IASB/FASB Joint Board Meeting 17-18 November 2010

IASB Agenda reference	3B
FASB Agenda reference	8B

Staff Paper

Project	**Offsetting of financial assets and liabilities**
Topic	**Simultaneous settlement of a financial asset and liability**

Background

1. At the September 2010 meeting, the boards discussed whether and when offsetting of financial assets and liabilities is appropriate or provide useful information. The Boards concluded that the following factors may be helpful in determining when offsetting provides useful information on the face of the statement of financial position or in the notes:
   (a) whether the parties need to have the ability to offset or settle net
   (b) whether the parties need to demonstrate an intent to settle net
   (c) whether the amounts owed under the respective contracts ought to be settled on the same date or be settled simultaneously
   (d) whether the financial asset and liability ought to have the same maturity
   (e) whether the financial asset and liability ought to have the same underlying risk
   (f) whether offsetting should be on the basis of bilateral or multilateral netting arrangements.

2. At the October 2010 meeting the Boards discussed:
   (a) description of each of the factors mentioned in paragraph 1;
   (b) possible interactions among those factors; and
   (c) a framework for analysing the usefulness of offsetting.

3. The Boards indicated that an entity should be able to offset a recognised financial asset and liability if the entity has an unconditional right of offset and intends to

settle net. The Boards also decided to consider whether there are any other circumstances under which it may be appropriate to offset.

4. Agenda Paper – IASB 3A/FASB 8A addresses whether offset should be allowed or permitted if an entity has an unconditional right of offset and intends to settle net.

Purpose of this Paper

5. This paper asks for the Boards decision on whether an entity should offset a recognised financial asset and liability if the entity has an unconditional right to offset but intends to realise the asset and settle the liability simultaneously.

Simultaneous settlement

6. Simultaneous settlement ('to realise an asset and settle a liability simultaneously') is a requirement under IAS 32 for offset if settlement is not net:

   'A financial asset and a financial liability shall be offset and the net amount presented in the statement of financial position when, and only when, an entity:

   (a) currently has a legally enforceable right to set off the recognised amounts; and

   (b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.' (IAS 32 paragraph 42)

7. Although current and deferred tax assets and liabilities are recognised, measured and presented separately, IAS 12 *Income Taxes* (see paragraph 71 – 74) require offset of those amounts in the statement of financial position subject to the same criteria as in IAS 32.

8. IAS 32, paragraph 48, specifies that – '**<u>…realisation of an asset and settlement of a liability are considered simultaneous only when the transactions occur at the same moment</u>**.

9. The staff notes that the standard does not define 'same moment' but it explains that simultaneous settlement requirement is only met if the contracts are settled gross and there is no exposure to credit or liquidity risk between the settlement of the two

contracts. The cash flows under a simultaneous settlement (that is settlement at the same moment) are thus seen to be effectively equivalent to a single net amount.

10. Staff research indicates that in practice, if the instruction of transaction is simultaneous but, due to processing constraints, actual settlement takes place over a short period, and over this period there is no potential for any movement in the value of the transactions (ie no exposure to market changes and no exposure to loss from any other sources); this is regarded as simultaneous settlement.

11. On the other hand, realisation and settlement of an asset and a liability at the same nominal time but in different time zones is not considered to amount to simultaneous settlement. Additionally, where there are different maturity dates, the parties would not be considered to be in a position to realise the asset and liability simultaneously.

Alternatives

12. Based on the above, the staff presents the following alternatives for the Boards to choose from:

    a. **Alternative 1:** An entity <u>**should offset**</u> a recognised asset and liability if the entity has an unconditional right of offset and intends to settle the asset and liability simultaneously

    b. **Alternative 2**: An entity <u>**should not offset**</u> a recognised asset and liability if the entity has an unconditional right to offset but intends to settle the asset and liability simultaneously.

Analysis

13. In practice, an entity's intentions with respect to settlement of particular assets and liabilities may be influenced by the requirements of the financial markets, and other circumstances and may lead to gross settlement although the entity may have the right to offset.

14. The rules of an exchange or clearing house may provide for purchases and sales of a particular contract/instrument to be recognised separately and as gross outstanding positions to be settled on the maturity of those contracts. Hence before

maturity of those contracts, the participant and the exchange will have gross obligations and claims against each other. On maturity of the contracts, the amount of money to be paid or received will be calculated based on each participant's net position in each of those contracts. These positions will be aggregated before settlement or transfer of funds.

15. For example, an entity buys 1,000 interest rate futures contracts that are traded on an exchange. The settlement date for the contracts is in December 20X1. In October 20X1 the entity enters into an offsetting trade by selling 1,000 identical contracts and novation netting does not apply (ie the positions are treated as gross claims or entitlement). Settlement of the contracts in December 20X1 will be via a clearing house. On the settlement date, the entity's right to payment (asset) and obligations to pay (liabilities) under the two sets of contract, although gross, will be netted off to zero (NB: there is no exposure to credit or liquidity risk).

16. On the other hand in some centrally cleared derivatives markets with a central counterparty (CCP) or face to face exchanges, the rules of the clearinghouse or exchange may provide for simultaneous unwinding of asset and liability positions under different asset classes. That is, an asset position may be liquidated to settle a liability position instantaneously.

17. Also, the rules of an exchange or clearing house may require that the amount to be paid or received for cash products and for derivative products should not be netted. Hence a clearing participant may make payment or receive payment separately for cash and derivative products.

18. In these circumstances, some will argue that the cash flows are, in effect, equivalent to a single net amount and there is no exposure to credit or liquidity risk. Thus some argue that if an entity has an unconditional right of offset and an intention to settle the asset and liability simultaneously, offsetting reflects an entity's expected future cash flows from settling those separate financial instruments. They also argue that when an entity does intend to settle simultaneously and it has a legal right of offset, presentation of the asset and liability on a net basis reflects more appropriately the risks to which those cash flows are exposed.

19. Others ague that the right to set off may in and of itself be a sufficient condition for presenting net a financial asset and a financial liability. If a right of setoff is unconditional, the financial asset and financial liability together may be seen as forming a single asset or liability regardless of how the parties intend to settle the two positions. Hence they argue that presenting the asset and liability net when an entity has an unconditional right to setoff would provide useful information to users.

Staff recommendation

20. Some staff believe that when an entity has an unconditional right of offset and intends to settle the asset and liability simultaneously, both liquidity and credit risks are mitigated and thus offset on the basis of simultaneous settlement provides useful information about the following:

    (a) expected future cash flows;

    (b) an entity's liquidity and solvency position; and

    (c) the risks an entity is exposed to

21. Other staff believe that any gross settlements which involve two payments between the parties should not qualify for offsetting, irrespective of the length of time between the two payments (even when they occur at the same moment). This is based on the view that the form of the settlement (or the actual cash flows) matter. They emphasise that this view faithfully represents the actual cash flows of the transaction. Thus net presentation of an asset and a liability should be allowed only when actual cash flows resulting from the settlement of the two instruments are the same as that which is depicted by presenting the asset and liability net.

Question for the boards
Which of the alternatives in paragraph 12 do the Boards prefer?