

Hot Topic

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Big changes proposed to balance sheet offsetting

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Summary

The Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) (collectively, the Boards) have proposed significantly restricting the ability of companies to offset assets and liabilities on their balance sheets.¹ Under the proposal, a financial asset and financial liability would be required to be offset only if the entity has an unconditional and legally enforceable right of set-off and intends to either settle the asset and liability on a net basis or simultaneously.

Based on the proposed requirement, derivatives entered into with a counterparty under a master netting arrangement – which provides for only a conditional right of offset – would be required to be presented on a gross basis. This would be a major change in practice under US GAAP that would significantly increase the size of many financial institutions' balance sheets.

In addition, institutions that currently set-off certain repo and reverse repo balances based on the existing exception under US GAAP may be required to gross up their

balance sheets. The Boards' proposed restrictions on balance sheet offsetting may adversely affect leverage ratios, regulatory capital requirements and debt covenants.

The proposal would also eliminate certain offsetting practices within the broker dealer, construction and depository and lending industries.

The proposal is similar to the current requirements of IFRS and would converge this area of accounting. In so doing, the proposal would eliminate the single biggest quantitative difference in reported numbers in the balance sheets prepared under IFRS and US GAAP.

Companies would generally be required to disclose information about assets and liabilities subject to offset and related arrangements (such as collateral agreements), as well as the effect of those arrangements on their net exposure.

The Boards have not proposed an effective date and are seeking input before making that determination. The proposed requirements would have to be applied for all years presented on the balance sheet. Comments are due by 28 April 2011.

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¹ Proposed Accounting Standards Update, *Balance Sheet (Topic 210) - Offsetting*, 28 January 2011

Reasons for proposed changes

As a general principle of financial reporting, assets and liabilities are reported separately, representing either resources or obligations. While US GAAP and IFRS provide for certain assets and liabilities to be offset (i.e., reported on a net basis on the balance sheet) when certain conditions are met, their criteria differ substantially.

Among the differences, derivatives entered into under a master netting agreement – which consolidates multiple contracts into a single agreement and allows one party to terminate the arrangement and demand the net settlement of all contracts if the other party fails to make a payment – may be netted under US GAAP. IFRS requires them to be presented on a gross basis. This difference reduces comparability between financial statements prepared under IFRS and US GAAP.

Following requests from financial statement users and others, the Boards have proposed converging the balance sheet offsetting requirements for financial assets and financial liabilities.

Scope and summary of proposed offsetting requirements

Scope

The proposal would replace the guidance in US GAAP² and IFRS for offsetting financial assets and financial liabilities and all derivative assets and liabilities (both financial and nonfinancial). Some examples of assets and liabilities affected by the proposal include:

- ▶ Notes and trade accounts receivable and payable
- ▶ Mortgages, commercial loans and credit card receivables and payables

- ▶ Repurchase agreements (repos and reverse repos) and securities lending arrangements receivables and payables
- ▶ Amounts due under sales-type and direct-financing leases
- ▶ Assets and liabilities arising from swap agreements, futures contracts and forward purchase and sale commitments (regardless of whether the underlying is a physically settled nonfinancial asset)

The proposal would also eliminate several industry-specific offsetting practices, including:

- ▶ Payables and receivables arising from unsettled regular-way trades by brokers and dealers (ASC 940-320-45-2 and 45-3)
- ▶ Advances received on certain construction contracts (ASC 910-405-45-1 and 45-2)
- ▶ Reciprocal account balances with other banks to be offset in the process of collection or payment (ASC 942-305-45-1)

The proposal would make clear that nonfinancial assets and nonfinancial liabilities (except for the nonfinancial derivatives discussed above) cannot be offset unless specifically permitted by another standard. Other areas of US GAAP that address the concept of offsetting that would not be affected by the proposal include:

- ▶ Leveraged leases (ASC 840-30-35-32 through 35-52)
- ▶ Pension plan assets and liabilities (ASC 715-30)
- ▶ Defined benefit plan assets and liabilities (ASC 715-60)
- ▶ Net income tax asset or liability amounts (ASC 740-30)

Proposed offsetting requirements

While offsetting is currently elective under US GAAP, the proposal would require a financial asset and a financial liability (and all derivative assets and liabilities) to be offset when the company both:

- ▶ has an unconditional and legally enforceable right of set-off

- ▶ intends either to settle the asset and liability on a net basis or to realize the asset and settle the liability simultaneously (i.e., at the same moment)

The “legally enforceable” criterion for offsetting would be met only if the right of set-off is legally enforceable in all circumstances. Because of this requirement, derivatives under a master netting arrangement would be required to be presented on a gross basis because the right of set-off under that arrangement is only upon default by or bankruptcy of a counterparty, which is a conditional event.

The offsetting criteria would apply whether the right of set-off arises from a bilateral arrangement or from a multilateral arrangement (i.e., between three or more parties).

For settlements to be considered simultaneous, they must occur at the same moment (i.e., there is exposure to only the net or reduced amount). Accordingly, if settlements take place over a period (even though during this period there is no potential for any change in value of the asset or liability, and the period between settlements of the instruments is brief), it is not simultaneous settlement. The procedures of clearing houses or exchanges will need to be carefully evaluated to determine whether settlements will occur at the same moment.

Importantly, while the proposal would affect the presentation of financial assets and liabilities on the balance sheet, the Boards have confirmed that the proposal would not affect their separate forthcoming fair value measurement guidance, which would permit the fair value of certain financial assets and liabilities to be determined on a net exposure basis.

The proposal would expand and consolidate the disclosure requirements for offsetting arrangements, regardless of whether the rights of set-off result in assets and liabilities being reported on a net basis on the balance sheet.

² If adopted as proposed, the proposal would amend the balance sheet offsetting guidance in ASC 210-20 (formerly FIN 39: *Offsetting of Amounts Related to Certain Contracts an interpretation of APB Opinion No. 10 and FASB Statement No. 105*, FSP FIN 39-1: *Amendment of FASB Interpretation No. 39 and FIN 41: Offsetting of Amounts Related to Certain Repurchase and Reverse Repurchase Agreements an interpretation of APB Opinion No. 10 and a modification of FASB Interpretation No. 39*).

Companies would be required to disclose information about financial assets and liabilities subject to offset and related arrangements (such as collateral agreements), as well as the effect of those arrangements on their net exposure, by class of financial instrument, including:

- (1) The gross amount (before taking into account amounts offset on the balance sheet and other mitigating factors such as portfolio-level adjustments for counterparty credit risk)
- (2) Showing separately,
 - (a) Amounts deducted as a result of the proposed offset criteria to determine the net amounts in the balance sheet
 - (b) Portfolio-level adjustments made in the fair value measurement to reflect the effect of the entity's net exposure to the credit risk of counterparties or the counterparties' net exposure to the credit risk of the entity
 - (c) The net amount presented in the balance sheet
- (3) The amount of the exposures that is covered by an unconditional and legally enforceable netting agreement but the company does not intend to settle net or simultaneously
- (4) The amount of assets and liabilities that the company has a conditional right to set off (separately by each type of conditional right)
- (5) The net amount of assets and liabilities after taking into account the effect of the items in (1)-(4)

- (6) The amount of financial instrument collateral (cash collateral and fair value of noncash financial asset collateral should be separately disclosed), excluding the amount in excess of the amount in (2)(c), obtained or pledged in respect to those assets and liabilities
- (7) The net exposure after taking into account the effect of the items in (5) and (6)

The proposed disclosures would be required to be presented in tabular format (separately for assets and liabilities), unless another format is more appropriate. Moreover, companies would be required to describe each type of conditional right of offset included in item (4) above, including the nature of those rights and how management determines each type.

If the proposed qualitative disclosures are presented in one or more notes separate from the quantitative information discussed above, the company must cross-reference where each of the items required by the proposal is disclosed.

Effects of proposed changes on US GAAP

The proposal would significantly change US GAAP's current requirements.

First, offsetting of applicable assets and liabilities would be required when a company has both the unconditional and legally enforceable right of set-off and intends to settle either on a net basis or simultaneously. US GAAP currently permits offsetting (as a policy election), but does not require the financial assets and financial liabilities to be presented on a net basis.

Offsetting would not be permitted for some arrangements where the ability to set-off is conditional (e.g., upon bankruptcy, insolvency or default of a counterparty) and there is no intention to set-off, or such intention is conditional.

The proposal would eliminate the separate guidance in US GAAP for offsetting repos and reverse repos, as well as industry-specific offsetting guidance. As a result, those companies would be able to set-off assets and liabilities only if all of the proposed offsetting requirements are met.

Companies will need to carefully analyze their contracts and operational procedures for realizing assets and settling liabilities to determine how they would be affected.

Transition requirements

The proposal would require retrospective application whereby all comparative periods would be presented to reflect the revised offsetting requirements, for consistency and comparability.

Looking ahead

The proposal does not specify an effective date. Instead the effective date will be considered as part of another project for all major joint projects underway. The Boards have requested comments by 28 April 2011. Final guidance is expected to be issued by the end of June 2011.

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