

21 April 2011

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Dear Sir/Madam

**SAICA SUBMISSION ON EXPOSURE DRAFT ON *OFFSETTING FINANCIAL ASSETS AND FINANCIAL LIABILITIES***

In response to your request for comments on the IASB's exposure draft on *Offsetting Financial Assets and Financial Liabilities*, attached is the comment letter prepared by The South African Institute of Chartered Accountants (SAICA). Please note that SAICA is not only a professional body, but also secretariat for the Accounting Practices Board (APB), the official standard-setting body in South Africa. The SAICA comment letter results from deliberations of the Accounting Practices Committee (APC), which is the technical advisory body to the APB.

We thank you for the opportunity to provide comments on this document.

Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours sincerely

**Sue Ludolph**  
**Project Director – IFRS**

cc: Moses Kgosana (Chairman of the Accounting Practices Board)  
Prof Alex Watson (Chairman of the Accounting Practices Committee)

# SAICA SUBMISSION ON EXPOSURE DRAFT ON *OFFSETTING FINANCIAL ASSETS AND FINANCIAL LIABILITIES*

## GENERAL COMMENTS

We firstly commend the International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (FASB) for developing the joint proposals on the offsetting requirements. This will further enhance comparability of financial statements by reducing one of the most substantial differences between International Financial Reporting Standards (IFRS) and United States Generally Accepted Accounting Principles (US GAAP).

Whilst we acknowledge the Boards' reasons for revising such requirements, we are concerned that the proposals may be more onerous than what is currently required under IFRS. Under current IAS 32 – *Financial Instruments: Presentation* (IAS 32), the first requirement to offset a financial asset and financial liability in the Statement of Financial Position is that “*an entity currently has a legally enforceable right to set off the recognised amounts*”. Under the new requirements, the entity must have “*an **unconditional** and legally enforceable right to set off the financial asset and financial liability*” (per paragraph 6(a) of the exposure draft; emphasis added). Our concern is that the terms “current” and “unconditional” have different meanings. Under IFRS, if a current legally enforceable right of offset exists in respect of a financial asset and a financial liability at the reporting date, this would meet the above requirement. However, from the guidance provided in the exposure draft, it seems that the right must be unconditional at all stages, including bankruptcy of the counterparties to the transaction.

Legislation in South Africa may prohibit the right of offset on bankruptcy, which may then result in some financial assets and financial liabilities no longer achieving the unconditional and legally enforceable right to set-off. Financial statements in terms of IFRS are presented on a going concern basis and therefore the right to offset should follow this model.

Some of our constituents were of the view that the right of offset in bankruptcy was always required per the standard and that this is not a new requirement. Therefore, the change in the terms current and unconditional should not affect the application of the offsetting requirements.

Furthermore, the requirement for transactions to be settled simultaneously seems far more onerous than previously required under the current IAS 39 – *Financial Instruments: Recognition and Measurement*.

## SPECIFIC COMMENTS

### **Question 1—Offsetting criteria: unconditional right and intention to settle net or simultaneously**

*The proposals would require an entity to offset a recognised financial asset and a recognised financial liability when the entity has an unconditional and legally enforceable right to set off the financial asset and financial liability and intends either:*

- (a) *to settle the financial asset and financial liability on a net basis; or*
- (b) *to realise the financial asset and settle the financial liability simultaneously.*

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*Do you agree with this proposed requirement? If not, why? What criteria would you propose instead, and why?*

In response to these questions our constituents had mixed views. The first view was that the right of offset should only be required in the ordinary course of business and should not be considered for purposes of bankruptcy. The second view is that the right of offset should always be applied, even in bankruptcy.

### **View 1: (majority view) – Offsetting requirements only need to be met in the ordinary course of business**

We do not agree that the unconditional right of set-off should be legally enforceable in all circumstances (i.e. enforceable both in the normal course of business and bankruptcy of one of the counterparties). We believe that the amount resulting from offsetting the financial asset and financial liability should reflect the entity's expected future cash flows at the reporting date. If an entity has an unconditional right of set-off in the ordinary course of business (and not on bankruptcy of its counterparty) and has the intention of settling on a net basis or simultaneously, the net amount reflects expected cash flows in the ordinary course of business. Under the exposure draft it appears that an entity is not permitted to set-off if the entity may not have the right of offset on bankruptcy (as the unconditional right to set-off is then not legally enforceable in all circumstances) and the consequence of this is that the resulting gross financial assets and financial liabilities would not reflect the expected cash flows in the ordinary course of business. This appears to contradict the assumption that financial statements are prepared on a going concern basis per the *Conceptual Framework for Financial Reporting*.

By stipulating that the unconditional right of set-off should be legally enforceable in all circumstances, including bankruptcy or liquidation, the financial statements will also depict the entity's exposure to credit risk. However, in BC36 of the exposure draft the Boards observed that the Statement of Financial Position does not represent an aggregation of credit risk of an entity. BC36 further states that "*it is not its (statement of financial position's) purpose to set out the rights or the obligations of an entity if counterparties fail or become bankrupt.*" While BC36 primarily addresses conditional rights of offset, it does state that rights of offset that exist only upon failure/bankruptcy should not qualify for accounting offset. We agree with this conclusion, which aligns with the going concern assumption. Similarly, we believe that the dependence of a continued right of offset on failure/bankruptcy not occurring should not prevent accounting offset.

Paragraph C6 states that "*the law applicable to relations between the parties (e.g. contractual provisions, the law governing the contract, and the bankruptcy laws of the parties) need to be considered to ascertain whether the right of set-off is enforceable in all circumstances*". It is our view that this paragraph assumes that the right to set-off in all circumstances has been legally tested and there is a clear legal precedent. In some jurisdictions, the right of set-off upon bankruptcy or insolvency may not have been legally tested. It is our recommendation that the unconditional right of set-off should be legally enforceable only in the ordinary course of business. That unconditional right of set-off should be reassessed on a regular basis, at least at each and every reporting date.

Furthermore, we do not agree with the guidance in paragraph 10(f) indicating that realisation of a financial asset and settlement of a financial liability are considered

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simultaneous “*only when settlements are at the **same moment**”* (emphasis added). We are of the view that the requirements to satisfy the intention to realise a financial asset and settle the financial liability simultaneously may have practical challenges, which would hinder these instruments from being settled at the same moment. Paragraph C11 mentions that if settlement takes place over a period, even though there is no potential for any change in the value of the financial asset and financial liability, such settlement is not considered simultaneous. We do not agree with this as we are of the view that if settlement takes place within a reasonably short period, such as a business day or two, and there is no exposure to price risk, the requirements for simultaneous settlement should be considered met. However, a minority of our constituents are of the view that credit risk is more relevant than price risk when it comes to simultaneous settlement.

Globalisation has brought about a plethora of international business transactions that entail a myriad of settlements in different time zones. Thus, the mere fact that there are different time zones necessitating business transactions at different times across the world (as contemplated in paragraph C11 of the exposure draft) should not preclude an entity from setting off financial assets and financial liabilities as long as there is no potential for a change in values of both the financial asset and the financial liability.

### **View 2: Offsetting requirements should be met in all circumstances**

A minority of our constituents believe the current changes would not change the current application as required by IAS 32. These constituents were of the view that IAS 32 requirements already require the consideration of offset at bankruptcy too. Therefore, they are convinced that the majority of the changes recommended have no effect and consider the changes appropriate. However, there are certain concerns for transactions settled simultaneously and this requirement seems to be stricter than the reading of the current IAS 32. We urge the Boards to reconsider their intention in this regard.

### **Question 2—Unconditional right of set-off must be enforceable in all circumstances**

*It is proposed that financial assets and financial liabilities must be offset if, and only if, they are subject to an unconditional and legally enforceable right of set-off. The proposals specify that an unconditional and legally enforceable right of set-off is enforceable in all circumstances (i.e. it is enforceable in the normal course of business and on the default, insolvency or bankruptcy of a counterparty) and its exercisability is not contingent on a future event. Do you agree with this proposed requirement?*

*If not, why? What would you propose instead, and why*

No, we are not in agreement with the revised requirements for offset, as set out in our response to Question 1.

### **Question 3—Multilateral set-off arrangements**

*The proposals would require offsetting for both bilateral and multilateral set-off arrangements that meet the offsetting criteria. Do you agree that the offsetting criteria should be applied to both bilateral and multilateral set-off arrangements? If not, why? What would you propose instead, and why? What are some of the common situations in which a multilateral right of set-off may be present?*

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Yes, we believe that multilateral set-off arrangements should qualify for accounting offset if the offsetting criteria are satisfied. We have no specific examples to which we believe this applies, but it may be applicable to clearing house arrangements.

### **Question 4—Disclosures**

*Do you agree with the proposed disclosure requirements in paragraphs 11–15? If not, why? How would you propose to amend those requirements, and why?*

Whilst we are mindful of the fact that from the IASB's outreach activities there was consensus among users that information about both the gross amounts of financial assets and financial liabilities and the net amount of the results from offsetting is useful, we are of the view that the proposed disclosure requirements could be onerous for the preparers of financial statements.

A majority of the constituents are not convinced that the following disclosures would provide useful information to users of financial statements:

- the amount of financial assets and financial liabilities subject to an unconditional and legally enforceable right of set-off but that the entity does not intend to settle net or simultaneously (paragraph 12(c) of the exposure draft);
- the amount of financial assets and financial liabilities subject to conditional rights of set-off, separately by each type of conditional right (paragraph 12(d) of the exposure draft); and
- the fair value of financial instrument collateral (particularly where the financial instruments are unquoted). In *Improvements to IFRSs* issued in May 2010, the Board addressed a concern that the disclosure of the fair value of collateral may be potentially misleading by removing paragraph 37(c) of IFRS 7 – *Financial Instruments: Disclosures* (IFRS 7), because, within a class of assets, some might be over-collateralised while others might be under-collateralised. Therefore, we believe the proposed disclosure would suffer the same potential to mislead users because of the limited use to the users of financial statements.

We are also of the view that the requirements to cross-reference per paragraph 14 of the exposure draft would not generate any additional benefits to the users of financial statements. As long as the required disclosure is presented in the financial statements, this should be sufficient for the users of the financial statements and cross-referencing should not be required.

Based on the proposals contained in the exposure draft, there are consequential amendments to IFRS 7. However, we suggest that the IASB reconsider these amendments as there appears to be an overlap in disclosures:

- IFRS 7 paragraph 36(a) already requires disclosure of netting agreements which do not meet the offset criteria in IAS 32, which are included in paragraph 12(c) and (d) of the exposure draft.

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- IFRS 7 paragraph 26 requires disclosure of fair values to be provided on a net basis where the carrying values are offset in the statement of financial position, whereas the proposed paragraph 12(b) requires fair value measurement disclosure at a level lower than a class of financial instruments.

### **Question 5—Effective date and transition**

- (a) *Do you agree with the proposed transition requirements in Appendix A? If not, why? How would you propose to amend those requirements and why?*

No, we are not in agreement with the proposed transition requirements. While we appreciate the need to enhance consistency and comparability, we are of the view that the final standard on offsetting should be applied prospectively rather than retrospectively. We believe that the costs associated with systems changes and time taken in collating information for prior periods may exceed the benefits to be derived from providing this information.

- (b) *Please provide an estimate of how long an entity would reasonably require to implement the proposed requirements.*

In line with our response to question 5(b) of the IASB's exposure draft on *Request for Views on Effective Dates and Transition Methods*, the mandatory effective date of the standard should not be before 1 January 2014.

### **OTHER COMMENTS**

#### **Measurement inconsistency**

A measurement inconsistency may exist between financial assets and financial liabilities that qualify for offset, for example the financial asset is measured at fair value through profit or loss while the financial liability is measured at amortised cost. If the set-off conditions in paragraph 6 of the exposure draft are met in such instances, the net amount between the financial asset and the financial liability will not necessarily match the expected future cash flows as there is a portion attributable to the measurement inconsistency. The exposure draft does not seem to address this issue. We believe that offset should be permitted in such instances, as it is reflective of the normal course of business at the reporting date - measurement does not need to be aligned to achieve offset. Perhaps the misalignment between the net amount and expected future cash flows could be addressed through disclosure.

#### **Offsetting should be an election not a requirement**

A minority of our constituents are of the view the preparers that meet offsetting requirements should elect to set-off and should not be required to offset.

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