Applying IFRS

Offsetting financial instruments: clarifying the amendments

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Ernst & Young
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A number of interpretation issues have emerged as entities continue to prepare for the adoption of the December 2011 amendments to (a) the offsetting criteria in IAS 32 *Financial Instruments: Presentation* (IAS 32 amendments); and (b) the disclosures on offsetting financial assets and financial liabilities in IFRS 7 *Financial instruments: Disclosures* (IFRS 7 amendments). The mandatory effective dates are financial years beginning on or after 1 January, 2014 and 2013, respectively.

In this publication, we summarise some of these issues and explore the interpretation difficulties associated with them.

Does the IAS 32 legal right of set-off need to be a multi-directional right?

To offset two or more financial instruments in the statement of financial position, the amendments to IAS 32 clarify, among other things, that an entity must currently have a right of set-off that cannot be contingent on a future event, and must be legally enforceable in all of the following circumstances: (i) the normal course of business; (ii) an event of default; and (iii) an event of insolvency or bankruptcy of the entity or any of the counterparties.

Constituents have raised two issues in relation to the meaning of this clarification:

(1) Whether the counterparty (or counterparties) to a netting arrangement is required to have an equivalent right of set-off as that of the reporting entity

In a recent publication,[1] we noted that the Basis for Conclusions to the IAS 32 amendments states that "... **the right must exist for all counterparties** so that, if an event occurs for one of the counterparties (including the entity), the other counterparty or parties will be able to enforce the right of set-off against the party that has defaulted or gone insolvent or bankrupt".[2] [Emphasis added]. This led to the tentative view that the right of set-off should be available for all counterparties to the netting agreement.

However, IAS 32 (as amended) does not seem to require all parties to currently have a legal right to set off; the standard focuses on *the reporting entity* and requires *only* the reporting entity to currently have a right of set-off and that right must be legally enforceable in certain circumstances.

This emphasis on the right of set-off in the hands of the reporting entity, regardless of whether the counterparty has an equivalent right, is also clear from the Application Guidance which states "... an entity must currently have a legally enforceable right of set-off. This means that the right of set-off: (a) must not be contingent on a future event; and (b) must be legally enforceable in all of the following circumstances: (i) the normal course of business; (ii) the event of default; and (iii) the event of insolvency or bankruptcy of the entity and all of the counterparties."[3]

In our view, it is clear from the above guidance that the reference to 'all of the counterparties' in (b) above pertains to the legal enforceability in the circumstances listed (i.e., the normal course of business, the events of default, insolvency or bankruptcy), and not who holds the set-off right.

This issue is relevant in situations where only one party to a netting agreement has the legal right of set-off. An example could be when a financial institution has both the intent to settle net and an enforceable right to set off its customers' loans against its customers' deposits in: (a) the normal course of business; (b) upon default, bankruptcy or insolvency of the customers; and (c) upon its own default, bankruptcy or insolvency, but the customer does not have an equivalent right.

Applying the wording in the Basis for Conclusions (as noted above) to this example could be interpreted to imply that the financial institution would not set off the amounts due and payable under the customers' loans and deposits. However, the standard would indicate that the offsetting criteria, as stipulated, have been met.

How we see it

There seems to be an inconsistency between the paragraphs in the body of the Standard and its Application Guidance on the one hand and its Basis for Conclusions on the other. Since the body and Application Guidance are an integral part of the Standard and the Basis for conclusions is not, it is our view that normally the Standard would prevail over the Basis for Conclusions and we consider that the IASB's most likely intention, consistent with the wording in the body and Application Guidance of the Standard, was to only require the reporting entity to have a legal right to set off in the circumstances noted above — including, in the event of the reporting entity's own default, insolvency or bankruptcy. We believe that the IASB should address this matter.

(2) The relevance of the requirement that a reporting entity must be able to legally enforce a right of set-off in the event of its own bankruptcy

We believe this requirement simply means that the counterparty (or counterparties) to a netting agreement must not have the ability to force gross settlement in the event of the reporting entity's default, insolvency or bankruptcy. If, however, according to a netting agreement, the counterparty can insist on settling the amounts due and payable between the parties on a gross basis, this would mean that the reporting entity may not achieve a net amount in the event of its own bankruptcy.

Many contracts give only the non-defaulting party the right to enforce the netting provisions in case of default, insolvency or bankruptcy of any of the parties to the agreement. Such contracts

[1] *IFRS Developments issue 22 (December 2011): Offsetting of financial instruments*, available at www.ey.com/ifrs.

[2] Paragraph BC 80.

[3] Paragraph AG38B.

would fail the IAS 32 criteria because the reporting entity cannot enforce such rights of set-off in its own bankruptcy. In practice, most of these contracts would not achieve offsetting under IAS 32 anyway, because the legal right of set-off available under such contracts is usually not enforceable in the normal course of business. Generally, these contracts are structured this way because entities do not intend to net settle other than in situations of default. For all other situations, entities need to determine if the right to enforce net settlement would survive their own bankruptcy.

The IFRS 7 transition reference to "*interim periods*"

The IFRS 7 amendments apply for "annual periods beginning on or after 1 January 2013 and interim periods within those annual periods".[3]

Some constituents have questioned the relevance of the reference to "interim periods" when IAS 34 *Interim Financial Reporting* has not been consequentially amended to that effect. In particular, they have asked whether this means that these new disclosures need to be included only in the first interim financial statements prepared under IAS 34 or whether, for example, in the case of quarterly reporting, the disclosures should be included in all interim reports of the year of adoption or even beyond the first year.

The answer to this question is not straight forward, not least because it is unusual for IFRSs to include in the transitional provisions a reference to interim periods. Another relevant question is what the implications are for other new disclosure requirements that do not have a similar transitional requirement.

How we see it

We believe that by highlighting "interim periods", it was the IASB's intention that entities should provide the disclosures in all interim financial statements in the year of adoption. However, we would not expect this interpretation to apply to other new disclosure requirements that do not have a similar transitional provision.

The IFRS 7 reference to "*enforceable*"

The new offsetting disclosures include financial instruments (that have not been offset in the balance sheet) "that are subject to an enforceable master netting arrangement or similar agreement". [4]

Many master netting arrangements or similar agreements do not meet the offsetting criteria in IAS 32 because the right to set-off is usually conditional on an event of default. Accordingly, these arrangements would be within the scope of these disclosures, but only to the extent that they are legally enforceable.

If such arrangements are not legally enforceable, it would be inappropriate to include them in the disclosures. This is because it would reflect an understated net exposure to counterparty risk that will not be achieved if the counterparty or counterparties defaulted or became bankrupt or insolvent.

Enforceability in the context of netting agreements comprises two elements: first, enforceability as a matter of law under the governing laws of the contract; and second, consistency with the bankruptcy laws of the jurisdictions where the reporting entity and the counterparty or counterparties to the netting agreement are located. The latter is critical since, regardless of the jurisdiction selected to govern the contract, local insolvency laws in an insolvent counterparty's jurisdiction can override contractual terms in the event of insolvency.

To set off amounts in their statements of financial position, entities are required by IAS 32 to currently have a legally enforceable right of set-off. To prove legal enforceability, reporting entities normally seek to obtain a legal confirmation of this right in the circumstances stipulated in IAS 32 as amended (including under the local bankruptcy laws of its jurisdiction and the jurisdictions of its counterparties).

In order to prove enforceability of a netting arrangement or similar agreement *for purposes of the IFRS 7 disclosures*, entities have questioned whether they need to obtain a legal opinion confirming enforceability of such arrangements in a similar fashion.

In our view, entities should provide the most valuable information for users of the financial statements, which will require the use of judgement. If management expects that the arrangement would most likely be enforceable, as intended, we believe all amounts subject to master netting arrangements or similar agreements need to be disclosed for financial instruments within the scope of the disclosure requirements.

In contrast, if the level of legal uncertainty is so high that management does not believe it can rely on the netting arrangement, it would be inappropriate to include the arrangement in the disclosures. If management expects the arrangement to be effective, but there are some legal uncertainties, for example, when the local bankruptcy laws have never been tested, then it may be appropriate to provide details of these uncertainties in addition to the effect of the netting arrangement.

How we see it

For IFRS 7 disclosure purposes, we do not believe that it is necessary to obtain legal confirmation as to the enforceability of a master netting arrangement or similar agreement. Management must apply judgement in making this determination.

[3] Paragraph 44R.
[4] Paragraph 13C(d).

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