EFRAG
European Financial Reporting Advisory Group

DRAFT ENDORSEMENT ADVICE AND EFFECTS STUDY REPORT ON OFFSETTING FINANCIAL ASSETS AND FINANCIAL LIABILITIES (AMENDMENTS TO IAS 32 AND IFRS 7)

INVITATION TO COMMENT ON EFRAG'S ASSESSMENTS

Comments should be sent to commentletters@efrag.org or uploaded via our website by 24 February 2012

EFRAG has been asked by the European Commission to provide it with advice and supporting material on the *Offsetting Financial Assets and Financial Liabilities, (Amendments to IAS 32)* and *Disclosures–Offsetting Financial Assets and Financial Liabilities (Amendments to IFRS 7)* ('the Amendments'). In order to do that, EFRAG has been carrying out an assessment of the Amendments against the technical criteria for endorsement set out in Regulation (EC) No 1606/2002 and has also been assessing the costs and benefits that would arise from its implementation in the European Union (the EU) and European Economic Area.

A summary of the amendments to IAS 32 and IFRS 7 is set out in Appendix 1.

Before finalising its two assessments, EFRAG would welcome your views on the issues set out below. Please note that all responses received will be placed on the public record, unless the respondent requests confidentiality. In the interest of transparency EFRAG will wish to discuss the responses it receives in a public meeting, so we would prefer to be able to publish all the responses received.

EFRAG initial assessments summarised in this questionnaire will be amended to reflect EFRAG's decisions on Appendix 2 and 3.

1 Please provide the following details about yourself:

(a) Your name or, if you are responding on behalf of an organisation or company, its name:

John Boulton – ICAEW Financial Reporting Faculty

(b) Are you a:

☐ Preparer ☐ User ☒ Other (please specify)

ICAEW works in the public interest to promote high-quality financial reporting.

(c) Please provide a short description of your activity:

ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 138,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained.

(d) Country where you are located:

International body with headquarters in London

(e) Contact details including e-mail address:

John.boulton@icaew.com

2 EFRAG's initial assessment of the Amendments is that they meet the technical criteria for endorsement. In other words, they are not contrary to the principle of true and fair view and it they meet the criteria of understandability, relevance, reliability and comparability. EFRAG's reasoning is set out in Appendix 2.

(a) Do you agree with this assessment?

☒ Yes ☐ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

(b) Are there any issues that are not mentioned in Appendix 2 that you believe EFRAG should take into account in its technical evaluation of the Amendments? If there are, what are those issues and why do you believe they are relevant to the evaluation?

Please see our comments below question 7.

3 EFRAG is also assessing the costs that are likely to arise for preparers and for users on implementation of the Amendments in the EU, both in year one and in

subsequent years. Some initial work has been carried out, and the responses to this Invitation to Comment will be used to complete the assessment.

4 The results of the initial assessment of costs are set out in paragraphs 2 to 15 of Appendix 3. Overall, EFRAG's initial assessment is that the one-off costs will be significant for those entities that have a large volume of derivative activities, while the ongoing costs are on balance insignificant. The Amendments are likely to result in insignificant costs for users.

Do you agree with this assessment?

☒ Yes ☐ No

If you do not, please explain why you do not and (if possible) explain broadly what you believe the costs involved will be?

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5 In addition, EFRAG is assessing the benefits that are likely to be derived from the Amendments. The results of the initial assessment of benefits are set out in paragraphs 16 to 18 of Appendix 3. To summarise, EFRAG's initial assessment is that the Amendments will allow users to assess better the (potential) effect of netting arrangements, including rights of set-off on the entity's financial position and will help preparers in applying and improving the consistency in the application of the offsetting criteria.

Do you agree with this assessment?

☒ Yes ☐ No

If you do not agree with this assessment, please provide your arguments and indicate how this should affect EFRAG's endorsement advice?

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6 EFRAG's initial assessment is that the benefits to be derived from implementing the Amendments in the EU as described in paragraph 4 above are likely to outweigh the costs involved as described in paragraph 3 above.

Do you agree with this assessment?

☒ Yes ☐ No

If you do not agree with this assessment, please provide your arguments and indicate how this should affect EFRAG's endorsement advice?

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7 EFRAG is not aware of any other factors that should be taken into account in reaching a decision as to what endorsement advice it should give the European Commission on the Amendments.

Do you agree that there are no other factors?

☐ Yes ☒ No

If you do not agree, please provide your arguments and indicate how this should affect EFRAG's endorsement advice?

We are disappointed that faster progress has not been made toward endorsement of the IASB's new approach for accounting for financial instruments. Work in this area was commenced as part of the Board's rapid reaction to the financial crisis and is so far, in our opinion, resulting in the emergence of a new principles based standard that is an improvement over current practice. We are conscious that it is unfortunate that the Board has not been able to move more quickly toward a complete new standard in this area or yet been able to achieve a consensus with the FASB.

However, we do not believe that the view hitherto taken by EFRAG on the endorsement of IFRS 9 has been helpful. Certain elements of the new package, such as the resolution for the issue of 'own credit' have strong support from market participants but are unable to be implemented due to endorsement having been withheld.

While we understand the difficulties here and appreciate that the current situation, with the crucial new financial instruments standard remaining incomplete in some key respects, is problematic. It would be helpful if, four years into the financial crisis, EFRAG could act more positively to make available to European market participants solutions to some key issues that have already been released by the Board. As a result we strongly disagree with the dissenting view. We welcome the progress of the IASB in achieving convergence with the thinking of the FASB, but it is not a viable option to perpetuate delay in this crucial area to await a converged solution. Improvements to financial instrument accounting have been identified, in our view we should move as rapidly as possible to embracing these.

APPENDIX 1

A SUMMARY OF THE AMENDMENTS TO IAS 32 AND IFRS 7

Background

1 IAS 32 *Financial Instruments: Presentation* requires presentation of financial assets and financial liabilities on a net basis when doing so reflects an entity's expected future cash flows from settling two or more separate financial instruments.

The issue

2 The differences in the requirements for offsetting financial assets and financial liabilities cause significant differences between amounts presented in statements of financial position prepared under IFRSs and those prepared under US GAAP. Users requested and the Financial Stability Board recommended that the IASB and FASB address this issue and add a project to their respective agendas to improve, and potentially achieve convergence of, the requirements for offsetting financial assets and financial liabilities.

3 While the IASB and FASB were unable to agree on a common approach to offsetting in the statement of financial position, they agreed on requirements regarding the disclosure of gross and net information in the notes to the financial statements to meet the needs of users.

What has changed?

Offset criteria

4 IAS 32 requires that 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.

5 The IASB amended IAS 32 to add application guidance to address the inconsistent application of the standard in practice. The application guidance clarifies that the phrase 'currently has a legal enforceable right of set-off' means that the right of set-off must not be contingent on a future event and must be legally enforceable in the normal course of business, in the event of default *and* in the event of insolvency or bankruptcy, of the entity and all of the counterparties. It should be noted that the US GAAP offsetting model, while similar to the model in IAS 32, also provides a broad exception that permits entities to present derivative financial assets and derivative financial liabilities subject to master netting arrangements net in the statement of financial position even if an entity does not have a current right or intention to settle net.

6 The application guidance also specifies the characteristics of gross settlement systems in order to be considered equivalent to net settlement.

Disclosure requirements about rights of set-off and related arrangements

7 The amendments to IFRS 7 *Financial Instruments: Disclosures* require an entity to disclose quantitative information about:

(a) the gross amounts of those recognised financial assets and recognised financial liabilities;

(b) the amounts that are set off in accordance with the criteria in IAS 32 when determining the net amounts presented in the statement of financial position;

(c) the net amounts presented in the statement of financial position;

(d) the amounts subject to an enforceable master netting arrangement or similar agreement that are not otherwise included in (b) above, including:

(i) amounts related to recognised financial instruments that do not meet some or all of the offsetting criteria in IAS 32; and

(ii) amounts related to financial collateral (including cash collateral); and

(e) the net amount after deducting the amounts in (d) from the amounts in (c) above.

When do the amendments become effective?

8 The Amendments will apply retrospectively, with different effective dates:

(a) the amendments to IFRS 7 will apply for annual and interim reporting periods beginning on or after 1 January 2013.

(b) the amendments to IAS 32 will apply for annual and interim reporting periods beginning on or after 1 January 2014. Earlier application is permitted. If an entity applies the amendments in IAS 32 from an earlier date, it shall disclose that fact and shall also make the disclosures required by the amendments in IFRS 7.

APPENDIX 2

EFRAG'S TECHNICAL ASSESSMENT OF THE AMENDMENTS AGAINST THE ENDORSEMENT CRITERIA

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity of contributing to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity of advising the European Commission on endorsement of the definitive IFRS in the European Union and European Economic Area.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS or Interpretation against the technical criteria for the European endorsement, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRSs or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

Does the accounting that results from the application of the amendments to IAS 32 and IFRS 7 meet the technical criteria for EU endorsement?

1 EFRAG has considered whether the amendments to IAS 32 and IFRS 7 meet the technical requirements of the European Parliament and of the Council on the application of international accounting standards, as set out in Regulation (EC) No 1606/2002, in other words that the amendments to IAS 32 and IFRS 7:

(a) are not contrary to the principle of 'true and fair view' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

(b) meet the criteria of understandability, relevance, reliability and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

EFRAG also considered, based only on evidence brought to its attention by constituents, whether it would not be conducive to the European public good to adopt the amendments to IAS 32 and IFRS 7.

Relevance

2 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations.

3 EFRAG considered whether the amendments to IAS 32 and IFRS 7 would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information.

4 The amendments to IFRS 7 *Financial Instruments: Disclosure* require disclosures that:

(a) provide both gross and net information about financial assets and financial liabilities that is relevant for analysing financial statements and derive key financial ratios (e.g. leverage);

(b) enable users of financial statements to evaluate the (potential) effect of netting arrangements, including rights of set-off associated with an entity's recognised financial assets and recognised financial liabilities, on the entity's financial position; and

(c) provide information about collateral and collateral in the form of the financial instruments and the effect of such arrangements on the entity's financial position.

5 EFRAG believes that this information is relevant as it has predictive value regarding future cash flows. Users of financial statements are interested in arrangements that an entity has entered into that mitigate the entity's credit risk exposure to financial instruments in the normal course of business and/or in the events of default and insolvency or bankruptcy. In addition, the disclosures allow users to compare better the credit risk exposures of entities reporting under IFRSs with those of entities reporting under US GAAP, which is particularly important in the light of the recent financial crises.

6 The amendments to IAS 32 *Financial Instruments: Presentation* clarify the definition of the term 'currently has a legally enforceable right to set off the recognised amounts' and remove two important inconsistencies in practice regarding the interpretation of 'settle on a net basis' and 'realise ... simultaneously'. EFRAG's overall initial assessment is that the amendments to IAS 32 and IFRS 7 would result in the provision of relevant information; and therefore they satisfy the relevance criterion.

Reliability

7 EFRAG also considered the reliability of the information that will be provided by applying the amendments to IAS 32 and IFRS 7. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

8 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness. In EFRAG's view, the amendments to IAS 32 and IFRS 7 do not raise any significant issues concerning freedom from material error and bias.

9 As noted above, the amendments to IAS 32 are addressing inconsistencies in the application of some of the offsetting criteria. Although this is considered to mainly impact comparability of information, EFRAG's view is that the amendment will also lead to information that is more reliable because it represents more faithfully what it is expected to represent. In particular, EFRAG believes that the clarification that the net amounts of financial assets and financial liabilities presented in the statement of financial position should represent an entity's exposure in the normal course of business and its exposure if one of the parties will not or cannot perform under the terms of the contract would more faithfully reflect the economic substance of the entity's rights and obligations.

10 The amendments to IFRS 7 require disclosure of important new information about an entity's exposure in the normal course of business, as well as in the events of default and insolvency or bankruptcy. Reliability of information is enhanced through:

(a) disclosures by type of financial instrument rather than by class of financial instrument. Disclosures by type of financial instrument would better meet the disclosure objective, which is to enable users of the financial statements to evaluate the (potential) effect of netting arrangements on the entity's financial position.

(b) flexibility as to whether the information required by paragraph 13C(c)–(e) of IFRS 7 is presented by type of financial instrument or by counterparty. This allows preparers to present the disclosures in the same way that they manage their credit exposure.

11 Therefore, EFRAG's overall initial assessment is that the amendments to IAS 32 and IFRS 7 would raise no concerns about risk of error or bias; and therefore they satisfy the reliability criterion.

Comparability

12 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.

13 EFRAG has considered whether the amendments to IAS 32 and IFRS 7 result in transactions that are:

(a) economically similar being accounted for differently; or

(b) transactions that are economically different being accounted for as if they are similar.

14 The amendments to IAS 32 eliminate inconsistencies and divergence in the application of the offsetting criteria. The additional application guidance is expected to increase comparability of information provided to users in circumstance where that is currently not the case.

15 The amendments to IFRS 7 will enhance the comparability of disclosures between entities reporting under IFRSs. In addition, they will introduce a degree of comparability between the offsetting disclosures of entities that report under IFRSs and those that report under US GAAP, while the difference in offsetting of financial assets and financial liabilities in the statement of financial position will remain.

16 Finally, the requirement that disclosures be presented in a tabular format, unless another format is more appropriate, facilitates comparison between entities.

17 EFRAG's initial assessment is that the amendments to IAS 32 and IFRS 7 satisfy the comparability criterion.

Understandability

18 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting and the willingness to study the information with reasonable diligence.

19 Although there are a number of aspects to the notion of 'understandability', EFRAG believes that most of the aspects are covered by the discussion above about relevance, reliability and comparability.

20 As a result, EFRAG believes that the main additional issue it needs to consider, in assessing whether the information resulting from the application of the amendments to IAS 32 and IFRS 7 is understandable, is whether that information will be unduly complex.

21 In EFRAG's view, the amendments to IAS 32 and IFRS 7 do not introduce any new complexities into the financial statements and will provide information about netting arrangements, including rights of set-off associated with the entity's recognised financial assets and recognised financial liabilities in a way, which is easy to understand and follow. Therefore, EFRAG's overall initial assessment is that the amendments to IAS 32 and IFRS 7 satisfy the understandability criterion in all material respect.

True and fair

22 EFRAG's initial assessment is that the information resulting from the application of the amendments to IAS 32 and IFRS 7 would not be contrary to the true and fair view principle.

European public good

23 EFRAG is not aware of any reason to believe that it is not conducive to the European public good to adopt the amendments to IAS 32 and IFRS 7.

Conclusion

24 For the reasons set out above, EFRAG's initial assessment is that the amendments to IAS 32 and IFRS 7 satisfy the technical criteria for EU endorsement and EFRAG should therefore recommend its endorsement.

APPENDIX 3

EFRAG'S EVALUATION OF THE COSTS AND BENEFITS OF THE AMENDMENTS

1 EFRAG has also considered whether, and if so to what extent, implementing the amendments to IAS 32 and IFRS 7 in the EU might result in incremental costs for preparers and/or users, and whether those costs are likely to be exceeded by the benefits to be derived from their adoption.

Cost for preparers

2 EFRAG has carried out an initial assessment of the cost implications for preparers resulting from the amendments to IAS 32 and IFRS 7.

3 EFRAG notes that the most significant change resulting from the amendments to IAS 32 and IFRS 7, which is expected to affect the costs for preparers, is the requirement to provide disclosures on netting arrangements, including rights of set-off associated with the entity's recognised financial assets and recognised financial liabilities, which are not currently provided in the financial statements.

4 The set of preparers most affected by those costs are those that have a large volume of derivative activities, which are subject to an enforceable master netting arrangement or similar agreement (repurchase agreements/reverse repurchase agreements and securities lending arrangements).

One-off costs

5 The amendments to IAS 32 and IFRS 7 will require entities to reconsider their existing reporting systems and will require some of them to upgrade existing systems. To the extent that an entity does not have a significant portfolio of financial assets and financial liabilities that are subject to various netting arrangements, the costs are expected to be insignificant.

6 As noted above, particularly for entities that engage in a large volume of derivatives trading the costs of implementing IFRS 7 could be significant. However, often their systems already capture some information about the gross and net positions for risk management and regulatory purposes. In those cases the costs of implementing the amendments to IFRS 7 will not be as significant.

7 While all entities need to assess the impact of the amendments to IAS 32, most entities will conclude that the new requirements will not result in a change to their accounting. In those cases, the one-off costs of the amendments to IAS 32 will be insignificant.

8 To the extent that entities are affected by the amendments to IAS 32, they will need to assess, for each (type of) contract and for each jurisdiction, whether a right of set-off is enforceable in the event of default and in the event of insolvency or bankruptcy of the entity. This should generally not result in significant one-off costs as this type of analysis would typically already be part of existing risk management activities and would not require additional legal opinions on enforceability. Furthermore, it is unlikely that these entities will need to implement completely new systems. On balance, only some entities may incur significant costs to implement the amendments to IAS 32.

Ongoing costs

9 The additional time needed to prepare the specific disclosures based on the existing information, might result in some incremental costs for preparers compared to the existing requirements. However, gathering information for the amended disclosures should not be too burdensome for these preparers, especially as the information is related to the presentation of instruments that entities have already recognised and measured.

10 EFRAG also notes that costs linked to applying the amendments in IFRS 7 are limited because of the limited scope of the disclosures, which will still provide the information that users of financial statements had requested.

Conclusion

11 Overall, EFRAG's initial assessment is that the one-off costs will be significant for those entities that have a large volume of derivative activities, while the ongoing costs are on balance insignificant.

Costs for users

12 EFRAG has carried out an initial assessment of the cost implications for users resulting from the amendments to IAS 32 and IFRS 7.

13 As indicated above, the amendments to IAS 32 will result in a more consistent application of the offsetting criteria, but not change the underlying principle and the offsetting criteria. EFRAG believes that those changes are unlikely to increase the costs for users.

14 The amendments to IFRS 7 bring additional disclosures on netting arrangements, including rights of set-off; however, the new disclosures are related to instruments that entities have already recognised and measured and information, which users already used in their analysis. Therefore, the amendments to IFRS 7 are unlikely to increase the time required for a user to perform an analysis.

15 Overall, EFRAG's initial assessment is that the amendments to IAS 32 and IFRS 7 are likely to result in insignificant costs for users.

Benefits for preparers and users

16 EFRAG has carried out an initial assessment of the benefits for users and preparers resulting from the amendments to IAS 32 and IFRS 7.

17 EFRAG initial assessment is that the amendments to IAS 32 and IFRS 7 will allow users to assess better the (potential) effect of netting arrangements, including rights of set-off on the entity's financial position and will help preparers in applying and improving the consistency in the application of the offsetting criteria.

18 The amendments to IFRS 7 will enhance comparability of disclosures on netting arrangements, including rights of set-off, between entities reporting under IFRSs. In addition, they will provide users with information about amounts that have been set off in accordance with IFRSs in a way that allows for comparison with entities reporting under US GAAP. Global groups preparing financial statements both under IFRS and US GAAP will benefit from having to prepare only one converged consolidated disclosures.

Conclusion

19 Overall, EFRAG's initial assessment is that the benefits to be derived from implementing the amendments to IAS 32 and IFRS 7 are likely to outweigh the costs involved.

APPENDIX 4

DISSENTING OPINION

1 Two EFRAG TEG members dissent from the drafting of Appendix 2 of the draft endorsement recommendation of *Offsetting Financial Assets and Financial Liabilities (Amendments to IAS 32)* and *Disclosures–Offsetting Financial Assets and Financial Liabilities (Amendments to IFRS 7)*, but support the endorsement of these amendments.

2 While these EFRAG TEG members recognise that the new disclosure requirements bring a first level of convergence, they believe that the failure of the IASB and FASB to achieve full convergence is detrimental to the European public good.

3 These EFRAG TEG members believe that EFRAG's basis for conclusions supporting its tentative decision to recommend endorsement of the Amendments to IAS 32 should have reflected their concerns regarding the European public good criterion. These EFRAG TEG members have reached this conclusion because they believe that the assessment of the European public good criterion needs to reflect the lack of full convergence between IFRS and US GAAP in the context of the call of the G20.

European public good and conclusion

4 In 2009, the G20 published a report – *Declaration on Strengthening the Financial System* – assessing the progress against each of the 47 actions set out in the *Washington Action Plan* that formed part of their commitment to reform the financial sector. At subsequent summits in Pittsburgh (2009), Toronto (2010), Seoul (2010) and Cannes (2011) the G20 leaders reaffirmed their support for a single set of global accounting standards and for the completion of convergence of international and US accounting standards in pursuit of that objective.

5 In that context, the IASB and the FASB have been working together to align how assets and liabilities are presented in the statement of financial position (financial asset and liability offsetting). The boards published an exposure draft of proposals in January 2011 that focused on netting on the basis of the ability and intention to offset payments on a day-to-day basis. This was closer to the requirements in IFRSs than to US GAAP, which, for derivatives, gives primacy to bankruptcy. The FASB voted not to support finalising the proposal but instead to align their disclosure requirements to allow comparability between financial statements prepared in accordance with IFRSs and US GAAP. The IASB finalised its own proposition when it published *Offsetting Financial Assets and Financial Liabilities, (Amendments to IAS 32)* and *Disclosures–Offsetting Financial Assets and Financial Liabilities (Amendments to IFRS 7)*.

6 In the view of these EFRAG TEG members, an assessment of the European public good cannot be expressed without referring to the call for convergence made by the G20, because:

(a) the amendments relate to an area that is of particular significance for such a globalised industry as financial institutions; and

(b) additional disclosures cannot rectify inappropriate accounting policies and the additional disclosures require an assessment of the eventual consequences of disparate accounting in the statement of financial position between financial institutions reporting under IFRS and those reporting under US GAAP.

7 For the above reasons, these EFRAG TEG members dissent from the expression by EFRAG in Appendix 2 that EFRAG is not aware of any reason why the two amendments would not be conducive to the European public good criterion. They believe EFRAG should have reflected their concerns regarding the effect, if any, of the limited convergence achieved by the IASB and the FASB compared to the call of the G20.