Audit Insights

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Overview of the offsetting rules

As companies explore hedging strategies in today's uncertain economy, management might need to become familiar with the accounting rules for offsetting. Here are the basics, including what needs to be disclosed in your footnotes about these contractual arrangements.

Right of setoff

In general, it's not proper to offset assets and liabilities in the balance sheet — except when there's a right of setoff. This exists when the following four criteria are satisfied:

1. The debt amounts are determinable.
2. The reporting entity has the "right" to setoff.
3. The right is enforceable by law.
4. The reporting entity has the "intention" to setoff.

Gross vs. net presentation

If these requirements are met, the company may offset the gross figure for the liability against the gross figure for the asset and, instead, report a single net amount for the asset and liability on the balance sheet. Under U.S. Generally Accepted Accounting Principles (GAAP), the offsetting rules apply to:

- Derivatives accounted for under provisions of Accounting Standard Codification (ASC) Topic 815, *Derivatives and Hedging*,
- Repurchase agreements and reverse repurchase agreements, and
- Securities borrowing and lending transactions.

For example, a company might have a derivative asset with a fair value of $10 million and a derivative liability with a fair value of $7.5 million, both with the same party. If the four criteria are met, the company can offset the derivative liability against the derivative asset on the balance sheet, resulting in the presentation of only a net derivative asset of $2.5 million.

Offsetting is allowed for derivatives that are subject to legally enforceable netting arrangements with the same party, even if the right to offset is available only in the event of bankruptcy or default. However, offsetting doesn't apply to unsettled regular-way trades (trades that are settled within the normal settlement cycle for that type of trade) or ordinary trade payables or receivables.

Disclosure requirements

Under GAAP, companies must disclose financial instruments and derivative instruments that are either offset on the balance sheet in accordance with ASC Section 210-20-45 or ASC Section 815-10-45 or subject to an enforceable master netting arrangement or similar agreement. So-called "master netting arrangements" consolidate individual contracts into a single agreement between two counterparties. If one party defaults on a contract within the arrangement, the other can terminate the entire arrangement and demand the net settlement of all contracts.

Specifically, companies must disclose:

- The gross amounts subject to offset rights,
- Amounts that have been offset, and
- The related net credit exposure.

Detailed disclosures are also required for the collateral pledged in netting arrangements and a description of the rights associated with covered assets and liabilities subject to netting arrangements. These disclosures — which are usually presented in a tabular format — help investors, lenders and other financial statement users to understand the potential effect of netting arrangements on the company's performance.

For more information

The rules for offsetting differ under International Financial Reporting Standards (IFRS). So, comparisons between entities that apply different standards may require adjustments based on the footnote disclosures. Contact us to determine whether your hedging arrangements fall under the scope of the offsetting rules. We can help you comply with the rules and benchmark your performance with global competitors.