The costs and benefits of implementing the amendments to IAS 32 and IFRS 7

OFFSETTING FINANCIAL ASSETS AND FINANCIAL LIABILITIES

Introduction

1 Following discussions between the various parties involved in the EU endorsement process, the European Commission decided in 2007 that more extensive information than hitherto needs to be gathered on the costs and benefits of all new or revised Standards and Interpretations as part of the endorsement process. It has further been agreed that EFRAG will gather that information in the case of *Offsetting Financial Assets and Financial Liabilities, (Amendments to IAS 32)* and *Disclosures–Offsetting Financial Assets and Financial Liabilities (Amendments to IFRS 7)* ('the Amendments').

2 EFRAG first considered how extensive the work would need to be. For some Standards or Interpretations, it might be necessary to carry out some fairly extensive work in order to understand fully the cost and benefit implications of the Standard or Interpretation being assessed. However, in the case of the Amendments, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work. The results of the consultations that EFRAG has carried out seem to confirm this. Therefore, as explained more fully in the main sections of this report, the approach that EFRAG has adopted has been to carry out detailed initial assessments of the likely costs and benefits of implementing the Amendments in the EU, to consult on the results of those initial assessments, and to finalise those assessments in the light of the comments received.

EFRAG's endorsement advice

3 EFRAG also carries out a technical assessment of all new and revised Standards and Interpretations issued by the IASB against the so-called endorsement criteria and provides the results of those technical assessments to the European Commission in the form of recommendations as to whether or not the Standard or Interpretation assessed should be endorsed for use in the EU. As part of those technical assessments, EFRAG gives consideration to the costs and benefits that would arise from implementing the new or revised Standard or Interpretation in the EU. EFRAG has therefore taken the conclusion at the end of this report into account in finalising its endorsement advice.

A SUMMARY OF THE AMENDMENTS TO IAS 32 AND IFRS 7

Background

4 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

5 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.

6 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 need of users.

What has changed?

Offsetting criteria

7 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.

8 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.

9 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

10 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?

11 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.

EFRAG's initial analysis of the costs and benefits of the Amendments

12 EFRAG carried out an initial assessment of the costs and benefits expected to arise for preparers and for users from implementing the amendments, both in year one and in subsequent years. The results of EFRAG's initial assessment can be summarised as follows:

(a) *Costs* – one-off costs would be significant for those entities that have a large volume of derivative activities, while the ongoing costs were on balance insignificant. The amendments to IAS 32 and IFRS 7 should result in insignificant costs for users.

(b) *Benefits* – the benefits to be derived from implementing the amendments to IAS 32 and IFRS 7 were likely to outweigh the costs involved.

13 EFRAG published its initial assessment and supporting analysis on 26 January 2012. It invited comments on the material by 25 February 2012. In response, EFRAG received ten comment letters. Six respondents agreed with EFRAG's

assessment of the benefits of implementing the Amendments and the associated costs involved for users and preparers. The other respondents did not comment specifically on EFRAG's initial assessment of the costs and benefits of implementing the Amendments in the EU, but supported EFRAG's recommendation that the Amendments be adopted for use in Europe.

EFRAG's final analysis of the costs and benefits of the Amendments

14 Based on its initial analysis and stakeholders' views on that analysis, EFRAG's detailed final analysis of the costs and benefits of the Amendments is presented in the paragraphs below.

Cost for preparers

15 EFRAG has carried out an assessment of the cost implications for preparers resulting from the Amendments. EFRAG notes that the most significant change resulting from the Amendments, 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.

16 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

17 The Amendments 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.

18 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.

19 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.

20 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

21 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.

22 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

23 Overall, EFRAG's 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

24 EFRAG has carried out an assessment of the cost implications for users resulting from the Amendments.

25 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.

26 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.

27 Overall, EFRAG's assessment is that the Amendments are likely to result in insignificant costs for users.

Benefits for preparers and users

28 EFRAG has carried out an assessment of the benefits for users and preparers resulting from the Amendments.

29 EFRAG 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.

30 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

31 Overall, EFRAG's assessment is that the benefits for preparers and users to be derived from implementing the Amendments are likely to outweigh the costs involved.

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