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File Reference No. 2011-100: Exposure Draft of a Proposed Accounting Update (ASU) "Balance Sheet (Topic 210)-Offsetting"

The Financial Reporting Executive Committee (FinREC) of the American Institute of Certified Public Accountants (AICPA) has reviewed the Exposure Draft (the "ED" or the "Proposal") of the Proposed Accounting Standards Update, "Balance Sheet (Topic 210) – Offsetting" and are pleased to present these comments for your consideration. FinREC supports the ongoing efforts of the FASB and the IASB (together the "Boards") to achieve convergence through the development of principles based models, including the proposed ED and we also support the development of a converged standard that eliminates the differences that currently exist in the offsetting requirements in U.S. Generally Accepted Accounting Principles (U.S. GAAP) and International Financial Reporting Standards (IFRS). However, we have concerns with the Proposal as currently drafted. Our concerns and related recommendations are included below and our responses to the questions posed by the Boards to solicit input have been included as an Appendix A.

FinREC has two fundamental concerns with the ED:

- The presumption that gross presentation provides better information to the user of financial statements than does net presentation, and
- The Boards' criteria to restrict offsetting based on unconditional rights of set-off that are legally enforceable in all circumstances and the entity's intention to settle net or simultaneously.

We are also concerned about impact of the ED on certain entities subject to various governmental regulations or loan covenants that require the maintenance of certain prescribed analytics (such as capital or leverage ratios) that would report different financial results due proposed changes to the criteria for offsetting and of the proposed disclosures, and therefore would encourage the Boards to allow sufficient time for reporting entities and users of the financial statements to understand and appropriately incorporate application of the guidance into their analysis.

Our Proposal

We propose that the Boards should reconsider whether:

- Derivative assets and derivative liabilities (and related cash collateral amounts) subject to enforceable master netting agreements should be presented on a net basis in the statement of financial position;
- The effort required to meet the operational challenges of assessing compliance, in all circumstances, with the unconditional and legally enforceable criterion is commensurate with the resulting benefit and
- The proposed offsetting criterion to settle net or simultaneously as it relates to clearinghouses and exchanges provides meaningful information to the financial statement users or unnecessarily increases the complexity in financial reporting;
- Additional changes are needed to the proposed disclosure requirements to improve the quality of the information to the reader of the financial statements as further discussed in our response to Question 4 located in Appendix A.

Gross vs. Net Presentation of Derivative Instruments Subject to Enforceable Master Netting Agreement

Consistent with the Boards' Conceptual Framework, as noted in paragraph BC13 of the ED, we recognize the importance of financial reporting in providing information to potential investors, lenders, and other creditors

> "a. to help them assess the prospects for future net cash flows to an entity
> b. about the nature and amounts of a reporting entity's economic resources and claims against the entity to identify the reporting entity's financial strengths, weaknesses, <u>liquidity, and solvency</u> and its needs for additional financing…"(emphasis added).

We agree that disclosures of amounts that reconcile gross exposure to net credit exposure, particularly if such disclosures are aligned with the credit risk management of the asset and the underlying rights and related arrangements, would provide useful information to investors, lenders and other creditors, and we support such disclosures. However, we are concerned that gross presentation on the statement of financial position for derivative instruments (and related collateral amounts) with the same counterparty subject to the enforceable master netting agreement will not provide financial statement users with the most relevant information about the timing and uncertainty of an entity's cash flows or sufficient information to support analysis of an entity's liquidity and solvency.

The gross presentation, although reporting larger balances, fails to provide the insight necessary to evaluate credit risk as it would not associate the amounts presented with the net exposure to a given counterparty. We believe that providing better information to users of financial statements should be the primary consideration behind the Boards' deliberations as opposed to focusing on a conceptual model that may not be appropriate in all circumstances. We believe that transparency for users can be captured through disclosure.

The fair value of a derivative represents the present value of estimated net cash inflows and net cash outflows of the contract. Derivative assets and liabilities may have various scheduled settlement dates that extend years after the date of the statement of financial position. To be able to translate the fair value of derivative assets and derivative liabilities into anticipated cash flows, the users of the financial statements would need to know not only the timing of such expected cash flows but also information about the underlying risks. Such detailed data is easier to understand when presented in the footnote disclosures. Presentation of derivative assets and liabilities (and related collateral amounts) with the same counterparty subject to the enforceable master netting agreements on a gross basis will not provide any decision-useful information needed to evaluate the timing and uncertainty of cash flows.

We are also concerned that requiring a gross presentation, as currently proposed in the ED, would create inconsistency in how a single derivative is presented when compared to multiple derivatives executed with the same counterparty under a master netting agreement, even though both may have identical cash flows and risks. Lastly, the ED could have unintended consequences and mislead users of financial statements in situations in which an entity ultimately will not receive the cash flows associated with a derivative asset presented gross in the statement of financial position, because such cash flows will be reduced at settlement by the amount of a liability the entity has with the same counterparty that is subject to a conditional right of offset.

As it relates to the evaluation of an entity's liquidity and solvency, we challenge whether gross presentation provides better information to the potential investors, lenders, and other creditors than that provided by a net presentation for derivatives with the same counterparty under an enforceable master netting agreement. We noted that the Boards stated in paragraph BC36 that "the statement of financial position does not represent an aggregation of the credit risk of an entity." We believe, however, that an understanding of an entity's credit risk is important to any evaluation of that entity's liquidity and solvency, which are key aspects of financial reporting as articulated in the Boards' Conceptual Framework.

We believe that a net presentation better reflects an entity's credit risk relating to derivatives executed with the same counterparty under an enforceable master netting agreement. The credit risk is generally monitored and evaluated by entities on a net basis when such contracts have the same counterparty and are transacted under a legally enforceable master netting agreement. Margin calls and additional collateral posting requests by counterparties are made based on the entity's net exposure to such counterparty. Collateral posting requirement represent a significant liquidity consideration and, in fact, contributed to a number of institutions' financial difficulties during the credit crisis. Collateral posting requirements are determined consistent with the credit exposure and manner in which derivatives are risk managed and priced - on a net basis by counterparty when such transactions are subject to the master netting arrangements. As a result, we believe net presentation should include collateral received or paid.

We believe that a legally enforceable master netting agreement mitigates an entity's credit risk. Based on the information presented in the paragraph BC83 of the ED derived from the Boards' outreach, an enforceable master netting agreement consolidates multiple derivative arrangements with the same counterparty into one agreement and failure to make payments under such arrangement will entitle the counterparty to demand net settlement of all contracts. We share the alternative view expressed in the ED that the mandatory offsetting requirement when an entity has a conditional and legally enforceable right to offset derivative assets and derivative liabilities with the same counterparty, coupled with the disclosure requirements as we discuss below, would provide better information to the users of the financial statements than that provided by gross presentation.

After considering the Boards' discussion of the master netting arrangements in the *Background Information and Basis for Conclusions* in the ED, for the reasons discussed above, we believe that derivative instruments (and related cash collateral amounts) subject to an enforceable master netting agreement have unique attributes that generally do not exist in other financial instruments. We further believe these unique attributes have been acknowledged in the alternative views expressed in the ED. We also note that the Boards have proposed to provide an exception to the measurement of fair value of financial assets and financial liabilities when a reporting entity has offsetting positions in market risk and counterparty credit risk as proposed in their fair value measurement exposure draft issued on July 29, 2010. Although we acknowledge that the exception provided in the fair value measurement exposure draft relates to measurement of fair value, we believe that the Boards should provide a similar exception to the presentation of derivatives executed with the same counterparty under an enforceable master netting arrangement.

Operational Challenges

Although, in practice, the proposal would result in offsetting fewer financial assets and financial liabilities, the potential costs to comply with the proposal as currently drafted may be significant. We are concerned about the operational challenges associated with assessing compliance with the proposed criterion that requires an entity's right of setoff to be unconditional and legally enforceable (<u>in all circumstances</u>). To comply with this requirement, reporting entities would need to analyze whether contractual agreements they enter into have unconditional and legally enforceable rights to offset in each and every circumstance. Such legal analysis can be complex and may extend to various foreign jurisdictions. The financial reporting systems of many entities currently do not capture the required information about the legal enforceability and settling mechanisms of every position. Laws and settling mechanisms in various jurisdictions are continually changing and evolving; the legal analysis is complicated even further when it involves multilateral or multijurisdictional arrangements. Therefore, we strongly recommend that the Boards perform an outreach and cost study prior to finalizing this proposal. We recommend outreach to various constituents such as: the legal community, multinational entities, and investment advisers that consolidate investment companies with large portfolios of financial assets and financial liabilities. We believe that adopting our proposal would eliminate some of these operational concerns. We further note that, if the Boards do not support our proposal to allow netting for derivatives with the same counterparty subject to legally enforceable master netting agreement, the Boards should still consider the views articulated in ASC 210-20-45-9 related to whether a right is legally enforceable, as an alternative. Those views recognize the cost-benefit constraint, allow for consideration of all of the information that is available, and provide for reasonable assurance that the right of setoff would be upheld in bankruptcy. We believe that views expressed in ASC 210-20-45-

9, even within the framework of the mandatory offsetting requirement, will carry fewer operational challenges than those in the ED.

Simultaneous Settlement

The ED sets forth criterion regarding net or simultaneous settlement that we believe would create operational issues and additional implementation costs for entities that use exchanges or clearinghouses with minimal, if any, benefit to the financial statement user. To achieve offsetting, the ED would require that transactions settle on a net basis, or that they settle simultaneously.

We understand that some exchanges and clearinghouses are not able to settle all transactions at the exact same moment due to operational and systems limitations. We urge the Boards to evaluate the current U.S. GAAP model and consider whether certain security transfer or clearing systems that meet specific requirements (focused on their design, operation and ability to perform) effectively achieve economic net settlements even though their operational processes require intra-day non-simultaneous gross settlement of individual transactions. We recommend that the Boards consider that the transactions processed through such exchanges or clearinghouses generally have lower credit risk, thus providing the financial presentation on a gross basis will not provide an insightful indication of the credit and liquidity risks that an entity has encountered.

We believe that the proposed offsetting criterion to settle net or simultaneously as it relates to clearinghouses and exchanges would unnecessarily increase complexity in financial reporting and we urge the Boards to revisit this issue, particularly in light of the expected increased use of exchanges and clearinghouses. After consideration of the settlement process, the Boards should include in the ED an analysis of what factors indicate the transactions meet or fail the simultaneous settlement criterion if they are executed on an exchange or through a clearinghouse.

We understand that developing a common conceptual framework that fits a myriad of transaction types with developed common practices is a challenging process. However, we believe that the proposed offsetting presentation model carries operational challenges and increases the complexity of financial reporting without enhancing the quality of the information needed to perform an enhanced and more informed analysis of financial statements.

Representatives of FinREC or the offsetting comment letter task force would be happy to discuss our comments with you at your convenience.

Our responses to the questions raised in the ED are in Appendix A that follows this letter.

Sincerely,

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FinREC

Maryna Tully, Chairman
Offsetting Task Force

April 29, 2011

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Appendix A – Responses to Questions

Question 1: The proposals would require an entity to offset a recognized eligible asset and a recognized eligible liability when the entity has an unconditional and legally enforceable right to setoff the eligible asset and eligible liability and intends either:

1. To settle the eligible asset and eligible liability on a net basis
2. To realize the eligible asset and settle the eligible liability simultaneously.

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

Response: As discussed in the body of this letter, we do not support the basic premise of the Proposal, which would eliminate the ability to offset recognized derivative assets and recognized derivative liabilities (and related cash collateral) executed with the same counterparty under an enforceable master netting arrangement. The proposal provides for more limited criteria than currently permitted under U.S. GAAP and we believe that the current U.S. GAAP model is in most respects operational and presents useful information to users of financial statements. We have suggested an alternative to the current proposal based on how the entity manages its credit and liquidity risks. We believe that this is preferable to the Proposal and more consistent with the way that many financial instruments are managed with respect to credit and liquidity risk. As noted in the body of the letter, we also believe that the Boards should consider whether the proposed offsetting criterion to settle net or simultaneously as it relates to clearinghouses and exchanges provides meaningful information to the financial statement user or unnecessarily increases complexity in financial reporting.

Question 2: Under the proposals, eligible assets and eligible liabilities must be offset if, and only if, they are subject to an unconditional and legally enforceable right of setoff. The proposals specify that an unconditional and legally enforceable right of setoff is enforceable in all circumstances (that is, 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?

Response: As discussed in the body of this letter, we do not support the narrow set of criteria proposed in the ED. We further recommend that the Boards clarify the unit of account that is eligible for the offsetting. There is an apparent inconsistency between the proposed guidance in paragraph 10(b) that indicates that the right of set-off may apply to "all or a portion of an amount ...." and paragraph 6 which refers to offsetting "a recognized eligible asset and a recognized eligible liability." The Board should resolve the apparent inconsistency in these statements.

Question 3: The proposals would require offsetting for both bilateral and multilateral setoff arrangements that meet the offsetting criteria. Do you agree that the offsetting criteria should be applied to both bilateral and multilateral setoff arrangements? If not, why? What would you propose instead, and why? What are some of the common situations in which a multilateral right of setoff may be present?

Response: We agree that the offsetting criteria should be applied to both bilateral and multilateral arrangements.

Question 4: 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?

Response: We generally agree that the disclosure requirements that reconcile gross exposures to net credit exposures will provide useful information to the users of the financial statements and address their desire for such information. As discussed above, for derivatives (and related collateral amounts) executed with the same counterparty under enforceable master netting arrangement and certain transactions processed through exchanges or clearinghouses, we believe that the primary reporting on the statement of financial position should be on a net basis. However, we understand that users of financial statements find information about both gross and net exposure to be useful information for some analysis. As such, we are supportive of disclosure of this information. We urge the Boards, however, to simplify the proposed disclosures to improve their usefulness - such disclosures would be more helpful to the users if they are aligned with the reporting entity's credit risk management of the asset and the underlying rights and relating arrangements.

We are also concerned that the ED's requirement to disclose quantitative information by class may result in presentation that is inconsistent with how preparers manage their business. We believe that the information presented to the users of financial statements will be improved if the final standard provides principles based disclosure requirements that would allow a level of flexibility for preparers to provide disclosures that are meaningful and relevant in the context of how they manage credit, liquidity and other relevant risks. We believe that one of the principles should require that information presented in the disclosure should cross-link back to the statement of financial position. To the extent that the Boards proceeds with existing disclosure requirements as currently proposed, we recommend that they consider whether financial guarantees and collateral delivered to the counterparty in excess of the amounts of financial assets and liabilities defined in paragraph of 12(b)3 should be disclosed, because financial statement users may want to factor the existence of such overcollateralization into their analyses.

We also recommend that the Boards consider initiating a project to evaluate and develop guidance related to credit risk and liquidity risk disclosures, to the extent that they are not within the scope of recently issued guidance found in ASU 2010-20. This project should be a comprehensive consideration of all credit risk management activities, rather than those limited to the rights of set off and related collateral arrangements. This project also should consider concepts such as those related to the evaluation of counterparty creditworthiness through a requirement for disclosure of the counterparty ratings or similar information. It should also evaluate the need for disclosure of collateral that is not in the form of cash or financial instruments, to the extent it is relevant in the context of how of how the entity manages its credit, liquidity and other relevant risks.

If the Boards decide to proceed with the proposed tabular presentation requirement, it would be helpful if the example in paragraph IE1 illustrated the disclosure for an entity with both unconditional and conditional right of set-off and also collateral in excess of the amounts of financial assets and liabilities, as defined in paragraph of12(b)3 of the ED.

Question 5: Do you agree with the proposed transition requirements in Appendix A? If not, why? How would you propose to amend those requirements and why? Please provide an estimate of how long an entity would reasonably require to implement the proposed requirements.

Response: We believe, given the magnitude of the impact on financial reporting systems of the proposed changes to the criteria for offsetting and of the proposed disclosures, entities would need considerable time, probably a three year window, for retrospective application. They would need the time to recast at least two years of historic transactions. Many entities are subject to various governmental regulations or loan covenants that require the maintenance of certain prescribed analytics (such as leverage ratios) that will be impacted by the adoption of the standard as proposed. Although the economic exposure of the entity will not be affected by Proposal, the requirements will likely result in an entity reporting more financial assets and liabilities on a gross basis, which could affect computation of the entity's performance metrics. These revised metrics could cause entities to fail regulatory tests or fail to meet loan covenant and adversely affect the entity. As a result, we believe the standard should provide a sufficient transition period for the regulators to develop revised standards or for the entities to negotiate revisions to the terms of the lending agreements.

We strongly recommend that the Boards perform an outreach and cost study prior to finalizing this proposal. We recommend outreach to various constituents such as: broker-dealers, banks, utility and energy companies, and investment advisers that consolidate investment companies.