash and securities throughout the financial system in a practical and operational manner and arrangements such as intraday credit agreements ensure that settlement within a current business day is effectively the same as net settlement. We therefore support the current view in U.S. GAAP whereby a settlement mechanism can be considered the “functional equivalent of net settlement” if stringent conditions have been met.

Gross presentation of derivatives contracts does not provide information regarding an entity’s ability to generate cash in the future or about the claims against the entity. The relevant measure of risk is the net risk amount by counterparty as that balance represents the credit risk. In a default event, credit risk and liquidity risk are equal for derivatives because any cash required to be settled is calculated on a net basis pursuant to the master netting arrangement. Net presentation best reflects an entity’s credit risk profile and is consistent with how entities manage the risks of their portfolios. We believe it would be optimal if the accounting were aligned with the risk management of these instruments.

**Operational Risk and Cost Burden**

The FRC is concerned that the Boards have not fully considered the cost/benefit of the Proposed Update. Although nothing has changed economically to the derivatives contracts, preparers will have to incur significant conversion costs and out of pocket expenses as a result of the Proposed Update. The number and variety of contracts, counterparty preferences, clearinghouse practices, and collateral maintenance requirements that financial institutions will need to address with reporting systems modifications is significant.
The extent of contracts that may require reporting system changes may go well beyond derivatives. The Proposed Update also may require significant changes to clearing and settlement arrangements with credit card merchants, merchant processing, and interbank ATM settlement. Also, it is unclear whether procedures for brokerage payables, receivables, and other transactions relating to trade date/settlement date differences that are currently recorded on a net basis will need to be modified. A gross presentation will also result in real out of pocket costs to regulated entities where other charges, such as Federal Deposit Insurance Corporation assessments, Securities Investor Protection Corporation fees, and local taxes are calculated on the basis of total assets.

The FRC believes the complexity and scale involved in these changes must be thoughtfully considered and weighed by the Boards in evaluating what appears to us to be a disclosure issue that could be more efficiently addressed through enhancements to existing IFRS requirements. Regardless of how the Boards view the issue, there is no question in our minds that the costs of implementing this Proposal far exceed the benefits.

**Alternatives**

Notwithstanding the arguments presented above, if the Boards believe that presentation of gross balances on the face of the statement of financial position provides superior information for financial statement users, we request that the Boards consider a linked presentation approach. Under this alternative gross assets and liabilities are presented, along with a corresponding deduction for amounts currently offset in accordance with existing U.S. GAAP, such that the net (offset) balances would continue to be reported on the statement of financial position within total assets and total liabilities, respectively. We believe that this treatment is supportable, especially for derivatives, given the special treatment that is afforded these instruments in bankruptcy.

If the Boards are unable to support the current U.S. GAAP offsetting requirements, we urge the Boards to consider a more practical and relevant approach to reporting by reconsidering how the ED would apply to fully collateralized derivatives and secured financing transactions. Under such arrangements, the collateral may be used to offset a counterparty’s liability in the event of default and the marging provisions ensure that sufficient collateral will be available at all times to settle the contract. In the case of a derivative traded on a central exchange or clearing house, the exchange or clearing house stands in the place of the counterparty. As we discuss in more detail in Appendix A, clearing house requirements and procedures are designed to mitigate credit risk, and we believe that their collateral posting requirements are economically the same as daily settlement of outstanding positions. Even for those not settled through an exchange or clearing house, daily exchanges of collateral equal to the fair value of the contract are typically required, such that the credit risk and liquidity risk associated with the existing receivables or payables has already been mitigated.

In summary, we urge both the FASB and the IASB to reconsider the Proposed Update. We recommend that the Boards issue guidance that converges to current U.S. GAAP and augments existing IFRS disclosure to provide the necessary information for investors. If this is not possible, we encourage the Boards to consider one of the alternatives described above, which we believe will better meet the needs of both users and preparers of

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2 Created by the Securities Investor Protection Act (15 U.S.C. §78aaa et seq., as amended), the Securities Investor Protection Corporation is a nonprofit, membership corporation, funded by its member securities broker-dealers. When a brokerage firm is closed due to bankruptcy or other financial difficulties and customer assets are missing, Securities Investor Protection Corporation steps in and, within certain limits, works to return customers' cash, stock and other securities, and other customer property.
financial statements. Finally, presenting on a gross basis will require significant cost and effort, so financial institutions may need additional time to implement the Proposed Update.

See Appendix A for our responses to certain questions presented by the Boards.

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We appreciate the Boards’ consideration of these comments. We are available to discuss these matters at your convenience.

Sincerely,

Allan Cohen
Chairman, Financial Reporting Committee
Institute of Management Accountants
The following are our responses to certain of the questions presented by the Boards:

**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?

Generally yes, but we believe that treatment under US GAAP for master netting agreements and certain secured borrowing is superior to gross presentation and more representationally faithful, as discussed below.

As preparers and users of financial statements, we believe that the current provisions for offsetting under U.S. GAAP appropriately reflect the credit risk and liquidity exposure of the reporting entity. We therefore recommend that derivatives be reported on net basis consistent with Fin 39 in the statement of financial position and gross in supplemental disclosure in the notes to the financial statements. Below we have briefly summarized our concerns with the Proposed Update.

We do not believe that the proposed guidance adequately addresses the unique features of derivative instruments. In particular, collateral requirements and master netting agreements are routinely used to mitigate risks arising from derivatives. Collateral requirements significantly mitigate credit risk and liquidity risk associated with derivative assets. Many derivatives require some level of cash collateral, and many derivatives, including those cleared through clearing houses, are required to be fully cash collateralized through daily margining on a net basis by counterparty. We believe that these collateral arrangements mitigate credit risk, protecting the net value against counterparty default and liquidity risk.

Although we believe that this holds true for both over-the-counter derivatives and derivatives cleared through clearing houses, the latter have very specific and routine collateral requirements that are designed to mitigate credit and liquidity risk.

We also disagree with the Boards’ assertions that assets and liabilities presented under the proposed offsetting requirements will provide information useful for assessing the ability to generate cash in the future and the entity’s liquidity and solvency. Given the economics of collateralization of these positions, we disagree with the assertion that the proposed gross presentation will provide better information about an entity’s ability to generate cash. Derivative instruments are reported at fair value, which is a representation of the current market view of future events that will impact future cash flows. In contrast, collateral arrangements (including margin practices), which are based on the positions netted in accordance with the counterparty MNA, result in actual outlays of cash or other liquid instruments. Therefore, the immediate cash flow requirements for derivatives are more closely aligned with the net position than the gross position. As a result, net balances actually provide better insight into an entity’s ability to generate cash flows from derivative assets.

We do not believe that the proposed presentation will provide better insight into a reporting entity’s liquidity and solvency. We believe that the gross presentation could misrepresent the reporting entity’s actual financial position at the reporting date because total assets and liabilities on the statement of financial position would fail to reflect the impact of collateral agreements and MNAs. The proposed presentation also ignores market practices whereby dealers in derivative instruments regularly close out derivative transactions by entering into
an offsetting transaction rather than by terminating the original contract. Under the Proposed Update, these instruments would likely be reported on a gross basis, thereby giving the misleading impression that market and liquidity risks of the original contract have not been eliminated. In addition, from a legal perspective, derivative contracts transacted under master netting agreements are viewed as part of a single agreement. Typically, MNAs are enforceable in bankruptcy with individual transactions settled as one position that ranks senior to the general creditors of the bankrupt entity. As such, gross presentation of these transactions doesn’t clearly present liquidity exposure of the reporting entity.

Under the Proposed Update, analysts, regulators and other users of financial statements may be led to believe that the reporting entity carries more risk and is more leveraged than is actually the case.

For secured borrowing arrangements like repurchase agreements, we object to the simultaneous settlement guidance where simultaneous is defined to be “at the same moment”. We believe that this is too strict, especially because it does not consider the practical operation of the various clearing houses. We believe that the U.S. GAAP approach whereby meeting strict requirements is considered to be the functional equivalent of net settlement results in a better understanding of the cash flow position as well as the credit risk position of the reporting entity because the requirements only permit offsetting where transactions settle on the same day. We believe that the existing interpretation of the guidance in IAS 32, paragraph 48 where it is noted that “… simultaneous settlement of two financial instruments may occur through, for example, the operation of a clearing house in an organized financial market or 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.”

It is our understanding that, for centrally cleared, bilateral repurchase agreements clearing houses cannot perform instantaneous settlement given the volume of daily activity. Instead, clearing houses typically settle through a combination of batch settlements and real time cash flows. It is impossible for a reporting entity to know which individual transactions will be settled when – this is at the sole discretion of the clearing house. A reporting entity would not be able to comply with the requirement to net as it would not be able to identify how individual transactions are settled. From an economic perspective this settlement process, while not at the same moment, is substantively the same as simultaneous settlement by virtue of the credit and liquidity arrangements in effect at the clearing houses. We believe that it is inappropriate to differentiate and apply offsetting only where there are actual net cash flows. In light of this, we request that the Boards reconsider the prohibitively narrow interpretation of “simultaneous settlement” to incorporate these types of processes.

**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?

As currently drafted the disclosures required in the Proposed Update are anticipated to be significant. The disclosures will require systems that can identify, collate, report and control information about netting arrangements for all financial assets and liabilities. It should be noted that this information is not housed in a single system and will initially be manually intensive. We urge the Boards to consider the necessity of the additional disclosure requirements in light of the existing extensive US GAAP disclosures currently provided to evaluate if these could be enhanced rather than require additional tables.
**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?
b) Please provide an estimate of how long an entity would reasonably require to implement the proposed requirements.

To the extent that the Boards vote to proceed with the Proposed Update, it is important that they recognize the magnitude of change that the proposal will have on U.S. GAAP preparers. Preparers will need time to educate users of financial statements, including regulators, analysts, and lenders.

Specifically, the Proposed Update will have a considerable impact on the leverage ratio for U.S. banks. Under the U.S. bank regulatory framework, U.S. banks are required to maintain certain leverage ratios in order to be considered adequately capitalized. If the proposal is finalized as written, it is imperative that regulated entities have sufficient time to engage and work with regulators to address the changes.

The extended disclosure requirements will require significant changes to systems and processes in order to identify, collate and report such sizeable volumes of data.