Tech Q&A

The Institute has recently issued, under the members' handbook update, some amendments to HKAS 32 *Financial Instruments: Presentation* and HKFRS 7 *Financial Instruments: Disclosures*, on the offsetting of financial instruments. Could you give me more details about the amendments?

On 30 December 2011, the Institute issued the following amendments in relation to the offsetting of financial instruments:

(i) Amendments to HKAS 32 *Financial Instruments: Presentation* – Offsetting Financial Assets and Financial Liabilities clarify the meaning of "currently has a legally enforceable right of set-off" and that some gross settlement systems may be considered equivalent to net settlement.

(ii) Amendments to HKFRS 7 *Financial Instruments: Disclosures* – Disclosures-Offsetting Financial Assets and Financial Liabilities help investors understand the extent to which an entity has set off in its statement of financial position and provide greater comparability between financial statements prepared in accordance with IFRSs/HKFRSs and those prepared in accordance with U.S. Generally Accepted Accounting Principles.

Offsetting, otherwise known as netting, takes place when entities present their rights and obligations to each other as a net amount in their statement of financial position.

At present, the circumstances when financial assets and financial liabilities may be presented in an entity's statement of financial position as a single net amount, or as two gross amounts, differ depending on whether the entity reports using IFRSs/HKFRSs or U.S. GAAP.

The accounting differences result in the single largest quantitative difference in reported numbers in statements of financial position prepared in accordance with IFRSs/HKFRSs or U.S. GAAP. This reduces the comparability of financial statements, and is especially prominent in the presentation of derivative assets and derivative liabilities by financial institutions.

As a result, users and preparers of financial statements have asked the International Accounting Standards Board and the U.S. Financial Accounting Standards Board to find a common solution for offsetting those items. Proposing a common solution is also consistent with requests from the G-20 and the Financial Stability Board.

In this connection, an exposure draft was issued in January 2011 to establish a common approach to offsetting financial instruments. As a result of the feedback received on the exposure draft, the boards decided to move forward separately with their respective offsetting models. The boards also noted that users of financial statements consistently asked for information to help them compare amounts that are prepared in accordance with IFRSs/HKFRSs and the amounts prepared in accordance with U.S. GAAP.

To meet the needs of users of financial statements, the boards agreed on common disclosure requirements by amending and finalizing the disclosures initially proposed in the exposure draft.

Inconsistencies in applying the offsetting criteria in IAS/HKAS 32 were also highlighted during the outreach on the exposure draft. As a result, the application guidance to IAS/HKAS 32 has been amended to clarify:

- The meaning of "currently has a legally enforceable right of set-off"
- That some gross settlement systems would be considered equivalent to net settlement

Meaning of "currently has a legally enforceable right of set-off"

In order to meet this criterion, the right of set-off:

(i) Must not be contingent on a future event

(ii) Must be legally enforceable in all of the following circumstances:
  - The normal course of business
  - The event of default
  - The event of insolvency or bankruptcy of the entity and all of the counterparties

Some gross settlement systems would be considered equivalent to net settlement

One of the offsetting criteria contained in paragraph 42 of IAS/HKAS 32 requires the reporting entity to intend either to settle on a net basis, or to realize that asset and settle the liability simultaneously. Paragraph 48 of the standard further states that simultaneous settlement of two financial instruments may occur through, for example, the operation of a clearing house in an

organized financial market or a face-to-face exchange.

However, feedback received during outreach indicated a diversity in practice related to the interpretation of "simultaneous settlement." Many preparers and accounting firms have interpreted paragraph 48 of the standard to mean that settlement through a clearing house always meets the simultaneous settlement criterion even if not occurring at the same moment.

In order to reduce diversity in practice, the amendments clarify that if an entity can settle amounts in a manner such that the outcome is, in effect, equivalent to net settlement, the entity will meet the net settlement criterion. This will occur if, and only if, the gross settlement mechanism has features that eliminate or result in insignificant credit and liquidity risk, and that will process receivables and payables in a single settlement process or cycle.

In relation to amended disclosure requirements on offsetting of financial instruments, an entity shall disclose information to enable users of its financial statements to evaluate the effect or potential effect of netting arrangements on the entity's financial position. To meet this objective, an entity shall disclose the following quantitative information separately for recognized financial assets and recognized financial liabilities that are set off in accordance with IAS/HKAS 32:

(i) The gross amounts of those recognized financial assets and recognized financial liabilities
(ii) The amounts that are set off in accordance with the criteria in IAS/HKAS 32 when determining the net amounts presented in the statement of financial position
(iii) The net amounts presented in the statement of financial position
(iv) The amounts subject to an enforceable master netting arrangement or similar agreement that are not otherwise included in (ii), including:
    - Amounts related to recognized financial instruments that do not meet some or all of the offsetting criteria in paragraph 42 of IAS/HKAS 32
    - Amounts related to financial collateral (including cash collateral)
(v) The net amount after deducting the amounts in (iv) from the amounts in (iii)

The information required shall be presented in a tabular format, separately for financial assets and financial liabilities, unless another format is more appropriate.

The amendments to IAS/HKAS 32 are not effective until annual periods beginning on or after 1 January 2014. However, the new offsetting disclosure requirements are effective sooner – for annual periods beginning on or after 1 January 2013. The amendments need to be provided retrospectively to all comparative periods.

The Institute's staff summary on offsetting of financial instruments can be accessed on our website's technical resources section.

Send your questions and comments to *commentletters@hkicpa.org.hk* for the attention of Steve Ong, the Institute's director of standard setting. The standard setting team will answer these questions in accordance with its policy, posted on the Institute's website.