ISDA® Safe, Efficient Markets

April 28, 2011

Sir David Tweedie
IASB Chairman
1st Floor
30 Cannon Street
London
EC4M 6XH
United Kingdom

Ms. Susan M. Cosper
Director of Technical Application and Implementation Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: File Reference Number 2011-100, Proposed Accounting Standards Update, *Balance Sheet – Offsetting* and ED/2011/1 *Offsetting Financial Assets and Financial Liabilities*

Dear Sir David Tweedie and Ms. Cosper,

The International Swaps and Derivatives Association's (ISDA) Accounting Policy Committee[1] appreciates the opportunity to provide comments and observations on the Financial Accounting Standards Board's ("FASB") and International Accounting Standards Board's ("IASB") exposure draft on the offsetting of financial assets and financial liabilities (the "Exposure Draft"). This letter articulates our organization's overall views on the proposed offsetting principles within the Exposure Draft, communicates our comments and concerns regarding specific aspects of the Exposure Draft, and provides responses to the questions for respondents included in the Exposure Draft (the latter two items are summarized in Appendix I attached hereto).

We acknowledge the desire for convergence in the area of offsetting and commend the Boards for working jointly to develop a common set of offsetting principles. Accordingly, we believe that it is important that global financial institutions apply the same robust offsetting principles to facilitate investors' evaluation of relative balance sheet size, leverage, returns on investment, and overall financial condition, whether those organizations report under U.S. Generally Accepted Accounting Principles (U.S. GAAP) or International Financial Reporting Standards (IFRS). However, we do not believe that the proposed offsetting principles will result in an improvement to either U.S. GAAP or IFRS, and therefore,

[1] ISDA's Accounting Policy Committee members represent leading participants in the privately negotiated derivatives industry and include most of the world's major financial institutions, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. Collectively, the membership of ISDA has substantial professional expertise and practical experience addressing accounting policy issues with respect to financial instruments and specifically derivative financial instruments.

International Swaps and Derivatives Association, Inc.
360 Madison Avenue, 16th Floor
New York, NY 10017
P 212 901 6000 **F** 212 901 6001
www.isda.org

NEW YORK WASHINGTON
LONDON BRUSSELS
HONG KONG SINGAPORE
TOKYO

we would not support the Boards' chosen approach for achieving convergence. As discussed during our meetings with members of the FASB and IASB Boards during the outreach process, ISDA favors the current U.S. GAAP offsetting principles in ASC 210-20-45 and ASC 815-10-45 (formerly FASB Interpretations Nos. 39 and 41) and believes that the principles that underscore the aforesaid standards, in conjunction with adequate disclosures, provide the best reflection of an entity's solvency, and its exposure to credit and liquidity risk for both derivatives and repurchase agreements. Therefore, we strongly recommend that the Boards reconsider their decisions reached under the project and develop a set of principles that reflect the unique nature of derivative instruments which would provide a more meaningful balance sheet netting framework.

Key messages:

- The proposed principles within the Exposure Draft do not provide the most faithful representation of an entity's financial position, solvency, and its exposure to credit and liquidity risk, and will not improve the decision usefulness of financial statements. The balance sheet gross-up that results from application of the Exposure Draft's provisions will misrepresent and obscure the real economic risks of certain companies; especially those that operate in the financial services sector. Consequently, riskier financial assets that bear considerably more credit and liquidity risk (e.g., certain loans receivable, certain debt securities, etc.) may appear less significant in relation to balance sheets that are substantially larger in size due to the gross-up of derivatives and repurchase agreements (which, in many cases, are secured by cash collateral or similar security interests). We believe that the most effective method for transparently portraying the underlying risks (including credit, liquidity and market risks) associated with derivative and securities financing activities is through a combination of qualitative and quantitative disclosures.

- Individual derivative transactions that are subject to a single enforceable master netting agreement or its equivalent should be eligible for offsetting in the balance sheet on the basis that such financial statement presentation is most faithfully representative of an entity's resources and claims (and therefore provides the most decision useful information). The basis for our view is that, upon termination of transactions subject to a master netting arrangement, the individual derivative receivables do not represent resources to which general creditors have rights and individual derivative payables do not represent claims that are parri passu to the claims of general creditors. Upon termination of a contract by the nondefaulting party, derivative asset "resources" are unavailable to satisfy other claims; further, the net termination amount (including collateral amounts) under the Close Out Netting provisions of the ISDA Master Agreement is not subject to stay under bankruptcy laws which govern the most significant capital markets, unlike other claims. On a going concern basis, the presentation of derivative receivables and payables that are subject to a legally enforceable master netting arrangement on a gross basis is also misleading based on how the collateral arrangements that accompany master netting arrangements function. If the Boards retain the current offsetting proposals, we believe it is critical that the financial statement line item(s) that contains gross derivative assets presented on the balance sheet (or, at minimum, in the footnotes to the financial statements) contain cautionary language highlighting that a large portion of the assets within the balance sheet is not available to the general creditors, but instead only to derivative counterparties. Our views regarding the merits of a master netting arrangement are more fully articulated in our letter to the FASB and IASB dated November 15, 2010[2] as well as Appendix I of this letter.

[2] http://www.isda.org/speeches/comments2010.html

- The proposed definition of "simultaneous settlement" would require certain centrally cleared transactions to settle at the "same moment". As virtually none of the securities clearance systems in the global financial markets operate in a way that ensures that all transactions settle "at the same moment", as would be required in order to qualify for offsetting under the Exposure Draft, the proposal will significantly change practice under both current U.S. GAAP and IFRS with respect to repurchase agreements. We believe that the principle for when such transactions (i.e., those transacted through centrally cleared market mechanisms) can be offset in the statement of financial position should be grounded in risk management and legal rights and not a rule based on the passage of time. We therefore strongly recommend that the Boards develop a principle for "simultaneous settlement" that is grounded in the substantial elimination of credit and liquidity risk along with a right of offset, much like the principles in ASC 210-20-45 (formerly FIN 41) and the interpretation by many IFRS preparers of paragraph 48 of IAS 32.

- We disagree with the rules based, "one size fits all" requirements for how companies should account for collateral and variation margin that secures exchange traded, centrally cleared and bilateral over-the-counter derivatives. Given that variation margin transferred under many U.S. and European exchange-traded products (e.g., futures and listed options) is treated by the rules of many organized exchanges as settlement, we strongly recommend deletion of any specific reference to *exchange traded futures* in paragraph C14 of the Exposure Draft. We recommend that the Boards replace the language in paragraph C14 with principles that require the presentation of collateral to be the same as any other eligible assets or liabilities based on principles grounded in the usefulness of the information presented in the statement of financial position. In an era of unprecedented change in the over-the-counter derivatives market we believe that a principles-based approach for determining the accounting for collateral and variation margin would provide the most faithful representation of these arrangements as they continue to develop and evolve.

- ISDA is generally supportive of the netting of individual cash flows that arise under derivative instruments, but we believe that in most, if not all cases, net presentation of all of the related cash flows associated with the instruments would provide more useful information. If it is the Boards' intent that the offsetting criteria requirements are to apply to individual payments within a financial instrument, then this raises two concerns:
    1) Operationality - For reporting purposes, entities under U.S. GAAP generally net on the basis of the conditional closeout netting and not on the basis of whether the individual, contractually scheduled cash flows of two or more derivatives will be settled net (herein referred to as "payment netting"). Therefore systems and processes are not in place to perform this level of analysis. As the proposed offsetting principles would require an entity to offset payments that meet the netting criteria (versus simply making an accounting policy choice), the proposed guidance will give rise to significant operational challenges and would necessitate the implementation of significant changes to systems and data capture processes to thoroughly analyze all future cash payments between an entity and its counterparties. As such, the requirement to net certain individual payments arising under two or more derivatives raises complexities that should be addressed by the Boards through conducting further due process on this matter such as user and preparer outreach and field testing to determine the costs and benefits of such a requirement and/or to further clarify or refine the requirement.
    2) Application of proposed principles - Depending on the level at which the proposed offsetting guidance should be applied (the entire derivative asset or derivative liability or individual payments associated with a derivative asset or derivative liability), the proposed guidance could produce different financial statement results and, in certain

cases, could yield counterintuitive results (i.e., higher balance sheet amounts after netting than before netting, as illustrated in comment # 15 within Appendix I to this letter). Even if netting by contractually scheduled cash flow payment date is permitted, there are different possible interpretations of how to determine the **net amount** described in paragraph 6 of the Exposure Draft and thus different methods by which payments could set-off in the balance sheet. If the Boards are to maintain the approach set out in the Exposure Draft, we recommend that the Boards provide clarity as to how payment netting should be applied.

- We find that certain of the proposed disclosures are duplicative of those required by other U.S. GAAP standards or IFRS, reach beyond the intended scope of the project, and are in some cases, nonoperational. Specifically, we believe that the disclosures should focus on showing clearly and concisely the amounts netted in the balance sheet and should not attempt to show the credit risk exposure of certain asset balances, as this is addressed already by the disclosure requirements in ASC 310-10-50 for financing receivables. Moreover, the basis for how the disclosures improve the usefulness of financial statements is not adequately explained. Furthermore, in our view the preparation costs of these disclosures would far exceed the benefits derived.

- Regarding the effective date and transition, in ISDA's view, if the final standard substantially reflects the proposals included in the Exposure Draft, our members would need at least two to three years from the end of the calendar year in which the final standard is issued (i.e., no earlier than January 1, 2015) to evaluate the impact of the Exposure Draft on processes, systems and the financial statements, and prepare for and implement the necessary changes needed to comply with the new guidance. If the final standard substantially reflects the Exposure Draft we would not support retroactive application as it is our view that there is limited usefulness in providing comparative information for standards that only impact an entity's statement of financial position, such is the case with offsetting, further supported by the fact that information regarding an entity's gross derivative positions is already available in financial statement footnotes under U.S. GAAP (and to some degree IFRS). If, however, the Boards agree to converge their offsetting standard based on current U.S. GAAP netting principles, and limit the scope of the proposed disclosures such that they apply only to financial instruments where an entity has the intent to offset (and do not require the disclosure of CVA and DVA by each class of instrument), we would likely be able to implement the proposed changes within a relatively short period (e.g., one to two years from the end of the calendar year in which the final standard is issued), and further, we would not object to the proposed transition guidance.

- Paragraphs C2, C7 and C9 of the Exposure Draft would appear to permit netting of individual payments across contracts. However, paragraphs BC 52 and BC 53 within the Basis for Conclusions suggest that the Boards intend for the proposed offsetting criteria to be applied at the unit of account/instrument level, and therefore in order for an entity to demonstrate its intention to net settle, a financial asset and a financial liability must have the same maturity date and same payment dates. If the offsetting criteria are to be applied at the instrument level, the proposed netting framework will have the following impact:
    a. Prohibit the netting of selected payments within a single derivative transaction and across financial instruments with the same counterparty where some but not all of the cash flows occur on the same date, and
    b. Prohibit the netting of most centrally-cleared derivatives which would represent a significant change to current U.S. GAAP and IFRS practices and make entities appear to be exposed to increased risk via the grossing up of derivatives on the balance sheet even though they have economically reduced their exposure to liquidity and credit risk.

If the Boards intend to require that financial instruments have the same maturity and payment dates in order to be offset in the balance sheet, we urge the Boards to reconsider their proposal and build a netting principle that is focused on the reduction of liquidity and credit risk— rather than rules—so that the reporting of financial instrument transactions in the balance sheet reflects the true economic risks to which the reporting entity is exposed. If the Boards reject our recommendation, we strongly urge the Boards to clearly articulate their full intentions in the body of the standard rather than in the basis for conclusions.

- For our members that prepare U.S. GAAP financial statements, the elimination of broker-dealer industry practices in ASC Topic 940 regarding netting of receivables and payables related to unsettled regular-way securities transactions represents a significant change in accounting practice and will (i) give rise to significant costs to create systems/processes to identify transaction counterparties prior to settlement date and apply the Exposure Draft's proposed provisions to each counterparty transaction, and (ii) produce a financial statement result that is no better (i.e., no more decision useful) than permitting brokers and dealers of securities to net brokerage payables and receivables. Given that the time period between trade date and settlement date is very brief (typically two to three days), the fact that settlement with the securities clearing organizations in most major markets occurs on a net basis, and the fact that securities brokers and dealers have robust controls in place to identify and account for failed trades (which are presented gross in the statement of financial position), we see little benefit in requiring entities to apply the proposed offsetting criteria to the individual transactions that underlie the brokerage payables and receivables (which in certain periods can exceed thousands of transactions at any given balance sheet date).

In Appendix I attached hereto, we have provided ISDA's specific comments on the Exposure Draft's provisions. We hope you find ISDA's comments informative and useful. Should you have any questions or desire further clarification on any of the matters discussed in this letter, please do not hesitate to contact the undersigned.

Daniel Palomaki

Daniel Palomaki
Citigroup
Chair, N.A. Accounting Policy Committee
International Swaps and Derivatives Association
212 816 0572

Tom Wise
HSBC
Chair, European Accounting Policy Committee
International Swaps and Derivatives Association
44 20 7991 9480

Appendix I

1. Offsetting Principles – General

We acknowledge the desire for convergence in the area of offsetting and commend the Boards for working jointly to develop a common set of offsetting principles. However, we do not believe that the proposed principles will result in an improvement to financial reporting under U.S. GAAP or IFRS. ISDA continues to be supportive of the current U.S. GAAP offsetting principles in ASC Topic 210-20-45 and ASC Topic 815-10-45 (formerly FIN 39 and FIN 41) and believes that the principles that underscore those standards, in conjunction with adequate disclosures, provide the best reflection of an entity's credit, liquidity, and solvency risk for both derivatives and repurchase agreements. ISDA is of the view that current U.S. GAAP netting:

- Is the best reflection of a company's credit, liquidity and solvency risk,
- Has been thoroughly tested throughout the economic cycle,
- Provides users of financial statements (i.e., investors, creditors, lenders and other stakeholders) meaningful balance sheet figures to understand better how derivatives are transacted and reported.

As there was no clear consensus among financial statement users as to whether gross or net presentation is more useful, we must question whether the proposal would meet the needs of users who do support offsetting and whether there is sufficient justification to abandon the current U.S. GAAP model which has been tested during one of the most severe global economic crises in recent history. If the Boards do not agree to converge based on the current U.S. GAAP offsetting model, we would support convergence based on one of the two following alternatives (in their stated order of priority):

1) Develop an offsetting model that is based on the current offsetting principles in U.S. GAAP and IFRS for certain types of financial instruments. ISDA would support a model that would require netting:
    a. For all collateralized (bilateral over-the-counter, exchange traded, and centrally cleared) derivatives in cases where there is daily posting of cash collateral/variation margin and the right to offset the derivative positions and cash collateral is legally enforceable (in the event of an early termination event such as bankruptcy), and
    b. For all other contracts only in situations where the criteria in current IFRS (as commonly interpreted) are met.

    The principle underpinning this approach would be based on the reduction of the counterparty's exposure to credit risk and liquidity risk through the posting of high-credit quality and liquid collateral/margin. Under this model, the substance of the collateral/margin procedures would drive the presentation in the statement of financial position.

2) Develop an offsetting model based on the concepts of linked presentation: ISDA would support the adoption of a converged offsetting model that requires linked presentation for derivatives and repurchase agreements where credit and liquidity risk are managed on a net counterparty basis (and would, at minimum, intend to settle net upon default of the counterparty).

Under this model, an entity would identify groups of derivative instruments and repurchase agreements where there is a conditional or unconditional legally enforceable right to offset by counterparty and present those financial instruments in the statement of financial position based on the net carrying value of the instruments (either within assets or liabilities) with display of both 1) the gross amount of assets and liabilities and 2) the net amount. The net amount would be aggregated based on other relevant accounting guidance for the transactions. The netting of all other financial instruments would be subject to the principles in current IFRS. We believe that the linked presentation model would serve as a compromise to both Boards' existing financial instruments netting standards and would meet all financial statement users' needs.

2. Offsetting Principles – Inconsistency with the Conceptual Framework

The basis for conclusions in the Exposure Draft offers the following principles regarding assets and liabilities:

BC8. It is a general principle of financial reporting that (a) assets and liabilities are reported separately from each other consistently with their characteristics as resources or obligations of the entity and (b) offsetting of recognized assets and recognized liabilities detracts from the ability of users both to understand the transactions, other events, and conditions that have occurred and to assess the entity's future cash flows.

BC14. Thus, the objective of financial reporting necessitates the providing of information in the statement of financial position about the economic resources of the entity (its assets) and the claims on those resources (its liabilities and equity).

BC15. Generally, presenting assets and liabilities net limits the ability of users of financial statements to assess the future economic benefits available to, and obligations of, the entity and their ability to assess the entity's financial strengths and weaknesses.

We agree that the financial statements should reflect an entity's economic resources and claims on those resources. For derivative transactions that are executed under a master netting arrangement we believe it is important to highlight that the master netting agreement and all transactions executed there under form a single legal agreement. When a new derivative transaction is executed, it modifies the entire agreement between the parties rather than forming a separate contract. If a default under the contract occurs, only a single amount will be due (equivalent to the net exposure that exists for all transactions between the parties that were executed under the master netting arrangement) and settlement will reflect that net amount.

Inherent in the Boards' view is the assumption that derivative receivables represent resources available to creditors other than derivative counterparties, and that derivative payables represent claims that are parri passu to those of other creditors. However, upon termination of transactions subject to a master netting arrangement, the individual derivative receivables do not represent resources to which general creditors have rights and individual derivative payables do not represent claims that are parri passu to the claims of general creditors. Upon termination of a contract by the nondefaulting party, derivative asset "resources" are unavailable to satisfy other claims; further, the net termination amount (including collateral amounts) under the Close Out Netting provisions of the ISDA Master Netting Agreement is not subject to stay under bankruptcy laws which govern the most significant capital markets, unlike other claims. Therefore, reporting derivative assets on a gross basis rather than on a net basis would mislead users of financial statements by overstating the economic resources of the entity. On a going concern basis, gross presentation would also be an overstatement of the economic resources of an entity, given collateral agreements and settlement processes provide that derivative cash settlements are returned the next day as collateral, and therefore, are not available to the creditors of the entity.

Based on the foregoing there is a compelling argument that net presentation of all derivative transactions executed under enforceable master netting arrangements is more faithfully representative and provides better information about an entity's solvency, credit and liquidity risk than presenting the individual transactions executed under those arrangements as individual assets or liabilities in the balance sheet on a gross basis.

3. Offsetting Principles – Usefulness

In light of the Boards' collective research revealing that there is no consensus amongst financial statement users as to whether net or gross presentation is more useful, we question the Boards' decision to favor a model that in our view impairs the usefulness of the financial statements while raising significant cost-benefit concerns. As stated in comment #2 above, derivatives transacted under master netting arrangements do not represent both resources and claims on those resources, but rather one net asset or liability. The gross derivative receivables transacted under a master netting arrangement are not available to general creditors in bankruptcy; rather a net amount would be available after offsetting derivative payables. We also disagree with the basis on which the Boards' reached their conclusion for choosing the principles that underscore the Exposure Draft. Paragraphs BC 17 and BC 18 provide:

> "BC 17 The Boards believe that offsetting of an eligible asset and an eligible liability in the statement of financial position is consistent with the objective of financial reporting only if on the basis of rights and obligations associated with an eligible asset and an eligible liability, the entity has, in effect, a right to or an obligation for only the net amount (that is, the entity has, in effect, a single net eligible asset or eligible liability)."

> "BC 18 The Boards believe that the net amount represents the entity's right or obligation if (a) the entity has the ability to insist on a net settlement or enforce net settlement in all situations (that is, the exercise of that right is not contingent on a future event), (b) that ability is assured, and **(c) the entity intends to receive or pay a single amount, or to settle the asset and liability simultaneous** [emphasis added]."

We do not agree with the Board's basis principally as it relates to over-the-counter (bilateral and centrally cleared) derivatives which represent the present value of future expected cash flows. Most master netting arrangements typically permit the parties to net payments on derivatives in the ordinary course when they coincide, and in many cases where systems and processes are set up in a way that permits net settlement, it is consummated in practice. If net settlement does not occur in the ordinary course it generally is due to the incompatibility of settlement and clearance systems, not intention. Additionally, fully collateralized derivatives are in effect settled each day on a net basis. Take the following example:

- Assume Bank A has a derivative receivable of $100 due in 10 years from Bank B and a derivative payable owed to Bank B of $30 due tomorrow. Bank A has cash collateral of $70 (its net receivable) paid by Bank B.
- When Bank A makes a payment of $30 to settle the payable tomorrow, Bank B will be required to immediately (typically, either later the same day or the following day) return $30 to post cash collateral on the open receivable balance of what is now $100.

- Bank A's liquidity risk is limited to the period between the settlement payment being made and the receipt of the resulting collateral call occurring on the same or following day.

In this example, we believe the gross movement of cash occurring over the course of one day results in minimal liquidity risk. Importantly, there is not a 10-year mismatch on the timing of cash flows related to the two illustrative derivative trades. The fact that the receivable and payable balances net to an asset of $70 does not obscure liquidity or credit risk when the net asset is collateralized. On the other hand, gross presentation of Bank A's $100 receivable due from Bank B would not faithfully reflect its "resources" because in the ordinary course, Bank A will ultimately receive $70 from Bank B and in the bankruptcy of Bank B, Bank A would only have a claim for a net $70.

Gross balance sheet presentation of the derivative receivable and payable would not capture the nominal inter-day liquidity risk, because Bank A would replace the initial derivative payable of $30 with a $30 payable to return collateral (for the incremental collateral received the next day against the $100 derivative asset) during the period between the collateral being called and received. This example demonstrates that, for secured derivatives, daily liquidity risk is driven by the cash collateral requirements which are calculated on a net basis, not a gross basis. Economically and from a credit and liquidity risk perspective, such derivatives are very similar to centrally-cleared derivatives that result in a single, daily cash flow that reflects changes in the overall net position of the derivative portfolio.

Overall, the balance sheet gross-up that will result from application of the Exposure Draft's provisions will distort and obscure the real economic risks of certain companies, including those in the financial services sector. Consequently, riskier financial assets held by these companies that bear considerably more credit and liquidity risk (e.g., certain loans receivable, certain debt securities, etc.) may appear less significant in relation to balance sheets that are double in size because of derivatives and repurchase agreement gross-ups (which, in many cases, are secured by collateral or similar security interests). We question how this result makes financial statements more useful.

4. Simultaneous Settlement

The proposed definition of "simultaneous" in the Exposure Draft as it relates to repurchase and reverse repurchase agreements represents a reversion from a "principle" in U.S. GAAP and IFRS that is based on minimizing credit and liquidity risk (which many practitioners believe paragraph 48 of IAS 32 reflected) to a "rule" based on the amount of time that has elapsed between settlement of two or more transactions. We understand that it was not the Boards' intent to fundamentally change the netting principles of IFRS. Many repurchase agreements and reverse repurchase agreements settle based on a batch process whereby positions that settle on a given day will be processed at different points during the day. For instance, an entity's net receivable may result in the anticipated receipt of cash at 10:00 a.m. and the anticipated requirement to make payment of cash at 2:00 p.m. on the same day. Based on the form of settlement in this example (slightly different timing based on systematic/administrative limitations), the proposed guidance would preclude the net presentation of the morning's receivable with the afternoon's payable. The proposed principles do not reflect how settlement systems in the capital markets operate and would result in a significant change in accounting practice merely based on the "form" of settlement (i.e., focusing on logistical or inconsequential timing differences) as compared to the substance of inter-day settlements where adequate credit and liquidity risk protection measures are in place such as daylight overdraft protection, lines of credit, and excess collateralization.

In developing the principles of simultaneous settlement, we strongly recommend that the Boards incorporate the principles currently found in U.S. GAAP under FIN 41 which is widely accepted as a reasonable approach to determining whether to present gross or net. Many preparers under current IFRS consider the criteria of FIN 41[3] to determine the appropriate accounting treatment of repurchase agreements. In the basis for conclusions of FIN 41, the FASB previously reached a determination that the clearing and settlement mechanisms described therein constituted the "functional equivalent" of net settlement. Under current U.S. GAAP and IFRS, those who support the principles of FIN 41 generally reference the language in IAS 32.48 which permits offsetting in the context of clearing and settlement arrangements that result in an economic outcome which is "in effect equivalent to a single net amount" based on the fact that settlement mechanisms result in "no exposure to credit or liquidity risk." If the Boards incorporated the principles underpinning FIN 41, the batch settlement of repurchase agreements would not contravene the "simultaneous" settlement criteria.

5. Collateral and Variation Margin

Another area of concern we have is the Exposure Draft's characterization of variation margin posted under collateralized derivatives. Paragraph C14 of the Exposure Draft states that:

> "Many financial instruments, such as interest rate swap contracts, futures contracts, and exchange-traded written options, require margin accounts. Margin accounts are a form of collateral for the counterparty or clearing house and may take the form of cash, securities or other specified assets, typically liquid assets. **Margin accounts are assets or liabilities that are accounted for separately** [emphasis added]… An entity shall not offset, in the statement of financial position, recognized eligible assets and eligible liabilities with assets pledged as collateral or the right to reclaim collateral pledged or the obligation to return collateral sold."

ISDA is concerned with the broad generalization that variation margin is collateral and therefore the obligation to return collateral or right to receive cash collateral must be recognized separate from the related derivative receivable or payable. Our interpretation of paragraph C14 of the Exposure Draft is that variation margin that does not legally represent settlement of the derivative transactions would not be eligible for offsetting against derivatives and, therefore, would need to be displayed gross in the balance sheet.

For most exchange-traded derivatives (e.g., exchange-traded futures and listed options), daily margin payments legally serve to settle the change in the value of the derivative contracts, so the offset of the fair value of the derivative contracts and the cash margin should not be an area of debate. As such we strongly recommend that any specific reference to exchange traded futures in paragraph C14 of the Exposure Draft be deleted. However, the procedures for the calling and use of cash collateral on centrally cleared derivative contracts vary, depending on the clearing house and contract. In some

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[3] FIN 41.3.

a. The repurchase and reverse repurchase agreements are executed with the same counterparty.
b. The repurchase and reverse repurchase agreements have the same explicit settlement date specified at the inception of the agreement.
c. The repurchase and reverse repurchase agreements are executed in accordance with a master netting arrangement.
d. The securities underlying the repurchase and reverse repurchase agreements exist in "book entry" form and can be transferred only by means of entries in the records of the transfer system operator or securities custodian.
e. The repurchase and reverse repurchase agreements will be settled on a securities transfer system that operates in the manner described in paragraph 4, and the enterprise must have associated banking arrangements in place as described in paragraph 4. Cash settlements for securities transferred are made under established banking arrangements that provide that the enterprise will need available cash on deposit only for any net amounts that are due at the end of the business day. It must be probable that the associated banking arrangements will provide sufficient daylight overdraft or other intraday credit at the settlement date for each of the parties.

cases, cash collateral is called by the clearing house and will be returned when the contract matures or is closed out (such as initial margin in the form of cash). As there is no intention to settle the derivatives with the collateral, they would not be eligible for offset under IAS 32.

However, there are also arrangements where daily (or intra-day) cash margin is called by, or paid by, the clearing house, based on the net present value of future derivative cash flows, and this cash collateral is used to settle the cash flows arising on the derivatives when they contractually fall due. There will be no cash collateral left to return when the derivatives mature or are closed out. In these cases there is both an unconditional right and intention to settle the derivatives with the collateral, and so they are normally offset under IAS 32. For such contracts, cash collateral is calculated for a portfolio of derivatives and so the practice is to offset the fair values of the portfolio of derivatives and the cash collateral, even though the cash flows on the derivatives may be contractually due to be paid or received on different dates. Absent a further change in market prices (which will lead to further margin calls) and ignoring the effect of time (as margin calls are based on net present values), no further cash will be paid to, or by, the parties (the reporting entity and clearing house).

Given the nature of how an entity's derivatives transacted through a clearing house are settled, variation margin (in the form of cash) is, in effect, an advance payment for settlement of cash flows arising from the derivatives. ISDA is therefore of the view that, where cash variation margin is not legal-form settlement, variation margin transferred to a clearing house is in-substance a form of settlement of the member's net derivative position and, therefore, believe the accounting for such variation margin should be based on its substance. Furthermore, we cannot see a basis for applying different netting rules to collateral payable and receivable balances. They are financial assets and liabilities and so should be subject to the same netting requirements as the other financial assets and liabilities that arise under the contracts to which they relate.

6. Disclosures – Scope

There are several questions and areas of concern that we have with respect to the proposed disclosure requirements. The guidance in paragraph C18 of the Exposure Draft discusses the disclosure of cash collateral and non-cash financial instruments pledged as collateral. Also, the illustrative example demonstrating the tabular format of disclosures includes columns for cash collateral and non-cash collateral (including collateral that would not be recognized in the statement of financial position). It is not clear whether nonfinancial instrument collateral (e.g., residential real estate) is to be included in the disclosures. If so, we recommend the Boards explicitly state so and cite the basis for why this information is useful and necessary.

7. Disclosures – Operationality

ISDA finds that the scope of the proposed disclosure requirements is too far reaching and goes beyond the intended scope of the project. We question whether all eligible financial assets and financial liabilities should be included in the footnote disclosure as some classes of financial instruments, while they may potentially provide for netting in certain remote conditions (or financial instruments for which an entity has no intention to net), will likely be presented gross in all cases under the proposed guidance (i.e., loans at amortized cost). Also, the requirement to identify and quantify the amount of non-derivative financial assets and financial liabilities that are presented gross yet have a conditional right to offset would be onerous and costly to preparers with little benefit to users. We have significant concerns that the expansiveness of disclosure requirements would be costly to implement and that the costs have not been adequately justified.

8. Disclosures – Usefulness

The majority of the proposed disclosure requirements require the presentation of information that is already required elsewhere in U.S. GAAP and IFRS. Paragraph 12 of the Exposure Draft requires disclosure, in a single footnote, of financial assets and financial liabilities that are both presented net in the statement of financial position and presented gross in the statement of financial position and which are subject to collateral and other similar arrangements. Much of the information required by the proposed disclosures is required in U.S. GAAP (e.g., ASC Topics 815 and 860), Management's Discussion and Analysis (for SEC registrants), and IFRS 7 (credit risk disclosures). With regard to U.S. GAAP, we believe there is substantial transparent disclosure provided in ASC Topic 815 (formerly SFAS 161) regarding an entity's gross derivative exposures, by primary underlying risk. As footnotes are an integral component of the financial statements, we contend that the information required by ASC Topic 815 should be sufficient to meet users' needs (since the basis for users requesting this information under SFAS 161 was to better understand the effect of derivatives on an entity's financial position). We also find the proposed disclosure requirements duplicative as it relates to providing information about the credit quality of financial assets as this information is already required to be disclosed under current U.S. GAAP and IFRS.

One of the proposed disclosure requirements within the Exposure Draft is the disclosure of CVA and DVA by each class of financial instrument (as defined in the Exposure Draft). We are not sure of the relevance of a fair value measurements disclosure embedded in a footnote regarding the financial assets and financial liabilities that are subject to offsetting. Aside from being, in part, duplicative of current fair value measurements disclosures, we question the relevance and usefulness of including CVA and DVA in the offsetting disclosure requirements. It is unclear from the Exposure Draft's basis for conclusions how an allocation of CVA and DVA by each class of financial instrument will provide insightful information to financial statement users. Moreover, the costs of determining the CVA and DVA attributable to each class of financial instrument would be significant as preparers, and their respective systems, currently allocate CVA and DVA by counterparty. If the Boards regard such disclosure as a potential improvement to financial reporting, we request that the Board's make the rationale clear in their basis for conclusions.

Lastly, should the Exposure Draft be issued as drafted we recommend that the following deletions to the U.S. GAAP accounting standards codification (ASC Topic 815-10-50-8) be made so that these disclosures do not result in redundancy. [Text deleted is stricken]

~~50-8 A reporting entity shall disclose the amounts recognized at the end of each reporting period for the right to reclaim cash collateral or the obligation to return cash collateral as follows:~~

~~a. A reporting entity that has made an accounting policy decision to offset fair value amounts shall separately disclose amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral that have been offset against net derivative positions in accordance with paragraph 815-10-45-5.~~
~~b. A reporting entity shall separately disclose amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral under master netting arrangements that have not been offset against net derivative instrument positions.~~
~~c. A reporting entity that has made an accounting policy decision to not offset fair value amounts shall separately disclose the amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral under master netting arrangements.~~

9. Cost-Benefit

A cost-benefit justification is generally documented in exposure drafts and final standards; however, no such section exists for the Offsetting Exposure Draft, resulting in the appearance that a thorough justification has not been provided. We note that Section II. D of the FASB Rules and Procedures states that the FASB "issue(s) standards only when the expected benefits exceed the perceived costs." Based on this important consideration which the Boards acknowledge, we believe the following consequences of the Exposure Draft should be further considered and the resulting costs-benefit analysis should be properly documented in the final standard (should the Boards decide to move forward with the proposal as drafted):

- The significant need for change in U.S. GAAP provided by the Exposure Draft and the determination that gross presentation is preferred by a majority of users,
- Operational costs incurred by certain preparers to assess each asset and liability that is eligible for netting and required to be netted,
- Potential significant regulatory costs incurred by certain preparers that may include increased regulatory capital requirements and limitations on certain standard business activities, the costs of which may be passed onto end users of these instruments,
- Significant taxes incurred by certain preparers in certain jurisdictions may, in lieu of net income, be based on the size of the balance sheet. Because the Exposure Draft will result in a dramatic increase in balance sheet footings for certain firms, there may be significant increases in taxes paid, despite there being no change in economics, and
- Operational costs incurred by certain preparers to modify information systems (if the Exposure Draft's proposed provisions would need to be applied to individual offsetting payments associated with financial assets and liabilities and brokerage payables and receivables arising from unsettled regular way trades, which is not being done today in practice).

10. Effective Date and Transition

In ISDA's view, if the final standard substantially reflects the proposals included in the Exposure Draft, our members would need at least two to three years from the end of the calendar year in which the final standard is issued (i.e., no earlier than January 1, 2015) to evaluate the impact of the Exposure Draft on processes, systems and the financial statements, and prepare for and implement the necessary changes needed to comply with the new guidance. Additionally, we would not support retroactive application as it is our view that there is limited usefulness in providing comparative information for standards that only impact an entity's statement of financial position, such is the case with offsetting, further supported by the fact that information regarding an entity's gross derivative positions is available in financial statement footnotes under U.S. GAAP (and to some degree IFRS). As such, we would recommend that transition only be applied prospectively in the initial period of adoption. If, however, the Boards agree to converge their offsetting standard based on the current U.S. GAAP netting principles, and limit the scope of the proposed disclosures such that they apply only to financial instruments where an entity has the intent to offset, we would likely be able to implement the proposed changes within a relatively short period (e.g., one to two years from the end of the calendar year in which the final standard is issued), and further, we would not object to the proposed transition guidance.

11. Offsetting Criteria – Unit of Account

Paragraphs C2, C7 and C9 of the Exposure Draft would appear to permit netting of individual payments across contracts. However, paragraphs BC 52 and BC 53 within the Basis for Conclusions suggest that the Boards intend for the proposed offsetting criteria to be applied at the unit of account/instrument level, and therefore in order for an entity to demonstrate its intention to net settle, a financial asset and a financial liability must have the same maturity date and same payment dates. If the offsetting criteria are to be applied at the instrument level, this will have the following impact:

a. Prohibit the netting of selected payments within a single derivative transaction and across financial instruments with the same counterparty where some but not all of the cash flows occur on the same date, and
b. Prohibit the netting of most centrally-cleared derivatives which would represent a significant change to current U.S. GAAP and IFRS practices and make entities appear to be exposed to increased risk via the grossing up of derivatives on the balance sheet even though they have economically reduced their exposure to liquidity and credit risk.

Application to exchange-traded and centrally-cleared derivatives

Paragraph C7 of the Exposure Draft provides, "To offset an eligible asset and an eligible liability in the statement of financial position, an entity must have an intention to settle net or settle simultaneously the eligible asset and eligible liability. **An entity's intention to settle net or settle simultaneously may be demonstrated through its past practice of executing setoff** [emphasis added] or simultaneous settlement in similar situations, its usual operating practices, or by reference to the entity's documented risk management policies." and paragraph C9 provides, "Also, in a centrally cleared financial market with a central counterparty, **the rules of the clearing house typically provide for automatic netting and cancellation of offsetting contracts. For such contractual arrangements, the entity's intention is considered to have been demonstrated at the date of entering into the contracts** [emphasis added]."

On the other hand, paragraphs BC 52 and BC 53 of the Exposure Draft appear to override the principles articulated in paragraphs C7 and C9 as they provide, "The Boards considered whether two instruments should be required to be offset if the instruments have the same contractual maturity or the asset settles before the liability. This criterion is aimed at preventing a situation in which an entity makes the required payment (for a liability) but is unable to obtain payment from the counterparty for its asset at a later time. The Boards noted that this criteria is useful, however, **the requirement for an entity to demonstrate its intention to settle net or settle simultaneously to qualify for offsetting addressed that concern. The Boards regard this requirement as redundant** [emphasis added]."

While literal application of paragraphs C7 and C9 to exchange-traded and centrally-cleared derivatives would lead to a conclusion that the proposed offsetting conditions are met (assuming the right to offset is legally enforceable), the presence of paragraphs BC 52 and BC 53 raise concerns that offsetting of exchange-traded and centrally cleared-derivatives with different maturities and payment dates would be prohibited. However, our discussions with certain Board members during the FASB and IASB's respective outreach meetings suggest that this may not be the case.

It is common for members of an exchange or clearing house to transact and clear multiple derivatives with the same underlying but with different payment dates and tenors. Take for example an entity that transacts four individual over-the-counter LIBOR-based interest rate swaps with a clearing house: two pay fixed, receive 3 month LIBOR with three and five year maturities and two pay 1 month LIBOR, receive fixed with seven and ten year maturities. Many over-the-counter derivative clearinghouses would require initial margin based on their rules of operation (which is generally in the form of a performance bond calculated as an estimate of the potential variability of a clearing member's overall portfolio; generally unrelated to and segregated from the daily P&L associated with the transactions comprising the entity's net position) and require the clearing member to transfer ongoing (daily or sometimes intra-day) variation margin in the form of cash, based on the fair value of the member's net derivative position (inclusive of any scheduled coupons on any of the swaps included in the member's net open position). The clearing house will settle once (or more times) per day based on the member's net open position—irrespective of whether the payment dates or tenors of the individual swaps match. It is commonly understood that the right to settle a member's net open position for certain large U.S. and European-based clearinghouses is legally enforceable. As discussed in comment # 5 above, absent a further change in market prices (which will lead to further margin calls) and ignoring the effect of time (as margin calls are based on net present values), no further cash will be paid to, or by, the clearing house.

Without further clarification of the Boards' intentions with respect to how the offsetting criteria should be applied (either at the individual cash flow level or unit of account level) or the full elimination of paragraphs BC 52 and BC 53, we believe that practitioners/auditors/regulators may conclude that the cash flow payment dates and maturity dates of all cash flows that make up two or more financial instruments must be the same in order to qualify for offsetting. Therefore, the proposed rules may preclude the offsetting of substantially all centrally-cleared derivatives, yielding significant unintended consequences and producing a counterintuitive financial reporting result (especially given that recent U.S.–based legislation will mandate an increased level of central clearing for over-the-counter derivatives in an effort to reduce systemic risk in the capital markets). As such, we strongly encourage the final standard to explicitly permit offsetting of derivative transactions where daily variation margin occurs and provides the functional equivalent of net settlement as discussed in paragraph C7 of the Exposure Draft.

We therefore urge the Boards to reconsider their proposal and build a netting principle that is focused on the reduction of liquidity and credit risk so that the reporting of certain financial instrument transactions is reflective of their true economic risks. Additionally, the use of a principle that is consistent with how market participants manage risk will increase the likelihood that the standard is relevant and can be consistently applied as markets develop and evolve. If the Boards reject our recommendation, we strongly urge the Boards to incorporate the additional conditions of paragraphs BC52 and BC53 into the body of the standard rather in the basis for conclusions so preparers can easily understand the rules and how they should be applied.

12. Definition of "Unconditional"

ISDA has concerns over the strict requirement that the right to set off must be unconditional. While we understand the Boards' intent, we believe that there are situations, however remote, that could potentially make any unconditional right, conditional. For instance, a change in law or force majeure event may preclude the net settlement of a financial asset and a financial liability. There are also application issues that must be addressed such as a situation in which an entity has the legally enforceable ability and intent to settle a financial asset with a financial liability net but the counterparty has the right to early terminate one or both contracts. The area of ambiguity is whether such a contract would meet the "unconditional" criteria from the outset given that there was no certainty that both contracts would remain outstanding until maturity.

We therefore strongly recommend that the Board modify the unconditional criteria to require consideration of only realistic/reasonable contingencies (versus those that are remote) so that offsetting of financial assets and financial liabilities is not precluded due to the possibility that a highly remote contingency may occur during the life of the financial instruments.

13. Brokerage Receivables and Payables[4]

The Exposure Draft would eliminate the U.S. GAAP industry practice of offsetting brokerage receivables and payables arising from unsettled regular-way securities trades. Removing the existing industry guidance regarding the offsetting of unsettled regular-way trades would significantly increase the amount of operational efforts and costs to identify individual trading counterparties at each balance sheet date and apply the Exposure Draft's provisions. We believe that this outcome yields little to no financial reporting benefits and have doubts whether this information would be useful to financial statement users. As this proposed change to U.S. GAAP was not deliberated publically we question whether sufficient due process was performed on this issue. Additionally, the cost of this proposal to U.S. GAAP preparers has not been adequately justified.

Brokers and dealers of securities use clearing organizations to reduce risk in the capital markets. Brokers and dealers typically settle all transactions with a particular clearing organization once per day on a net basis. Because of the volume of transactions involved and the electronic medium by which trades are transmitted, the trading counterparty in a regular-way securities trade is not readily known until the transactions settle (or fail, in which case the trades are reported gross), which typically occurs within a very short period of time (typically within two to three days of the trade date). In order to apply the proposed offsetting requirements to regular-way securities trades, brokers and dealers of securities would need to use hindsight to analyze trades that settled to identify the counterparty and then determine whether the right of offset under the arrangement with that counterparty is legally enforceable. It is unclear whether this analysis is technologically feasible at a reasonable cost.

Almost all regular-way transactions involving securities are settled without issue on the settlement date, and therefore a limited number of trades fail, thus resulting in the transfer of title of the financial asset from the seller to the buyer and the remittance of cash from the buyer to the seller. In some financial markets payment is, in effect, guaranteed after trade date by the clearing organization based on the strength of its credit standing. In practice, brokers and dealers rely on controls to identify failed trades upon settlement (which are presented gross) prior to the reporting of interim and annual financial statements thus eliminating any perceived risk that brokerage receivables and trade payables may be improperly presented net.

We therefore recommend that existing U.S. GAAP industry guidance be retained to permit the netting of brokerage payables and receivables in the financial statements of brokers and dealers of securities that transact regular-way trades as a core business activity. The basis for retaining this guidance would be based on the cost benefit test that would not be met should the FASB require brokers and dealers of securities to apply the proposed offsetting guidance within the Exposure Draft to the payables and receivables due to/from trading counterparties. Moreover, the proposed change is not compelling when considering the very short period of time between trade date and settlement date for these transactions and the insignificant amount of risk associated with transactions not settling. Lastly, we find it curious that, absent a scope exception in ASC Topic 815 for regular-way securities trades, the amounts recorded in the financial statements under derivative guidance would be significantly smaller than the gross amounts after this amendment and have the effect of derecognizing long positions (only the change in present value would be recorded). A similar outcome under IFRS would result should an entity elect to recognize regular-way securities trades on

[4] This comment is applicable only to ISDA's members that report under U.S. GAAP

a settlement date basis. As such, we strongly recommend that the FASB consider the merits of removing this guidance in light of other appropriate industry specific guidance it has provided in U.S. GAAP and the "election" provided under IFRS to report on a settlement date basis.

14. Payment Netting – Operationality

Paragraph C2 provides that an entity shall set-off in the statement of financial position all or a portion of a financial asset and financial liability for which the offsetting requirements in paragraph 6 are met only in relation to some of the cash flows of the financial asset and financial liability. Assuming payment netting across two or more financial assets and financial liabilities is permitted, ISDA interprets the aforementioned proposed guidance as requiring netting of scheduled payments under two or more contracts executed between the same parties (for example, netting the payments under a 5 year interest rate swap against the payments due during the first 5 years of a 10 year interest rate swap). While payment netting (as contemplated in paragraph C9) occurs in practice, there is also a provision generally within a master netting arrangement that provides for closeout netting upon (i) default and (ii) an election to terminate by the non-defaulting party. Generally for reporting purposes, entities may net on the basis of the conditional closeout netting and not on the basis of payment netting. Therefore systems and processes are not in place to perform this level of analysis.

As the proposed offsetting principles would require an entity to offset payments that meet the netting criteria (versus simply making an accounting policy choice), the proposed guidance will give rise to significant operational challenges and would necessitate the implementation of significant changes to systems and data capture processes to thoroughly analyze all future cash payments between an entity and its counterparties. This is an especially important issue as it relates to over-the-counter derivatives which are often executed at high volumes and involve a variety of different types of instruments and currencies that span many years. As such, we find the requirement to net individual payments arising under a financial asset and a financial liability to raise unexpected complexities that should be addressed by the Boards through conducting further due process on this matter such as user and preparer outreach and field testing to determine the costs and benefits of such a requirement and/or to further clarify or refine the requirement.

15. Payment Netting – Application/Measurement

If payment netting is permitted in situations where two or more financial instruments' cash flows and maturity dates do not match, ISDA is unclear how payment netting would be applied in practice. The proposed guidance in paragraph C2 of the Exposure Draft provides that, "A right of offset is a debtor's legal right…to settle or otherwise eliminate all or **a portion of an amount due to a creditor** [emphasis added] by applying against that amount all or **a portion of an amount due from the creditor** [emphasis added] or third party." Also, paragraph C9 provides the following:

> "Some contracts and master netting agreements provide for automatic setoff of payments due to or from parties if they occur on the same day and are in the same currency….For such contractual arrangements, the entity's intention is considered to have been demonstrated at the date of entering into the contracts."

It is unclear from this guidance how the netting criteria could be met with respect to portions of amounts due to/from a third party or with respect to amounts due to/from a third party that are subject to a master netting agreement. Based on the guidance within paragraphs C2 and C9 of the Exposure Draft, our interpretation is that the netting criteria could be met for some payments (as opposed to every contractual payment) related to a financial asset and financial liability. In our view, there are four possible methods of applying the requirements of the Exposure Draft to payment netting. To illustrate these options, consider the example below.

- Assume Counterparty A has executed two interest rate swap contracts with Counterparty B.
- The Counterparties have executed a master netting arrangement (which is legally enforceable in the ordinary course of business under the relevant jurisdiction) and have elected payment netting under the agreement.
- The interest rate swaps were executed in different time periods and their respective fair values are equal to the present value of their future payments.

The scheduled payments and related fair values for both swaps at the measurement date are as follow. Amounts shown in PMT columns are net cash receipts (cash payments) for each swap at each payment date.

	Fair Value Asset (Liability)	PMT1	PMT2	PMT3	PMT4	PMT5	PMT6
Swap A	50	(20)	(10)	35	25	15	5
Swap B	(40)	(35)		(15)		10	

Possible methods to apply payment netting:

Potential Methods	**Amounts Reported in the Statement of Financial Position**
• Method 1 - Derivatives fall under a Master Netting Arrangement and intent exists to net because both parties have elected payment netting pursuant to the contract; net both contracts	10 Derivative Asset
• Method 2 - Pierce unit of account; Net payments by specific payment date where offset of cash flows occur	35 Derivative Asset[5] (25) Derivative Liability[6]
• Method 3 - Pierce unit of account to identify whether a net payment could be made at any payment date under the contracts; Net payments by specific payment date and group receivables and payables	75 Derivative Asset[7] (65) Derivative Liability[8]
• Method 4 - Pierce unit of account to identify whether a net payment could be made at all payment dates during life of the contracts	50 Derivative Asset[9] (40) Derivative Liability

We note that Methods 2 and 3 would result in recording derivative assets and liabilities that are different than the fair value of each individual transaction, which seems inconsistent with the principles of fair value measurement and impermissible under current U.S. GAAP and IFRS. Method

[5] Derivative Asset calculated as fair value of Swap A less (15) associated with PMT3 of Swap B.
[6] Derivative Liability calculated as fair value under Swap B less (15) associated with PMT3 under Swap B.
[7] Derivative Asset calculated as sum of PMT3 through PMT6 (all net positive cash flows).
[8] Derivative Liability calculated as sum of PMT 1 through PMT2 (all net negative cash flows).
[9] Since net payments don't occur on all respective dates, Swap A and Swap B are not eligible for offsetting

4 seems inconsistent with the proposed guidance. Moreover, Methods 2, 3, and 4 each require piercing the unit of account which is inconsistent with the accounting for derivatives under U.S. GAAP and IFRS. As such, in our view Method 1 is preferable and request that the Boards clarify Method 1 is their intent.

As illustrated above, we are of the view that the proposed guidance, as currently drafted, will lead to significant complexity and diversity in practice. Therefore, we strongly encourage the Boards to consider the possible diversity that may arise in practice if payment netting were required and whether additional guidance is needed in this area prior to issuing a final standard.

16. Other Changes to the U.S. GAAP Accounting Standards Codification

It is unclear why the Exposure Draft is proposing to eliminate the guidance set forth in ASC 940-320-45-2; however, as this guidance does not in any way relate to offsetting we question the purpose of or need for its removal. Moreover, we are unaware of any due process that was performed in this area of U.S. GAAP. As such, we recommend that the FASB refrain from removing this guidance as part of its offsetting project.