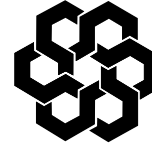

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International
Accounting Standards
Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: **December 2008, London**

Project: **Derecognition of Financial Liabilities**

Subject: **Proposed Derecognition Model (Agenda Paper 10E)**

INTRODUCTION

1. This paper discusses alternative approaches to derecognition of financial liabilities. The staff notes that the financial liability derecognition requirements have not created the significant application problems that exist with today's financial asset derecognition model.

2. However, the Board may want to consider other approaches to derecognition of financial liabilities as part of this project. Reasons might include:

   a. to establish a derecognition principle that could be extended to non financial (contractual) liabilities;

   b. to create greater symmetry between the recognition and derecognition requirements for financial assets and financial liabilities.

3. This paper focuses on a derecognition principle for financial liabilities.

4. Paper 10F analyses particular issues arising from the interaction between the derecognition approaches for financial liabilities and financial assets.

TODAY'S APPROACH

5. IAS 39 *Financial instruments: Recognition and Measurement* and FAS 140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* both primarily use a legal release approach to the derecognition of financial liabilities. A settlement approach is used in support of that legal release approach.

6. The legal release approach focuses largely on legal status - whether the debtor has been released entirely from, is only secondarily liable for, or remains primarily liable for the contractual obligation. . Thus, under this approach, derecognition is deemed inappropriate absent full release by the creditor's agreement or legal cancellation.

7. Under this approach, derecognition is appropriate when the contractual obligation that gives rise to the financial liability has been fully discharged by performance or exercise, has expired, has been forgiven by the creditor, has been assumed by a third party, or has been nullified or cancelled under law, and by implication, the debtor has no further obligations to the creditor

8. The settlement approach is used mainly as an application guidance, to illustrate some of the means by which a liability could be settled and hence how a debtor may be assessed as no longer obligated under a liability previously recognised by the debtor.

9. For example, IAS 39 provides the following examples as methods for settlement of a present obligation:
   a. payment of cash;
   b. transfer of other assets
   c. performance of services
   d. termination of a performance obligation by risk release (eg expiration of a financial guarantee contract)

e. replacement of that obligation with another obligation
f. transfer of the obligation to another party
g. conversion of the obligation to equity

10. The appendix sets out extracts from IFRS and US GAAP guidance on derecognition of financial liabilities.

ELEMENT DEFINITIONS

11. The IASB and FASB Conceptual Frameworks define liabilities as follows:

'Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.' – FASB Concept Statement 6

'A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits' – IASB Conceptual Framework

12. Based on the above definitions, a liability has two primary characteristics:

    a. it represents an expected future "outflow from the entity of resources embodying economic benefits"; and

    b. it is a present ("existing obligation") of the entity (i.e. the entity has a "duty or responsibility to act or perform in a certain way" which "leaves the entity with little, if any, discretion to avoid the outflow of resources to another party").

13. Hence, whether a particular item is a liability of an entity at a particular time requires three considerations:

    a. whether the item represents a present obligation of the entity (i.e. the entity has a "duty or responsibility to act or perform in a certain way");

    b. whether it represents an expected future outflow from the entity of resources embodying economic benefits;

c. whether all or any of the responsibility remains unsatisfied at the time of assessment.

ANALYSIS OF CURRENT APPROACH

14. The legal release approach focuses on the existence, or otherwise, of a legally enforceable contractual obligation. That is, it principally focuses on the first consideration set out above.

15. This approach has some advantages, including:

    a. high derecognition threshold and so anti-abuse?

    b. clear principle – hence few significant application issues

16. This approach has some disadvantages, including:

    a. the concept of being 'legally released from primary responsibility for the liability' (IASB) or 'legally released from being the primary obligor under the liability' (FASB) may have different meanings in different jurisdictions, reducing the comparability of financial statements;

    b. reliance on specific legal definitions to faithfully represent the effects of a transaction;

    c. asymmetry between derecognition of financial and non financial liabilities;

    d. asymmetry between derecognition of financial assets and financial liabilities.

ANOTHER POSSIBLE APPROACH

17. As noted, the current approach focuses on the legal extinguishment of an individual obligation based on the terms of the underlying contract or arrangement.

18. However, for a liability to exist an entity must have a present obligation that represents an expected future outflow from the entity of resources embodying economic benefits. [emphasis added]

19. An alternative to the approach used today might be to consider both the:

    a. continuing existence of a present obligation; and

    b. the requirement that that may result in a future outflow from the entity of an asset.

20. Such an approach will mirror the proposed derecognition principle for financial assets, in that:

    a. the principle first focuses on economic resources; and then

    b. on how the entity is linked to those economic resources.

21. To follow a parallel approach used in the proposed derecognition principle for financial assets we could state the derecognition principle for financial liabilities as follows:

> An entity should derecognise a financial liability or a component thereof when it no longer qualifies as a liability of the entity (ie when the present obligation is eliminated or the entity is no longer required to transfer economic resources to a third party in respect of the obligation).

22. This above principle is a mirror image of and is consistent with the core principle underlying the two approaches (Flow Charts 1 & 2) proposed for derecognition of financial assets i.e. for an item to qualify as an asset of an entity, the entity must have the ability to obtain the economic benefits and restrict others' access to those economic benefits (present access to economic benefits for its own benefit).

23. Using such a principle, a liability could cease to exist because of:

    a. specific actions of the entity (e.g. payment, performance); or

    b. changes in entity's circumstances (e.g. bankruptcy); or

c. factors external to the business (e.g. the company whose debt is being guaranteed had paid its creditor).

24. This derecognition principle would make liability derecognition more symmetrical with liability recognition.

25. This derecognition principle also would make the financial liability derecognition principle more symmetrical with the financial asset recognition and derecognition principle; the definition of an asset focuses on control over future economic benefits, and a financial asset is derecognised if the company no longer controls the economic benefits.

EFFECT OF ALTERNATIVE APPROACH

26. The alternative approach may result in no change for financial liabilities compared to today's requirement in most situations. For example:

   a. the setting aside of assets in trust does not, in and of itself, constitute the elimination of a liability. Though the assets are dedicated to a single purpose, the liability continues to be a present obligation of the entity.

   b. if an entity purchases its own debt instrument in the market, the repurchase will constitute an elimination of the obligation, regardless of whether the debt instrument is cancelled or held for re-issue. That is because, in such circumstances, honouring the instrument will not result in any outflow of net assets from the entity.

   c. A debtor would derecognise a liability if the debtor induces a third party to undertake it, with the consent of the creditor, and the entity becomes secondarily liable for the debt. However, if the debtor agrees to make payments on the debt to the third party or direct to its original creditor, the debtor would recognise a new debt obligation to the third party.'

SUMMARY AND STAFF RECOMMENDATION

27. The staff believes that the Board should consider whether the derecognition principle for financial liabilities should consider both the existence of a present

obligation <u>and</u> the requirement that the present obligation may result in a future outflow from the entity of an asset. The staff does note that for financial liabilities there appears to be little practical effect (compared to today's approach) of doing this.

28. However, while today's approach of focussing on legal extinguishment 'works' for contractual (financial) liabilities, it is problematic for non-contractual obligations.

29. Based the analysis set out in paragraphs 16 – 25, the staff recommends that the Board adopts the economic approach and the derecognition principle set out in paragraph 21.

30. **Questions for the Board:**

    a. **Does the Board agree with the staff recommendation? If not, why not?**

    b. **If so, is the principle set out in paragraph 21 an improved principle? If not, what do you suggest, and why?**

APPENDIX - EXTRACTS FROM IFRS AND US GAAP

IAS 39

'*An entity shall remove a financial liability (or a part of a financial liability) from its statement of financial position when, and only when, it is extinguished—i.e. when the obligation specified in the contract is discharged or cancelled or expires' (para 39)*

'An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability' (para 40)

'A financial liability (or part of it) is extinguished when the debtor either:

> *(a) discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or*
>
> *(b) is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. (If the debtor has given a guarantee this condition may still be met.)' (para AG57)*

'If an issuer of a debt instrument repurchases that instrument, the debt is extinguished even if the issuer is a market maker in that instrument or intends to resell it in the near term'. (para AG58)

'Payment to a third party, including a trust (sometimes called 'in-substance defeasance'), does not, by itself, relieve the debtor of its primary obligation to the creditor, in the absence of legal release.' (para AG59)

'If a debtor pays a third party to assume an obligation and notifies its creditor that the third party has assumed its debt obligation, the debtor does not derecognise the debt obligation unless the condition in paragraph AG57(b) is met. If the debtor pays a third party to assume an obligation and obtains a legal release from its creditor, the debtor has extinguished the debt. However, if the

debtor agrees to make payments on the debt to the third party or direct to its original creditor, the debtor recognises a new debt obligation to the third party.' (para AG60)

'If an entity repurchases a part of a financial liability, the entity shall allocate the previous carrying amount of the financial liability between the part that continues to be recognised and the part that is derecognised based on the relative fair values of those parts on the date of the repurchase. The difference between (a) the carrying amount allocated to the part derecognised and (b) the consideration paid, including any non-cash assets transferred or liabilities assumed, for the part derecognised shall be recognised in profit or loss.' (para 42)

FAS 140

'A debtor shall derecognise a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.

b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor.' (para 16)