Ihre Ansprechpartner

Sehr geehrte Damen und Herren,

für Rückfragen zu der beigefügten Publikation „In depth“ zur Thematik “Frequently asked questions – Offsetting financial instruments for investment funds” stehen Ihnen folgende Ansprechpartner gerne zur Verfügung:

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In depth
A look at current financial reporting issues

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What's inside:

Frequently asked questions – Offsetting financial instruments for investment funds

At a glance

The IAS 32 and IFRS 7 offsetting amendments have required investment funds to (i) reassess when they offset financial instruments for accounting purposes; and (ii) analyse what additional financial statement disclosures in relation to offsetting may be required. Offsetting is a complex area of accounting, where understanding of the operational and contractual arrangements that an investment fund enters into is key to arriving at the appropriate accounting conclusion. A previous 'in depth' was issued in July 2014 entitled 'offsetting financial instruments for financial institutions'. This 'in depth' sets out our views on the main questions we are seeing in practice specifically for investment funds.

Background

What was the issue?

IAS 32, 'Financial instruments: Presentation' sets out the relevant criteria, which once met, would require entities to offset relevant financial assets and liabilities.

In December 2011 the IASB issued an amendment to the application guidance in IAS 32, to clarify some of the requirements for offsetting financial assets and financial liabilities on the statement of financial position.

The IASB also published, at the same time an amendment to IFRS 7, 'Financial Instruments: Disclosures', which amended existing disclosures required under IFRS 7 to include information that will enable users of an entity's financial statements to evaluate the effect or potential effect of netting arrangements on the entity's financial position.

What are the key provisions?

The amendments do not change the offsetting model in IAS 32, which requires an entity to offset a financial asset and financial liability in the statement of financial position 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 amendments 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 IAS 32 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, continue not to meet the offsetting requirements (IAS 32 paragraph 50).

What are the impacts on disclosures?

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 statement of financial position, as well **as those recognised financial instruments that are subject to master netting or similar arrangements irrespective of whether they are offset** (IFRS 7 paragraph 13A).

What are the transitional arrangements and effective dates?

The offsetting disclosures included in the IFRS 7 amendment are to be retrospectively applied, with an effective date of annual periods beginning on or after 1 January 2013.

The amendments to the application guidance in IAS 32 are also to be retrospectively applied, with an effective date of annual periods beginning on or after 1 January 2014.

This publication is not a substitute for reading the standards and interpretations themselves or for professional judgment as to fairness of presentation. It does not cover all possible disclosures, nor does it take into account any specific legal framework. Further specific information may be required in order to ensure fair presentation under IFRS. We recommend that readers refer to our publications 'IFRS Disclosure Checklist 2014' and 'Illustrative IFRS financial statements 2014 – Investment Funds'. Additional accounting disclosures may be required in order to comply with local laws, stock exchange or other regulations.

Illustrative tabular disclosures

The amendments to IFRS 7 as referred to above include additional disclosure requirements for reporting entities which have relevant transactions and account balances that are within the scope of these amendments.

In relation to the quantitative disclosure requirements required under the amendments to IFRS 7, the standard does provide an illustrative tabular disclosure for reporting entities to adopt. An illustrative of this tabular disclosure, which is included below, is referred to throughout the rest of this 'in depth'.

	A	B	C = A-B	D		E = C-D
	Gross amounts of recognised financial assets	Gross amounts of recognised financial liabilities set-off in the statement of financial position	Net amounts of financial assets presented in the statement of financial position	Related amounts not set-off in the statement of financial position		
				D(i) and D(ii) Financial Instruments	D(ii) Cash collateral	Net amount
Description						
2014: Derivative assets	1,600	–	1,600	1,115	–	485
2013: Derivative assets	1,300	–	1,300	538	–	762

Source: PwC Illustrative IFRS financial statements 2014 – Investment funds

Frequently asked questions

Question 1: What assets and liabilities should be considered in offsetting?

Where the offsetting criteria of IAS 32 paragraph 42 are met, applying offsetting accounting to the relevant financial assets and liabilities **is required**, it is **not an option**. In practice, which financial assets and liabilities should we be looking out for in relation to offsetting?

Answer 1:

Financial assets and liabilities where offsetting may be required and where analysis is typically needed, include collateralised over-the-counter derivatives, repurchase and reverse repurchase transactions, securities lending transactions, futures and listed derivatives. However, offsetting may be applicable in other 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.

In many instances it will be clear with little or no analysis that the offsetting criteria specified within IAS 32 paragraph 42 are not met. In other cases more analysis and discussions with fund managers, brokers, counterparties and legal counsel may be required.

We identified above that repurchase and reverse repurchase transactions should be considered as part of an entity's offsetting analysis under IAS 32. However when evaluating repurchase transactions and reverse repurchase transactions, the assets and liabilities that could be expected to meet the offsetting criteria under IAS 32 are typically the cash payable on the repurchase transactions and the cash receivable on the reverse repurchase transaction, and not the securities themselves.

Question 2: what does intention to settle on a net basis, or realise the asset and settle the liabilities simultaneously mean in practice?

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. What is required to demonstrate either intent to settle on a net basis or realise the asset and settle the liability simultaneously?

Answer 2:

The extent of evidence required will depend on the specific facts and circumstances, including the terms of the relevant contracts entered into by the entity and governing the assets and liabilities in question. Where an entity is contractually required to settle on a net basis, or to realise the asset and settle the liability simultaneously, and (where relevant) the settlement process meets the characteristics set out in IAS 32 paragraph AG38F, 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 by itself. If there have been instances where an entity's past settlement of similar transactions and balances has not been on a net basis or simultaneous in accordance with the criteria of IAS 32 AG38F, these should be assessed in detail.

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.

In practice some brokerage agreements contain clauses that allow for the net settlement of some, or all of the open positions under the agreement, at any time.

However this net settlement option is normally at the option of the counterparties to the agreement to exercise and is not a mandatory net settlement. To be within the scope of IAS 32 paragraph 42 the reporting entity has to have the **intent to settle** on a net basis as well as the **legal right**. Even if a legal entity has a legally enforceable right of off-set, if it has not historically exercised this right to settle net and settled positions on a gross basis previously, then it would likely be outside of the scope of IAS 32 paragraph 42. However disclosures are still required (refer to Question 4).

Question 3: Does settlement through a clearing house always meet the simultaneous settlement criterion?

As highlighted previously 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**. Some entities transact securities through clearing houses and in these instances is the simultaneous settlement criterion met?

Answer 3:

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. In other circumstances an Entity may settle two instruments by **receiving and paying separate amounts**, becoming exposed to credit risk for the full amount of the asset or liquidity risk for the full amount of the liability (IAS 32 paragraph 48).

In some scenarios the cash flows are, in effect, equivalent to a single net amount meaning that from the Entity's perspective there is insignificant exposure to credit or liquidity risk during the settlement process. This is more commonly seen in practice where the Entity in question is a securities broker and has direct access to the relevant clearing house or exchange.

An Investment Fund however is less likely to have direct access to either a clearing house or exchange and it will normally gain access **indirectly** through entering into brokerage or similar agreements with a securities broker. In these circumstances the Investment Fund should analyse its contractual arrangement with its counterparties as highlighted in question 2.

Question 4: What is the definition of a master netting arrangement or similar agreement?

The disclosures highlighted within IFRS 7 paragraph 13 are required for all recognised financial instruments that are offset in accordance with IAS 32. In addition, these disclosure requirements are extended to recognised financial instruments that are subject to an enforceable master netting arrangement or similar agreement, irrespective of whether they are offset in accordance with IAS 32. What are the characteristics of a master netting agreement or similar arrangement?

Answer 4:

IAS 32 paragraph 50 states that an entity that undertakes a number of financial instrument transactions with a single counterparty may enter into a 'master netting arrangement' with that counterparty. Such an agreement provides for a single net settlement of all financial instruments covered by the agreement in the event of default on, or termination of, any one contract.

These arrangements are commonly used by financial institutions to provide protection against loss in the event of bankruptcy or other circumstances that result in a counterparty being unable to meet its obligations (IAS 32 paragraph 50). A master netting arrangement commonly creates a right of set-off that becomes enforceable and affects the realisation or settlement of individual financial assets and financial liabilities only following a specified event of default or in other circumstances not expected to arise in the normal course of business.

The similar agreements referred to in IFRS 7 paragraph 13A, and above, include agreements such as derivative clearing agreements, global master repurchase agreements, global master securities lending agreements and any related rights to financial collateral (IFRS 7 paragraph B41). The determination of whether an agreement represents a master netting arrangement or similar agreement is not always straight forward. Entities should be forming their own conclusions as to whether their agreements meet the definition of master netting arrangements or similar agreements and this analysis may need to involve the entity's counterparties and/or legal advisors.

When reviewing such agreements preparers should be on the lookout for key clauses that indicate that the agreement represents a master netting arrangement or similar agreement. Such clauses can include items such as:

- A provision that allows for net settlement of some or all balances on the event of bankruptcy of default; and
- A provision that allows for unconditional net settlement of an open contract at any time but where the reporting entity has elected for gross settlement of positions (refer to question 2).

In practice one common master netting arrangement is an International Swaps and Derivative Association ('ISDA') agreement. These agreements are widely used by derivative counterparties and may allow for net settlement of payments in the normal course of business as well as providing specific rights of offsetting all open contracts with a given counterparty in the event of bankruptcy or default. As noted above when determining as to whether such agreements meet the definition of a master netting arrangement or similar agreement it is advisable for entities to consult with their counterparties and/or legal advisors. It is important to remember that the disclosures required under IFRS 7 should be made whenever there is a master netting arrangement irrespective of whether any balances have actually been offset in accordance with IAS 32 (refer to question 12).

Question 5: What if only the counterparty has a right of offset?

An entity is party to an agreement whereby the 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. Would the agreement be captured within the scope of the IFRS 7 disclosure requirements?

Answer 5:

This agreement referred to above would fall outside of the scope of IFRS 7 offsetting disclosures as the entity itself does not have the right of offset; this right only rests with the counterparty.

In the situation where the entity has no financial assets or financial liabilities subject to a right of offset, other than through collateral agreements or credit enhancements, the IASB concluded that there would be no incremental value in providing additional disclosure information for such instruments (IFRS 7 paragraph BC24G).

Paragraph BC24W in the basis of conclusions of IFRS 7 further indicates that an objective of the standard was to allow preparers to present disclosures in the same way that they manage **their credit exposure**. In the above scenario the reporting entity will always be obligated to settle gross with the counterparty and the fact that the counterparty has the ability to choose net settlement in the event of the reporting entity's default does not affect the credit risk to **which the reporting entity** is exposed.

It is common in practice for brokerage agreements to include clauses that allow the broker to arrange net settlement of open positions in the event of default of the counterparty (i.e. the reporting entity). Due care is needed when reviewing such agreements to identify whether such rights of offset are granted only to the broker or whether they are extended to the reporting entity. Only those agreements where **the reporting entity** is granted the right of offset should be considered when preparing financial statement disclosures required under IFRS 7 paragraph 13.

Question 6: Should all balances with the counterparty under a master netting arrangement or similar agreement be disclosed?

An entity has entered into an agreement with its prime broker. The entity holds numerous positions with the broker under this agreement not limited to long/short equities, derivatives, fixed income securities, trade receivables/payables on unsettled transactions and margin account balances. The brokerage agreement contains an 'all encompassing' netting arrangement. Should the entity include all balances captured within this agreement within its offsetting disclosures?

Answer 6:

Yes. After the IASB published its amendments in relation to offsetting, comments were received from industry participants about the scope of these amendments and suggesting that the scope was too encompassing. However to date, the IASB has not made any limitation to the amendments made to either IAS 32 or IFRS 7. Without any such scope limitation under IFRS, it is expected that all financial instruments captured within an enforceable master netting arrangement or similar agreements, where there is an enforceable right of offset, should be included within an entity's offsetting disclosures.

An analysis should be performed to evaluate whether an 'all encompassing' netting arrangement exists within an agreement that would, upon a relevant event, permit the entity to net settle all its outstanding positions under such agreement. In many cases 'all encompassing' clauses may be restricted to certain positions under such agreements and therefore, due care is needed when analysing which balances are within scope of the disclosure requirements.

An example of such terms is where under an agreement, the broker will hold a general lien against all assets of the entity held in the brokerage account. The conclusion as to whether the disclosure requirements of IFRS 7 should be applied to all balances with the counterparty depends upon the terms and conditions mentioned within the brokerage agreement and whether the right of offset really captures all assets and liabilities with the counterparty. However some examples of financial instruments that are not within the scope of the IFRS 7 disclosures are loans and customer deposits at the same institution (unless they are set off in the statement of financial position), and financial instruments that are subject only to a collateral agreement (IFRS 7 paragraph B41).

Question 7: Should excess collateral be included in the required disclosures?

An entity has entered into an agreement with one of its brokers. It has been concluded that this agreement represents an enforceable master netting agreement. The entity has provided/received excess collateral to this broker on its trading portfolio. Should the **entire collateral** value be included in the disclosures required under IFRS 7 paragraph 13C(d) or should the **excess collateral be excluded** from the offsetting disclosure? (i.e. within column D of the tabular disclosure illustrated in the amendments to IFRS 7).

Answer 7:

IFRS 7 paragraph 13D states that the total amount disclosed subject to an enforceable master netting agreement (being either financial instruments that do not meet the IAS 32 offsetting criteria or financial collateral) shall be **limited** to the net amount disclosed for that instrument in the statement of financial position (column C of the tabular disclosure illustrated in the amendments to IFRS 7, refer to page 1 of this document).

Any excess collateral above the entity's net amount reported in the statement of financial position **should be excluded** from these disclosure requirements.

The exception to this rule is where the excess collateral is available to be offset against another financial asset or financial liability under the same agreement provided the terms of the agreement permits this by having an 'all encompassing' netting agreement (refer to question 6 for more details).

If the entity, as of its reporting date, has derivative liabilities of US$100 with its prime broker against which it has pledged US$150 of cash collateral specifically for this type of instrument. Only US$100 of the cash collateral pledged can be included within column D of the tabular offsetting disclosure, bringing the entity's net position as disclosed in column E down to nil. The remaining US$50 is excess collateral and should ordinarily be excluded from the disclosure.

In the above example if we change the scenario such that the US$150 was cash collateral pledged against the entity's swap positions, of US$100, and the entity at the same time has an additional US$100 of options (liability) against which no cash collateral has been pledged, does this change the conclusion with respect to the excess collateral?

In these circumstances it could be possible for the US$50 of excess collateral to be offset, within the tabular offsetting disclosure, against the entity's options (within column D). This is provided that the agreement in question contains an 'all encompassing' netting provision which would permit any excess collateral against one type of financial instrument to be transferred to another type of financial instrument. In our example this would require the agreement to permit the entity to use the collateral to settle all its options and swaps.

Factoring in the above is important when preparers conclude on how to present the required IFRS 7 disclosures in their financial statements and the level of disaggregation required. Entities which have multiple master netting arrangements or similar agreements should ensure under-collateralised positions are not obscured in the disclosure if over collateralised positions exist with other counterparties. This is emphasised within the basis for conclusions in IFRS 7 where paragraph BC24S states that at no point in time should under-collateralisation be obscured.

Question 8: How should margin accounts be disclosed?

IFRS 7 paragraph 13C(d) requires the disclosure of amounts subject to an enforceable master netting arrangement or similar agreements, including amounts related to financial collateral be in cash or another form of collateral. Investment funds commonly maintain margin accounts at prime brokers. Should these margin accounts be included within the amounts disclosed for cash collateral? If so, under which column (as financial instruments or as collateral) should they be disclosed?

Answer 8:

The initial assessment to make is whether the amounts should be included within the tabular disclosure. This will involve a review and analysis of the agreement in place between the entity and the counterparty to assess whether it represents an enforceable master netting or similar agreement and whether these margin accounts fall in the scope of this agreement, as highlighted in question 5.

If the margin falls within the scope of a master netting arrangement or similar agreement, they should be disclosed under column D. The amounts to be included within the two columns under D are defined in the statement as;

i. Amounts related to recognised financial instruments that do not meet some or all of the offsetting criteria in IAS 32 paragraph 42 (disclosed in the first column under 'D' in the illustrative tabular disclosure on page 1); and

ii. Amounts related to financial collateral (including cash collateral) (cash collateral is disclosed in the second column under 'D' and other financial collateral is disclosed in the first column under 'D' in the illustrative tabular disclosure on page 1).

Some of the differences in interpretation that we have seen in practice could be explained by the flexibility of implementation that the standard highlights. The main text of the standard would highlight that collateral should be included within 'financial collateral' column of the tabular disclosures (IFRS 7 paragraph 13C); whereas the illustrative disclosure within the standard includes an amount of financial collateral in 'financial instruments' column (IFRS 7 paragraph IG40D).

Determination of where such margin accounts should be disclosed should be based on the facts and circumstances related to those margin accounts on a case by case basis.

Question 9: Is a tabular format required for IFRS 7 disclosures?

The amendment to IFRS 7 provides illustrative tabular disclosures to address the disclosures required by IFRS 7 paragraph 13C. This illustration uses one column for each item required to be disclosed, so six columns in total (refer to page 1 of this FAQ for an illustration). Is this presentation in a tabular format required in all circumstances?

Answer 9:

An entity's financial statements may include the full 6 columns tabular disclosure although there are no items to be disclosed in certain of the columns. This may be the case where an entity may hold derivative assets subject to an ISDA, which has been determined to be an enforceable master netting agreement. However the entity itself may have no corresponding liabilities which can be offset and did not receive any pledged collateral.

The requirement of the standard is that the information required under IFRS 7 paragraph 13C shall be presented in a tabular format, separately for financial assets and financial liabilities, unless another format is more appropriate.

In some instances where an entity has limited or nil balances subject to enforceable master netting agreements, disclosure in a narrative or other format may be more appropriate. However, disclosure in a tabular format is considered, for most entities, to be a more user friendly disclosure, which facilitates comparability between entities and consistent understanding of the information presented and as a result, this is why the amendment indicates a preference for this method of disclosure.

Question 10: Is a separate table for financial assets and liabilities required?

The amendment to IFRS 7 provides illustrative tabular disclosures to address the disclosures required by IFRS 7 paragraph 13C. These illustrations, represented within IFRS 7 paragraph IG40D, include a separate table for assets and liabilities. However, is it allowed under IFRS to present **assets and liabilities** within **one table?**

Answer 10:

The requirement of the standard is that the information required under IFRS 7 paragraph 13C shall be presented in a tabular format**, separately for financial assets and financial liabilities**, unless another format is more appropriate (IFRS 7 paragraph 13C).

Similar to question 9, the presentation can be adapted if the alternative presentation is more appropriate. It may be possible to combine both assets and liabilities into one table rather than disclosing these balances separately as highlighted in the standard. However, depending on the format chosen, providing one **'combined'** table may sometimes result in required disclosures being missed or **'hidden'**. Preparers opting for an alternative presentation should ensure all the relevant disclosures are made and no amounts are concealed or omitted. IFRS 7 paragraph BC24S, also states that at no point should under-collateralisation be obscured.

Question 11: What is the minimum disaggregation for IFRS 7 disclosures?

IFRS 7 13C requires quantitative disclosures in relation to offsetting, but what are the minimum expectations for disaggregation by type of instrument? For example, if all investments (including equities and derivatives) are included within the same line item within the statement of financial position, should the netting table apply further disaggregation (e.g. one line for equities and one for derivatives) or is it allowable to apply the same level of disaggregation as included within the statement of financial position?

Answer 11:

The primary objective of the amendments to IFRS 7 is to disclose information that will enable the users of an entity's financial statements to **evaluate the effect or potential effect of netting arrangements** on the entity's financial position. Although IFRS 7 does state some minimum disclosure requirements, the information to be disclosed, including the level of disaggregation should provide information which is **relevant and useful** to the users of those financial statements.

IFRS 7 paragraph B46 identifies that the same level of disaggregation as included in the statement of financial position would be appropriate for these note disclosures if that is the level of aggregation or disaggregation that the entity believes provides the most relevant information. However, IFRS 7 paragraph B46 further highlights that an entity can conclude that aggregation or disaggregation of individual financial statement line items provides more relevant information. This highlights that any entity is permitted to disclose this information on either a more aggregated or disaggregated basis than as disclosed in the statement of financial position.

An entity should therefore consider what level of disaggregation would be appropriate based on: (i) the nature of its arrangements; and (ii) the balances it has subject to these arrangements at the financial reporting date. For example, an entity with only one prime brokerage agreement and limited different types of instruments may consider the same level as disaggregation as included on the statement of financial position to be the most appropriate for this note disclosure.

Whereas an entity with numerous types of different instruments, with numerous counterparties, covered by numerous agreements, may conclude more disaggregation is needed to make the disclosure more understandable to users.

Entities should also consider what level of disaggregation is included in other financial statement disclosures. For example, the statement of financial position may disclose derivatives as one financial statement line item. However if within other notes to the financial statements (e.g. fair value measurements) these balances are disaggregated into type of derivative instrument (e.g. swaps, options, forwards, warrants etc.) then a similar level of disaggregation might be expected by users.

No matter how an entity concludes to present this information, IFRS 7 paragraph B46 highlights that the amounts required to be disclosed by IFRS 7 paragraph 13C(c) **must be reconciled** to the individual line item amounts presented in the statement of financial position.

Question 12: Is a narrative description of rights to offset required under IFRS 7?

An entity is party to several prime brokerage and other agreements which have been determined to represent enforceable master netting agreements. Is the entity required to disclose a description of its rights of offset associated with the entity's recognised financial assets and recognised financial liabilities subject to these enforceable master netting arrangements?

Answer 12:

Yes. This is covered by IFRS 7 paragraph 13E which requires that an entity shall include a **description** in the disclosures of the right of set-off associated with the entity's recognised financial assets and recognised financial liabilities subject to enforceable master netting arrangements and similar agreements that are disclosed in the financial statements in accordance with IFRS 7, **including the nature of those rights**.

These narrative disclosures required are designed to support the quantitative tabular disclosures we have discussed throughout this FAQ by providing further details on the underlying agreements containing those balances. The narrative disclosures should include details of the entity's conditional rights of offset. Where rights to offset are **contingent on a future event**, such as the event of default or bankruptcy, an entity should disclose the details of these contingent future events.

As highlighted previously, in practice some brokerage agreements have rights to offset that are not contingent on future events, but where the entity has elected to settle all open positions under such agreements on a gross basis. As a result the offsetting criteria of IAS 32 have not been met. IFRS 7 paragraph B50 highlights that in these circumstances, where rights of offset are **not contingent** on a future event, an entity shall disclose the reasons why the offsetting criteria have not been met.

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