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Banking and Securities Spotlight

Complying With the New Balance Sheet Offsetting Disclosure Requirements

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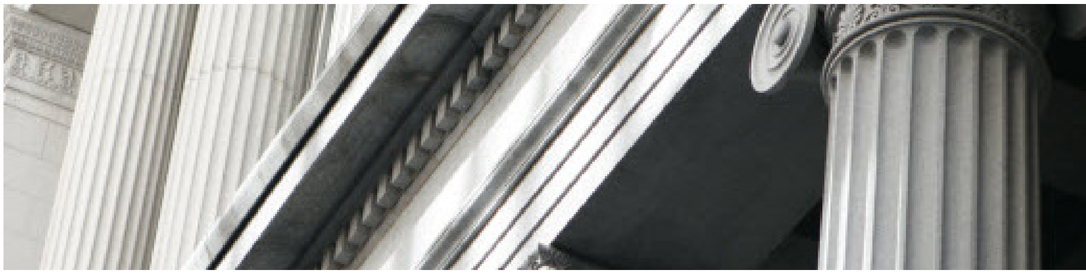

The Bottom Line

- In December 2011, the FASB issued ASU 2011-11[1] (codified in ASC 210-20[2]), which establishes new disclosure requirements related to the effect or potential effect of offsetting arrangements on a company's financial position. The standard is the result of the FASB's joint offsetting project with the IASB.
- In response to questions raised by preparers about the scope of ASU 2011-11, the FASB issued ASU 2013-01[3] (codified in ASC 210-20) to clarify which instruments and transactions are subject to the disclosure requirements. The IASB has not undertaken a similar project to date.
- The new disclosures will give financial statement users information about gross and net exposures, allowing them to more easily compare financial statements prepared under U.S. GAAP with those prepared under IFRSs.
- Under the new requirements, companies must disclose both (1) net amounts and gross information about specified instruments and transactions that are offset in the statement of financial position and (2) instruments and transactions subject to an enforceable master netting arrangement (MNA) or similar agreement. Companies will present this information in a tabular format in the notes to the financial statements (unless another format is more appropriate). In addition, companies must disclose qualitative information about the nature of the rights of setoff. The scope of the FASB's amended requirements includes fewer financial instruments than the scope of the offsetting requirements under IFRSs.
- When implementing and complying with the standard, some banking and securities companies may encounter operational challenges associated with expanding their data gathering, refining their tracking, adding resources, and supplementing their qualitative disclosures. The disclosure requirements are effective for fiscal years beginning on or after January 1, 2013, and interim periods therein, with retrospective application required for all comparative periods presented. The requirements for private companies are the same as those for public companies.

The disclosure requirements are effective for fiscal years beginning on or after January 1, 2013, and interim periods therein.

1 FASB Accounting Standards Update No. 2011-11, *Disclosures About Offsetting Assets and Liabilities.*
2 For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification.*"
3 FASB Accounting Standards Update No. 2013-01, *Clarifying the Scope of Disclosures About Offsetting Assets and Liabilities.*

Beyond the Bottom Line

Issued on December 16, 2011, ASU 2011-11 establishes new requirements for companies to disclose the nature of their rights of setoff and related arrangements associated with certain financial instruments and derivative instruments that are offset in the statement of financial position or subject to enforceable MNAs or similar agreements. The ASU's disclosure requirements were the result of a joint effort by the FASB and IASB to converge their reporting requirements on offsetting. Although the boards ultimately decided to retain their own existing offsetting models, they were able to agree on these expanded disclosure requirements, which were intended to make financial statements prepared under U.S. GAAP more comparable to those prepared under IFRSs.

Scope of the Amended Offsetting Guidance

In planning to implement ASU 2011-11, some preparers became concerned that the scope of the standard was broader than they had originally assumed. In particular, they noted that many of their trade receivable and trade payable agreements contained standard commercial provisions allowing either party to offset upon the default of the other. They believed that such provisions were similar to an enforceable MNA and that those receivables and payables would therefore be subject to new disclosure requirements. These preparers asked the FASB to reconsider whether the benefits of making such instruments subject to the offsetting disclosures justified the costs that preparers would incur to perform a comprehensive review of all of their agreements to determine whether the agreements contained netting provisions similar to MNAs.

The FASB issued ASU 2013-01 in January 2013 to clarify which instruments and transactions are subject to the disclosure requirements under ASU 2011-11.

In response to these concerns, the FASB issued ASU 2013-01 in January 2013 to clarify which instruments and transactions are subject to the disclosure requirements under ASU 2011-11. ASU 2013-01 limits the scope of the offsetting disclosures to the following instruments or transactions: "Recognized derivative instruments accounted for in accordance with [ASC] 815, including bifurcated embedded derivatives, repurchase agreements and reverse repurchase agreements, and securities borrowing and securities lending transactions that are":

- "[O]ffset in accordance with either [ASC] 210-20-45 or [ASC] 815-10-45" or
- "[S]ubject to an enforceable [MNA] or similar agreement, irrespective of whether they are offset in accordance with either [ASC] 210-20-45 or [ASC] 815-10-45."

Examples of a "similar agreement" include derivative clearing agreements, global master repurchase agreements, and global master securities lending agreements.

Under U.S. GAAP, an entity may elect to offset qualifying financial instruments on the balance sheet (as an accounting policy choice). However, an entity whose instruments are within the scope of the amended guidance must provide the new disclosures, regardless of whether it has elected to offset those instruments in the balance sheet. Therefore, the effect of the new disclosure requirements may be greater on certain banking and securities companies that have not previously tracked these instruments separately than on those without rights of setoff under enforceable MNAs (or similar agreements).

Disclosure Requirements

For instruments within the scope of the amended offsetting guidance, ASC 210-20-50-3 states that banking and securities companies must disclose, at a minimum, the following information in a tabular format (unless another format is more appropriate), separately for assets and liabilities:

a. The gross amounts of those recognized assets and those recognized liabilities
b. The amounts offset in accordance with the guidance in [ASC] 210-20-45 and [ASC] 815-10-45 to determine the net amounts presented in the statement of financial position
c. The net amounts presented in the statement of financial position

d. The amounts subject to an enforceable master netting arrangement or similar agreement not otherwise included in (b):

   1. The amounts related to recognized financial instruments and other derivative instruments that either:

      i. Management makes an accounting policy election not to offset.

      ii. Do not meet some or all of the guidance in either [ASC] 210-20-45 or [ASC] 815-10-45.

   2. The amounts related to financial collateral (including cash collateral).

e. The net amount after deducting the amounts in (d) from the amounts in (c).

To improve the transparency of collateralized transactions and to avoid the masking of undercollateralized positions by overcollateralized positions, the offsetting guidance limits the total amount that an entity can disclose for a particular instrument in ASC 210-20-50-3(d) above to the amount that it disclosed in ASC 210-20-50-3(c). In other words, the total of the amounts subject to an MNA and the collateral cannot exceed the amount reported in the balance sheet for a recognized instrument. However, rights to collateral that "can be enforced across financial instruments" also may be included in the amounts disclosed in ASC 210-20-50-3(d). In addition, for each type of right of setoff disclosed in ASC 210-20-50-3(d), an entity must provide a narrative description of the nature of that right, such as how and when the right can be exercised.

The amended guidance gives entities the option of grouping the quantitative information disclosed by type of instrument or by counterparty.

The amended guidance gives entities two options for grouping the quantitative information disclosed for items ASC 210-20-50-3(c) through (e) above. The entity may group such information by (1) type of instrument (e.g., derivatives and repurchase agreements and reverse repurchase agreements) or (2) counterparty. If the entity elects the latter option, it does not need to identify the names of specific counterparties; however, it should disclose individually significant counterparties separately, and it may group all other counterparties into a single amount. Entities making this election still must present the information in items ASC 210-20-50-3(a) through (c) by type of instrument.

The amended guidance emphasizes the importance of reconciling the net amounts disclosed in item ASC 210-20-50-3 (c) to "the individual line item amount(s) presented in the statement of financial position." Such reconciliation must be disclosed regardless of the level of aggregation or disaggregation used for the disclosures. To facilitate reconciliation to line items in the statement of financial position, the offsetting guidance permits an entity to include in the tabular offsetting disclosures all other recognized derivatives accounted for in accordance with ASC 815 (including bifurcated embedded derivatives), repurchase and reverse repurchase agreements, and securities borrowing and lending transactions).

Under the amended guidance, entities must also track and disclose collateral that is not recognized on the face of the balance sheet. Although banking and securities companies monitor collateral at a granular level, because the gathering of this information does not typically reside within the financial reporting function, such information may be difficult to compile. Banking and securities companies will need to ensure not only that their disclosures comply with the requirements but also that adequate internal controls are established for gathering the information.

Considerations for Banking and Securities Companies

As noted above, complying with the new disclosure requirements may present operational and technical challenges for certain banking and securities companies. Such challenges may include the following:

- *Data gathering* — Banking and securities companies may have a variety of data-tracking systems, especially if they use multiple service providers. Companies may need to expend considerable effort gathering information related to instruments within the scope of the new disclosure requirements. Also, as a result of having to disclose both recognized and unrecognized collateral (including cash collateral), financial reporting departments may need to compile new information that has not been previously gathered.

Complying with the new disclosure requirements may present operational and technical challenges for certain banking and securities companies.

- *Ongoing tracking* — Some banking and securities companies' current financial reporting systems might not be equipped to closely track, on an ongoing basis, information about rights of setoff for instruments within the scope of the amended guidance that are executed under MNAs or similar agreements. Because of the frequency with which they will need to update and disclose such information under the requirements, companies must ensure that their financial reporting infrastructure allows them to adequately monitor and analyze this information.
- *Determining collateral value* — Many organizations have uniform pricing policies for their financial reporting. However, for many banking companies, a valuation determination made by using the company's collateral management systems may not incorporate those uniform pricing policies. The amended guidance requires disclosure of amounts related to financial collateral (including cash collateral). Therefore, when financial statements are produced, banking companies should ensure that the collateral is appropriately valued and consistent with their uniform pricing policies.
- *Additional time and resources* — Personnel in financial reporting departments need to familiarize themselves with the new disclosure requirements. Further, additional resources may be necessary because more information must be given to the independent auditor than under previous guidance.
- *Potential legal analysis* — Financial accounting personnel may not have the legal expertise needed to determine whether financial instruments are subject to an enforceable MNA (or similar arrangement).
- *Master clearing agreements* — ASC 210-20-50-1(d) states that recognized derivative instruments accounted for in accordance with ASC 815 that are "subject to an enforceable [MNA] or similar agreement" are subject to the disclosure requirements, regardless of whether they are actually offset in the statement of financial position. Banking and securities companies should analyze the features and provisions of their master clearing agreements (and other arrangements that cover instruments within the scope of the amended guidance) to determine whether those agreements are similar to an MNA and whether they are enforceable. Exchange-cleared contracts of the types specified in ASC 210-20-50-1 that are subject to a clearing agreement that is determined to be enforceable and similar to an MNA would be within the scope of the offsetting disclosure requirements.
- *One-sided MNAs* — In preparing their disclosures, banking and securities companies should consider whether their MNAs are "one sided." In a one-sided MNA, the counterparty rather than the reporting entity has the right of offset upon default, and the reporting entity lacks a mirror right. From the perspective of the reporting entity, because such arrangements are not MNAs, instruments subject to the arrangement would not be within the scope of the disclosure requirements.
- *Qualitative disclosures* — ASC 210-20-55-17 states that to enable financial statement users to determine the effect of netting arrangements on a company's financial statements, an "entity may need to supplement [its] disclosures with additional (qualitative) disclosures depending on the terms of the enforceable [MNAs] and related agreements, including the nature of the rights of setoff and their effect or potential effect on the entity's financial position." Companies that use multiple counterparties and have multiple MNAs (1) will need to consider that the MNAs may have been drafted at different times on the basis of various risks and legal environments and (2) should understand the differences between these agreements.
- *Internal controls* — Banking and securities companies may need to adjust their controls in connection with systems, data gathering, and ongoing tracking, as well as their reviews of such controls.

- *Interaction with other U.S. GAAP* — Other U.S. GAAP provisions may require banking and securities companies to disclose information about certain amounts offset in the statement of financial position as well as information about (1) related collateral (pledged or received) and (2) exposures to credit risk. Although those provisions may require the disclosure of similar information, banking and securities companies should not assume that they have satisfied the disclosure requirements under the amended offsetting guidance because there may be differences in scope.

Thinking Ahead

For all entities, the amended offsetting guidance is effective for fiscal years beginning on or after January 1, 2013, and interim periods within those annual periods. The guidance must be applied retrospectively for any period presented that begins before an entity's date of initial application. Banking and securities companies need to ensure that they are prepared to implement the new disclosure requirements in the first reporting period of 2013 as well as determine the qualitative information to disclose and where to incorporate it in their notes to the financial statements.

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