Offsetting Assets and Liabilities.

The IAS 32 and IFRS 7 offsetting amendments have required corporates to re-assess when they offset financial instruments for accounting purposes; and analyse what additional financial statement disclosures in relation to offsetting may be required.

An entity is required to offset a financial asset and financial liability when, and only when, the entity currently has a legally enforceable right to set-off and intends to settle the asset and liability on a net basis or realise the asset and settle the liability simultaneously.

The accounting rules have been amended to clarify:

- That the right of set off must be available today – That is, it is not contingent on a future event;
- That the right of set off must be legally enforceable for all counterparties in the normal course of business, as well as in the event of default, insolvency or bankruptcy; and
- That gross settlement mechanisms, such as through a clearing house, with features that both (i) eliminate credit and liquidity risk; and (ii) process receivables and payables in a single settlement process, are effectively equivalent to net settlement and as a result they would satisfy the criterion in these instances.

Master netting agreements where the legal right of offset is only enforceable on the occurrence of some future event, such as default of the counterparty, does not typically meet the offsetting requirements

The amendment requires more extensive disclosures than were previously required under IFRS. The disclosures focus on quantitative information about recognised financial instruments that are offset in the Balance Sheet, as well as those recognised financial instruments that are subject to master netting or similar arrangements irrespective of whether they are offset.

The amendments are to be retrospectively applied, with an effective date of annual periods beginning on or after 1 January 2014.

Other matters

- Where the offsetting criteria are met, applying offsetting accounting to the relevant financial assets and liabilities *is required*, it is *not an option*.
- Offsetting may be applicable in situations such as cash pooling arrangements and where payables and receivables are settled net with the same counterparty. In all cases for the offsetting criteria to be met the respective financial asset and liability need to be recognised on balance sheet. For example in securities lending transactions the related collateral balance would need to have been recognised on balance sheet.
- There are two basic requirements of IAS 32 for offsetting to be applied, the second of which is that the entity intends either to settle on a **net basis**, or to realise the asset and settle the liability simultaneously.
- Where an entity is contractually required to settle on a net basis, or to realise the asset and settle the liability simultaneously, this alone should be sufficient.
- In other situations where there is no such contractual requirement, factors such as broader market practice and the entity's own past practice for similar transactions should be considered, though this may not necessarily be conclusive.
- For bespoke transactions, factors such as the commercial or operational implications of settling net versus gross, or simultaneously versus at different times, should be considered in judging whether or not there is sufficient evidence to demonstrate an intent to settle net or simultaneously.
- Simultaneous settlement of two financial instruments may occur through, for example, the operation of a clearing house in an organised financial market or face-to-face exchange. Analysis is required on a case by case basis to see whether the realisation of the financial asset and settlement of the financial liability occur *at the same time* in order to be treated as simultaneously settled.
- If a counterparty has the right of offset in the event of default of the entity, but under which the entity *does not* have the right of offset under any circumstance, this agreement referred would fall outside of the scope as the entity itself does not have the right of offset; this right only rests with the counterparty.

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For further information

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