European Financial Reporting Advisory Group

Jonathan Faull
Director General
European Commission
Directorate General for the Internal Market
1049 Brussels

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Dear Mr Faull,

Adoption of *Offsetting Financial Assets and Financial Liabilities, (Amendments to IAS 32)* and *Disclosures–Offsetting Financial Assets and Financial Liabilities (Amendments to IFRS 7).*

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards we are pleased to provide our opinion on *Offsetting Financial Assets and Financial Liabilities, (Amendments to IAS 32)* and *Disclosures–Offsetting Financial Assets and Financial Liabilities (Amendments to IFRS 7)* ('the Amendments'), which were issued by the IASB on 16 December 2011. In January 2011 the IASB and the FASB published the exposure draft (ED) *Offsetting Financial Assets and Financial Liabilities* and EFRAG commented on that draft.

IAS 32 was amended 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.

The amendments to IFRS 7 require disclosures that 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). The disclosures 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. Finally, disclosures are required that 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.

The amendments to IFRS 7 will apply for annual and interim reporting periods beginning on or after 1 January 2013. 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 has carried out an evaluation of the Amendments. As part of that process, EFRAG issued its initial assessment for public comment and, when finalising its advice and the content of this letter, it took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and its discussions of technical matters are open to the public.

EFRAG supports the Amendments and has concluded that they meet the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards in that they:

- 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
- 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.

For the reasons given above, EFRAG is not aware of any reason to believe that it is not conducive to the European public good to adopt the Amendments and, accordingly, EFRAG recommends their adoption. EFRAG's reasoning is explained in Appendix 1.

On behalf of EFRAG, I should be happy to discuss our advice with you, other officials of the EU Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely,

Françoise Flores
EFRAG Chairman

APPENDIX 1
BASIS FOR CONCLUSIONS

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG 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 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 different is that EFRAG's thinking may evolve.

Does the accounting that results from the application of the Amendments meet the technical criteria for EU endorsement?

1 EFRAG has considered whether the Amendments 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:

(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.

2 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.

Relevance

3 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.

4 EFRAG considered whether the Amendments 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.

5 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.

6 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.

7 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 assessment is that the Amendments would result in the provision of relevant information; and therefore they satisfy the relevance criterion.

Reliability

8 EFRAG also considered the reliability of the information that will be provided by applying the Amendments. 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.

9 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 do not raise any significant issues concerning freedom from material error and bias.

10 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.

11 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.

12 Therefore, EFRAG's overall assessment is that the Amendments would raise no concerns about risk of error or bias; and therefore they satisfy the reliability criterion.

Comparability

13 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.

14 EFRAG has considered whether the Amendments 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.

15 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.

16 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.

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

18 EFRAG's assessment is that the Amendments satisfy the comparability criterion.

Understandability

19 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.

20 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.

21 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 is understandable, is whether that information will be unduly complex.

22 In EFRAG's view, the Amendments 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 assessment is that the Amendments satisfy the understandability criterion in all material respect.

True and fair

23 EFRAG's assessment is that the information resulting from the application of the Amendments would not be contrary to the true and fair view principle.

European public good

24 EFRAG is not aware of any reason to believe that it is not conducive to the European public good to adopt the Amendments.

Conclusion

25 For the reasons set out above, EFRAG's assessment is that the Amendments satisfy the technical criteria for EU endorsement and EFRAG should therefore recommend its endorsement.

APPENDIX 2 – DISSENTING OPINION

1 Nicolas de Paillerets (EFRAG TEG member) dissents from the drafting of Appendix 1 of the 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 supports the endorsement of these amendments.

2 While Nicolas de Paillerets recognises that the new disclosure requirements bring a first level of convergence, he believes that the failure of the IASB and FASB to achieve full convergence is detrimental to the European public good.

3 Nicolas de Paillerets believes that EFRAG's basis for conclusions supporting its decision to recommend endorsement of the Amendments to IAS 32 should have reflected his concerns regarding the European public good criterion. Nicolas de Paillerets has reached this conclusion because he believes 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 Nicolas de Paillerets, 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, Nicolas de Paillerets dissents from the expression by EFRAG in Appendix 1 that EFRAG is not aware of any reason why the two amendments would not be conducive to the European public good criterion. He believes EFRAG should have reflected his concerns regarding the effect, if any, of the limited convergence achieved by the IASB and the FASB compared to the call of the G20.