



May 11, 2011

Sir David Tweedie
Chair
International Accounting Standard Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

Ms. Leslie Seidman
Chair
Financial Accounting Standard Board
401 Merritt 7 (P.O. Box 5116)
Norwalk, CT
06865-5116
USA

Re: Comment Letter on Balance Sheet Offsetting

Dear Sir David and Ms. Seidman,

The CFA Institute¹, in consultation with its Corporate Disclosure Policy Council (“CDPC”)², appreciates the opportunity to comment on the International Accounting Standards Board’s (“IASB”) Exposure Draft (“IASB Exposure Draft” or “IASB ED”), *Offsetting Financial Assets and Financial Liabilities*, and the Financial Accounting Standards Board’s (“FASB”) Exposure Draft, *Proposed Accounting Standards Update: Balance Sheet (Topic 210) Offsetting* (“FASB Exposure Draft” or “FASB ED”), collectively referred to herein as the Offsetting ED. The IASB and FASB are collectively referred to as the Boards.

CFA Institute is comprised of more than 100,000 investment professional members, including portfolio managers, investment analysts, and advisors worldwide. CFA Institute seeks to promote fair and transparent global capital markets, and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality.

¹ With offices in Charlottesville, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 106,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 133 countries, of whom nearly 94,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

² The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners’ perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

General Comments

CFA Institute supports the Boards' initiative to develop a converged solution for the offsetting of financial assets and financial liabilities. Currently, there are significant differences in the use of netting in reported financial assets and financial liabilities between entities who report under International Financial Reporting Standards (IFRS) and those who report under United States Generally Accepted Accounting Principles (U.S. GAAP) due to differences in the accounting for offsetting arrangements. These differences mask risks associated with these financial instruments which impacts comparability and consistency between reporting entities which reduces the decision-usefulness of the information to investors.

Our Long-Held Position Against Netting

CFA Institute has consistently supported the principle that all financial statements should be reported and explained on a disaggregated basis, which extends to netting of financial assets and financial liabilities. Presentation of financial assets and financial liabilities on a gross basis provides key information regarding both counterparty credit risk and market exposures. The position of CFA Institute is well documented in our *Comprehensive Business Reporting Model*³ where we state the following:

“For investors to be able to understand the changes that have occurred in financial statements and, consequently, to their wealth, it is essential that they be able to analyze the individual forces at work that affect the company's performance. **Accounting standards currently permit assets and related liabilities, revenues, and expenses as well as investing and financing cash inflows and outflows, to be reported on a highly aggregated or netted basis, causing much important information to be obscured or lost altogether. The information loss can result in misleading analyses, distorted conclusions, and suboptimal investment decisions. Such aggregation and netting should not be permitted.**”

Netting financial assets and liabilities with differing economic characteristics obscures the underlying risk exposures when netting is based solely on counterparty credit risk rather than economic exposure. For example, netting an interest rate swap with a currency swap hides the fact that changes in the value of the two swaps are independent of each other and the entity is exposed to two different risks.

Additionally, investors are not indifferent in their analysis between entities which both appear to have an equivalent net exposure but substantially different gross exposures. For example, an investor would not view the risks, exposures and volumes of an entity that has \$1 billion of derivative assets and \$980 million of derivative liabilities which net to a \$20 million derivative asset equivalent to an organization which has \$30 million in derivative assets and \$10 million of derivative liabilities simply because they also net to \$20 million. Presentation of this information in the footnotes does not sufficiently highlight the volume or nature of the instruments or risks the organization is undertaking. Credit risk exposure is not the only defining characteristic of a derivative asset or liability. While we understand that not all characteristics of an asset or liability can be fully displayed on the face of the statement of financial position, such significantly different exposures/volumes being buried in the financial statements substantially reduces the transparency of the financial statements.

³ CFA Institute, *A Comprehensive Business Reporting Model*, July 2007.



At the recent roundtable in Norwalk, several constituents noted that investors had contacted them regarding their gross exposures subsequent to the release of the Offsetting ED. This is a clear indication that including the information in the footnotes does not provide sufficient transparency to the gross exposures. If the disclosures were sufficiently transparent, then there would have been no need for the outreach to management as the information is already included within the footnotes. We would observe that if the information regarding exposures is so obviously apparent in the footnotes then investors should be able to identify with equal ease the net exposures in the footnotes. As such, presenting the information gross on the face of the statement of financial position should not be a major concern to reporting entities as the net information is accessible in the footnotes. The significant objection by preparers to the gross presentation on the face of the statement of financial position – with net presentation in the footnotes – is evidence of their recognition of the lower importance afforded to the footnote disclosures. Their recognition of this fact supports the assertion that the information should be presented gross on the statement of financial position.

Further, we would highlight that U.S. GAAP allows entities to report net exposures though this right to offset may only exist under conditions such as counterparty bankruptcy – which is not a going concern assumption for the counterparty and possibly not for the reporting entity depending upon the size of the net exposure. While asserting that the net presentation and credit risk are the most meaningful characteristics in defining the reported asset and liability, preparers provide no information on the actual counterparty or its current creditworthiness. Insistence by the preparer community of the sufficiency of net reporting and primacy of credit risk is ironic in light of the lack of actual counterparty information provided.

Finally, we noted at the recent roundtable in Norwalk that one participant indicated that presenting the information gross would be misrepresentative of the risks of the reporting entity and misleading to investors. We disagree with this observation because this statement implies that IFRS is presently misleading and we believe the Boards' decision is grounded in the conceptual framework as described in the following section.

The Boards' Decision Regarding Offsetting is Grounded Firmly in the Conceptual Framework

The Boards provide strong support for their position as described in the Conceptual Framework for Financial Reporting section of the Basis for Conclusions (Paragraphs BC 12 to BC 28G). Of particular note are the following key points made by the Boards in reaching their conclusion as set forth in these paragraphs of the Basis for Conclusions:

“...the presentation of gross amounts of assets and liabilities provides more relevant information than a net presentation. In particular, the boards believe that gross amounts of derivative assets and liabilities are more relevant to users of financial statements than the net amounts for assessing the liquidity or solvency of an entity.”

“Offsetting generally obscures the existence of some assets and liabilities in the statement of financial position and it changes the size of the statement of financial position. Thus, the boards believe that a net presentation of assets and liabilities in the statement of financial position generally does not provide a complete depiction of the assets and liabilities of an entity.”

“...offset that results in a net amount of zero and derecognition resulting in no gain or loss are indistinguishable in their effect in the statement of financial position. Likewise, not recognizing assets and liabilities of the same amount in financial statements achieves similar reported results. **Hence, the boards believe that offsetting could provide misleading information about an entity's financial position.**”



Boards Could Go Further, But Disclosure is a Sufficient Compromise

As highlighted previously, we are not in favor of offsetting of any kind. While the Offsetting ED as presently drafted still allows netting when there is the unconditional right of offset and management intent to settle net – and in this way does not agree with our view precisely – we believe that the proposed enhanced disclosure, which provides a fully gross presentation along with a linkage to the financial statement presentation, provides a reasonable compromise that we are willing to support. Further, we are supportive of the proposal because the Boards are eliminating differences between U.S. GAAP and IFRS which will improve comparability and provide more decision-useful information to investors.

Regulatory Impacts Should Not Dictate the Direction of Improved Financial Reporting Standards

We are also cognizant that the proposed changes, if enacted, could have a sizeable impact on financial institution leverage calculations for regulatory purposes. Many are unsupportive of these proposed changes because regulatory reporting presently utilizes U.S. GAAP as a starting point. This same reliance on U.S. GAAP for U.S. bank regulatory reporting was used as a reason not to support fair value accounting in the FASB's recent proposal on financial instruments classification and measurement. Regulatory reporting should not drive financial reporting. As we have stated innumerable in other comment letters, investors, under the IASB and FASB's mission and conceptual framework, are considered the primary users of financial statements. As such, accounting standards should be developed with their interests having primacy and with the objective of providing decision-useful information upon which capital allocation decisions can be made. Given that regulators have the ability to request additional or alternative information and have the freedom to establish an approach they see fit for their purposes, the Boards have a responsibility to focus on the needs of investors who depend solely on information from financial statements prepared in compliance with standards of the FASB and IASB.

Convergence vs. High-Quality Standards

Our members have told us that high-quality standards have primacy in the standard setting process over convergence. As such, we do not believe a converged answer which results in more offsetting is beneficial to investors.

Response to Specific Questions

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.*

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

As previously articulated, we are not in favor of offsetting financial assets and financial liabilities. We believe that netting suggests that counterparty credit risk is the only risk characteristic of concern to investors. However, this is not the case since many users are focused on exposures to other market risks, which are better revealed by prominently displaying the gross amounts on the face of the financial statements. Masking sizeable diverse risk exposures behind netting arrangements does not provide decision-useful information since it hides the risks and leverage a company may have assumed. Instead, we believe that both credit risk and other market risks are important for users to fully understand the true

nature of the risk exposures of an entity, and, therefore, we believe that both the gross assets and liabilities should be presented.

We believe that the final standard should clarify the guidance with respect to the requirement that the entity must have the intention to settle on a net basis. Although Paragraphs C7 and C10 offer an explanation, we believe the proposal could be drafted in such a way to establish that it is ultimately the entity's actions – not simply their intent – that are relevant. We believe that more guidance is necessary to stipulate the parameters, at the onset of the contract, regarding the evidence or actions needed to establish whether the counterparties intend to net settle the transaction. For example, we believe that an entity's historical pattern of settlement (i.e. do they normally net settle or not) should be the prime consideration in evaluating their stated intention.

We believe that simultaneous settlement should be very narrowly defined.

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?

We agree that the right of offset must be both unconditional and legally enforceable in all circumstances – not just in cases of bankruptcy or default by either of the counterparties – for offsetting to be permitted. Offsetting is not appropriate for a transaction where offsetting is contingent upon some future event, is not currently legally enforceable, is not expected to occur, or is used for contracts not currently settled on a net basis.

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?

Subject to our general opposition to offsetting, we agree with the Boards as stated in the Basis of Conclusions that although multilateral offsetting are likely to be unusual, there is no basis for excluding these netting arrangements from the scope of offsetting if the other criteria are met. We stress that details of the netting arrangement and the counterparties to the transaction should be fully disclosed in a manner that will enable users to fully understand all associated risks.



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?

As we have expressed above, our preference is for gross presentation in all circumstances. However, we agree that enhanced disclosures are a reasonable compromise. We agree with the proposal to require an entity to disclose information about the rights of set-off and related arrangements (such as collateral agreements) associated with the entity's financial assets and financial liabilities to enable users of its financial statements to understand the effect of those rights and arrangements on the entity's financial position.

However, we have identified some areas where the disclosure elements need further enhancement and clarification as follows:

- 1) Consistency Among Standards – The Boards should ensure that the disclosure requirements of this proposed are consistent (e.g., risk focused vs. instrument focused) with other financial reporting standards such as IFRS 9 and IFRS 7. As we have stated in other letters (most recently in our letter of May regarding the IASB proposed standard on hedging) we believe that most preparers do not do a good job of disclosing their risk exposures and the effect of hedging on those exposures. When netting involves hedged items and/or hedging instruments, it provides a further layer of obfuscation, resulting in disclosures that lack information content and decision-usefulness.
- 2) Overall Contents – Our review of the proposed disclosure table indicates that there needs to be some greater clarification on the overall contents of the table. For example, is the table meant to capture all financial assets and financial liabilities or just those financial assets and financial liabilities subject to offsetting? The title of the table implies that it should only include those subject to offset. However, it is our understanding that the proposed disclosure table is meant to include all financial assets and financial liabilities not just those subject to offset as is implied by the current title. Therefore, we suggest that the title to the table be modified to provide a more accurate description.
- 3) Reconciliation – The table should make it clear which total (or subtotal) will “tie” to the statement of financial position (either Column (i) or (iii)).
- 4) Reciprocity of Offsets – Until the overall contents of the table clear, it is not clear whether the financial liabilities offset against financial assets on the financial assets schedule will or should agree the financial liabilities presented on the financial liabilities schedule.
- 5) Nature of Instruments and Related Risk – The proposed disclosure provides for inclusion of items by the nature of financial instrument. However, such presentation does not provide a complete picture of the underlying risk (e.g. is the risk foreign currency risk, interest rate risk, or equity risk) or how it will behave relative to underlying market movements (e.g. options are asymmetric while futures and swaps are not). We believe it is important to provide disclosures with reference to the risk and the underlying risk exposure so that users have better understanding of the underlying risks.
- 6) Counterparties – The table provides disclosure of the nature of the financial instrument subject to offsetting, but it does not provide any information regarding the net credit position by key counterparty. Many say they don't support the offsetting proposal because only net credit risk is important, yet they are not simultaneously requesting information regarding who the underlying counterparties are. Both the nature of the financial instrument and its related risk and the credit risk of the key counterparties are essential disclosures for investors to have a more holistic understanding of all of the risks.



7) Portfolio-Level Adjustments – The table should separately reflect by financial instrument the portfolio-level adjustments in the fair value measurement to reflect the credit risk of the counterparties or the counterparties’ net exposure to the credit risk of the entity. Portfolio level adjustments which reduce the presentation of credit risk should be important to investors.

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

We believe that the new standard should apply to annual and interim reporting periods within one to two quarters after its final issuance, as this will enhance the comparability and decision-usefulness of information for investors.

* * * * *

If you, other board members or your staff have questions or seek further elaboration of our views, please feel free to contact either Matthew M. Waldron by phone at +1.212.705.1733, or by e-mail at matthew.waldron@cfainstitute.org.

Sincerely,

/s/Kurt N. Schacht
Kurt N. Schacht, JD, CFA
Managing Director
Standards & Financial Markets Integrity Division
CFA Institute

/s/ Gerald I. White
Gerald I. White, CFA
Chair
Corporate Disclosure Policy Council

cc: Corporate Disclosure Policy Council