1 February 2011

**To: Members of the Hong Kong Institute of CPAs
All other interested parties**

INVITATION TO COMMENT ON IASB EXPOSURE DRAFT OF *OFFSETTING FINANCIAL ASSETS AND FINANCIAL LIABILITIES*

Comments to be received by 7 April 2011

The Hong Kong Institute of Certified Public Accountants' (Institute) Financial Reporting Standards Committee (FRSC) is seeking comments on the IASB Exposure Draft which has been posted on the Institute's website at:
http://www.hkicpa.org.hk/en/standards-and-regulations/standards/financial-reporting/exposure-drafts/.

At present, the circumstances when financial assets and financial liabilities may be presented in an entity's statement of financial position as a single net amount, or as two gross amounts, differs depending on whether the entity reports using IFRSs or US generally accepted accounting principles (GAAP).

The accounting differences result in the single largest quantitative difference in reported numbers in statements of financial position prepared in accordance with IFRSs or US GAAP. This reduces the comparability of financial statements, and is especially prominent in the presentation of derivative assets and derivative liabilities by financial institutions. As a result, users and preparers of financial statements have asked the IASB and the US Financial Accounting Standards Board (the boards) to find a common solution for offsetting those items. Proposing a common solution is also consistent with requests from the G20 and the Financial Stability Board (FSB).

The boards are proposing that offsetting should apply only when the right of set-off is enforceable at all times, including in default and bankruptcy, and the ability to exercise this right is unconditional, that is, it does not depend on a future event. The entities involved must intend to settle the amounts due with a single payment or simultaneously. Provided all of these requirements are met, offsetting would be required. The proposals would amend IFRSs and US GAAP and eliminate several industry-specific netting practices.

--- A summary prepared by the IASB on the Exposure Draft is set out in the attached Appendix.

Comments should be supported by specific reasoning and should be submitted in written form.

To allow your comments on the IASB Exposure Draft to be considered, they are requested to be received by the Institute on or before **7 April 2011**.

Comments may be sent by mail, fax or e-mail to:

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Comments will be acknowledged and may be made available for public review unless otherwise requested by the contributor.

Snapshot: Offsetting Financial Assets and Financial Liabilities

This snapshot is an introduction to a proposed International Financial Reporting Standard (IFRS) on offsetting financial assets and financial liabilities. The project is being undertaken jointly by the International Accounting Standards Board (IASB) and the US-based Financial Accounting Standards Board (FASB).

This snapshot provides an overview of the exposure draft *Offsetting Financial Assets and Financial Liabilities* (ED)[1] published for public comment by the IASB and the FASB in January 2011.

Project objective:	To establish a common approach to offsetting financial assets and financial liabilities in the statement of financial position.
Project stage:	The exposure draft (ED) would replace the offsetting requirements for financial instruments in IFRSs and US generally accepted accounting principles (GAAP).
Next steps:	The boards invite comment from interested parties and will undertake further outreach during the comment period. Upon completion of those consultations the boards will redeliberate the proposals. The boards aim to finalise the revised requirements by June 2011.
Comment deadline:	The ED is open for public comment until 28 April 2011.

[1] Referred to as "Proposed Accounting Standards Update: Offsetting Assets and Liabilities" for FASB purposes

Background

Overview

The boards are aiming to establish a common approach to the offsetting, or netting, of financial assets and financial liabilities in a company's statement of financial position (balance sheet). Currently, the differences between IFRSs and US GAAP offsetting requirements for financial assets and financial liabilities can cause significant differences in reported figures.

What is offsetting?

In basic terms, offsetting occurs when companies that owe each other money present their rights and obligations to one another on a net basis in their statements of financial position.

A simple example is when Company A owes money to Company B, but Company B also owes money to Company A. Companies may enter into these arrangements for various reasons, including the separate needs of their businesses, clients or subsidiaries, or to reduce the risk of other transactions they have entered into. If accounted for on a 'gross' basis Company A and Company B would each show an asset and a liability for the full amounts due and owed in their statements of financial position. But, if offsetting is applied, they would each show the net of these amounts as a single asset or liability in their statements of financial position.

Why is offsetting so important for banks?

A bank's business differs significantly from a trading company's business. Trading companies may have receivables and payables with a wide range of counterparties.

By contrast, banks may buy or sell financial instruments, especially derivatives, to manage risk, meet client needs or facilitate settlement. Banks often enter into these transactions with each other because there are few appropriate counterparties. As a result, banks often have a greater number of asset and liability balances with the same counterparty compared with trading companies.

Why are the boards undertaking this project?

At present, what is offset in a company's statement of financial position will differ depending on whether the company applies IFRSs or US GAAP. Today, offsetting tends to occur more in financial statements prepared in accordance with US GAAP than in those prepared in accordance with IFRSs, especially for companies that have derivative contracts.

The differences in offsetting requirements between IFRSs and US GAAP can lead to vastly different numbers in the statement of financial position. This can raise a number of issues. From an investor's perspective, this presents difficulties in comparing companies. And, in general, this difference significantly reduces comparability even between similar companies with similar types of transactions.

Preparers, auditors, investors and others have called for a common approach to offsetting financial assets and financial liabilities.

For these reasons, the boards are undertaking this project.

What is being proposed?

The boards are proposing that offsetting be applied when the right of set-off is *enforceable at all times* (including default and bankruptcy), the ability to exercise that right is *unconditional* (does not depend on a future event), and the parties *intend* to settle net or settle the gross amounts simultaneously.

Proposed offsetting criteria

Financial assets and financial liabilities would be required to be offset in the statement of financial position only if **all** of the following criteria are met:

- There is an *unconditional* right of set-off
  A right of set-off is the right that Company A has, by contract or otherwise, to use an amount that is owed to it by Company B in full or partial payment of what it owes to Company B.

  Unconditional right of set-off means that the ability to exercise that right does not depend on a future event. If Company A is allowed to offset the amounts it owes to Company B only when a future event (such as the default of Company B) occurs, this is a *conditional* right of set-off. In those circumstances, Company A would not meet the proposed offsetting criteria.

- There is a *legally enforceable* right to set-off
  Legally enforceable means that the company's right of set-off must be available in all circumstances. This means that the right of set-off can be enforced both in the normal course of Company A's business and if Company A or Company B defaults or goes bankrupt.

What is being proposed? continued...

- The company *intends* to settle the asset and liability on a net basis, or the company will settle them simultaneously

  To qualify for offsetting, a company must show its intention to settle on a net or simultaneous basis. This may be demonstrated through a company's past practice in similar situations or its normal operating practices.

  Net settlement is when the company that owes the greater amount pays the difference between the amount that it owes and the amount owed to it.

  For example, if Company A owes CU[2]1,000 to Company B and Company B owes CU800 to Company A, they would net settle the transaction by Company A paying Company B CU200.

  Simultaneous settlement means that each company pays the full amount that it owes the other but the payments occur at the same moment. In this example Company A would pay CU1,000 and Company B would pay CU800 at exactly the same moment.

- Required or permitted?

  In order to improve comparability between financial statements a company that meets the proposed criteria must offset the related assets and liabilities in its statement of financial position.

  A company would not have the choice to show the amounts either gross or net.

[2] In these examples monetary amounts are denominated in 'currency units (CU)'.

How do the proposals compare with current offsetting requirements?

<table>
<tr><th colspan="3"></th><th colspan="2">Illustration I
Company A’s statement of financial position</th></tr>
<tr><th>Example I</th><th>Proposed accounting</th><th colspan="2">Changes from today</th><th>Current requirements</th><th>Proposed requirements</th></tr>
<tr><td rowspan="2">Company A owes CU1,000 to Company B.

Company B owes CU800 to Company A.

They have a legally enforceable agreement stating that they can offset amounts that are due to each other in all circumstances.

They will settle the amounts owed by Company A paying Company B CU200.</td><td rowspan="2">Company A and Company B would be required to present net amounts in their statements of financial position because they have an unconditional right of set-off and they will settle the amounts net.</td><td>IFRS</td><td>No changes – The proposals are the same as the offsetting requirements today.</td><td>Assets –

Liabilities
Net liability to Company B
(CU200)</td><td>Assets –

Liabilities
Net liability to Company B
(CU200)</td></tr>
<tr><td>US GAAP</td><td>At present Companies A and B would be permitted to show net amounts in the statement of financial position.

The proposals would require a net amount to be shown.</td><td>If A chooses gross presentation:

Assets –
Receivable from Company B
CU 800

Liabilities
Liability to Company B
(CU1,000)</td><td>Assets –

Liabilities
Net liability to Company B
(CU200)</td></tr>
</table>

continued...

Example II	Proposed accounting	Changes from today		Illustration II Company A's statement of financial position Current requirements	Proposed requirements
Company A has a derivative asset of CU9,000 with Company B. Company A also has a derivative liability of (CU10,000) with Company B. The companies have entered into a master netting agreement. Under the terms selected, they are allowed to offset amounts due only if one of the companies defaults or goes into bankruptcy. There is no offset allowed in any other circumstances.	Company A and Company B would be required to show gross amounts in their statement of financial position because they do not have an unconditional right of set-off.	IFRS	This is the same as current IFRSs.	*Assets* – Derivative with Company B CU9,000 *Liabilities* Derivative with Company B (CU10,000)	*Assets* – Derivative with Company B CU9,000 *Liabilities* Derivative with Company B (CU10,000)
		US GAAP	At present, in US GAAP, Company A is permitted but not required to show a net amount in its statement of financial position even though its ability to net is conditional on a future event. Under the proposals, Company A would be required to show gross amounts.	*If A chooses net presentation:* *Assets* – *Liabilities* Derivative with Company B (CU1,000)	*Assets* – Derivative with Company B CU9,000 *Liabilities* Derivative with Company B (CU10,000)

Outreach

In developing the proposals, the boards discussed the current accounting requirements and needs with stakeholders that would most likely be affected by any changes in the offsetting requirements. These included auditors, clearing houses, legal experts, industry groups, preparers, regulators and others. Outreach discussions, which were conducted in Asia, Europe and North America, provided the boards with important information about netting policies and practices and the legal framework and implications for offsetting.

The investor perspective

A significant amount of time was spent with investors to determine whether gross information or net information about financial instruments (and especially derivatives) is more useful for their analyses, and whether the boards should require or allow financial assets and financial liabilities to be offset in the statement of financial position.

The majority of investors stressed the importance of developing a common standard to allow for international comparability, especially among banks.

However, since these investors use both gross and net information on the statement of financial position, there was no consensus about the appropriateness of presenting gross information versus net information.

Responses varied depending on the geographical location of investors, the company represented and the type of investor. Some preferred gross presentation with no offsetting, while others preferred net. Some were indifferent as long as both gross information and net information are provided in the financial statements. Irrespective of their preferences investors were nearly unanimous that both gross information and net information is useful and required for analysing financial statements.

The majority of investors agreed that a common standard should be developed.

Common questions and responses

Question	Response
How will these proposals help investors?	The proposals provide information to investors about the claims on or against a company's resources, and, therefore, more information about the company's expected future cash flows. The proposed requirements would significantly increase comparability by requiring the same offsetting criteria for companies reporting in accordance with IFRSs or US GAAP. Investors are also interested in the amounts that have been netted in the statement of financial position as well as credit risk mitigation that has not resulted in net presentation. Therefore, the boards are proposing enhanced disclosures that will provide investors with information about rights of set-off and related agreements and the effects of such rights on a company's financial position.
Won't there be increased costs for IFRS preparers?	The proposals should not result in a significant incremental cost to companies, as these items are already recorded and measured as assets and liabilities of the company. The proposals are also similar to current IFRS accounting and therefore should not significantly affect IFRS preparers.
Won't the proposals have an effect on companies' ratios (for example, leverage ratios)?	Generally investors are aware of the differences between IFRSs and US GAAP in this respect and make their own adjustments to companies' statements of financial position to compare these ratios. This can be difficult to do based on the information that is currently available. The proposals will provide investors with better and more complete information for their analyses, and ensure that the statements of financial position are now truly comparable.
What will the regulatory consequences be?	Generally, regulatory calculations are not dependent on the accounting results. The prudential regulators have their own criteria for the calculation of regulatory capital and the related ratios. For example, the Basel leverage ratio calculations use regulatory netting rules based on the Basel II Framework for repurchase agreements and securities finance, and derivatives.[3] The accounting netting framework/requirements for leverage are not used for these items.
Who will be affected by these proposals?	Companies that have financial assets and financial liabilities and especially those with large derivative activities may be affected by these proposals. Large financial institutions that report in accordance with US GAAP will especially be affected. Generally, IFRS preparers should not be significantly affected by the proposals.

[3] Except the rules for cross-product netting in Annex 4, Section 3 of Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version (June 2006).

What happens next?

The deadline for comments on the ED is 28 April 2011.

The ED includes questions on the proposals. Respondents are invited to comment on any or all of the questions as well as on any other matter that they think the boards should consider in finalising the proposals. Because this is a joint project any comment letter sent to the IASB or the FASB will be considered by both boards. Comment letters will be posted on the boards' websites at www.ifrs.org or www.fasb.org

The boards will consider and discuss all responses to the proposals in public meetings.

The boards also plan to hold public round-table meetings at the end of the comment period.

The boards plan to finalise these proposals in 2011.

Stay informed

The boards will announce on their websites the dates of any meetings at which they discuss the responses to the ED.

To stay up to date about the project, you can visit the offsetting project page, http://go.ifrs.org/offsetting

To view the ED, submit your comments or subscribe to an email alert visit www.ifrs.org

Notes

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