30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**23 July 2008, London**
Project:	**Derecognition of Financial Instruments**
Subject:	**Proposal to add the project on derecognition of financial instruments to the Board's active agenda (Agenda Paper 2B)**

INTRODUCTION

1. This paper discusses a proposal to add to the IASB's active agenda a project on derecognition of financial instruments. The project is currently on the IASB's research agenda.

2. This paper

    (a) summarises the background of the derecognition project

    (b) discusses whether the project meets the IASB's agenda criteria

    (c) provides a staff recommendation

    (d) asks the IASB whether it wants to add the project to its active agenda

BACKGROUND TO THE DERECOGNITION PROJECT

3. The IASB and FASB decided in 2006 that both US GAAP and IFRS derecognition standards needed improvement. Statement 140 was then deemed unworkable, and still is despite ongoing repair and maintenance work. The

derecognition requirements set out in IAS 39 *Financial Instruments: Recognition and Measurement* were then, and still are, viewed by many as difficult to understand and apply and internally inconsistent.

4. For those reasons, the Boards decided that jointly developing a replacement for both standards was the best path forward and asked the staff to undertake research into a possible replacement for both standards.

5. The derecognition project is included in the Memorandum of Understanding (MoU) *A Roadmap for Convergence between IFRSs and US GAAP–2006 to 2008*.

6. In their joint Board meeting in April 2008, the boards affirmed that the derecognition project is a high priority.

IFRS requirements

7. The model in IAS 39 for derecognition of financial assets requires elements of a number of derecognition concepts to be applied in a specific order to determine whether part or all of a previously recognized financial asset should be derecognized. In summary:

    (a) A financial asset can be separated into components only in defined circumstances. Otherwise the derecognition tests have to be applied to the entire asset.

    (b) An entity is required to consider whether the asset has been 'transferred' to another party and, if so, whether the entity has also transferred substantially all the risks and rewards of the asset. If so, the asset is derecognized.

    (c) Otherwise the entity determines whether or not it has retained control of the asset. If control has been retained, the asset is not derecognized. If control has not been retained, the asset is recognized only to the extent of the entity's 'continuing involvement' in the asset.

8. The requirements of IAS 39 relating to derecognition of financial liabilities differ from those relating to derecognition of financial assets. Some argue they should be symmetrical.

9. The rules for derecognition of financial liabilities focus on the legal obligation and whether the legal obligation has been extinguished. The application of these requirements has proved less problematic than application of the requirements for derecognising financial assets.

Problems with IFRS requirements

10. One issue raised by some is how to apply the notion of "substantially all the risks and rewards". There is little guidance in IAS 39. For example, questions have arisen about whether each identified risk and reward should be substantially surrendered to allow for derecognition, whether all risks should be aggregated separately from all rewards, and whether risks and rewards should somehow be offset and then combined for evaluation and interpreting what 'substantially all' means in the evaluation of those risks and rewards. If a transfer includes derivative instruments (for example, interest rate swaps) further questions also arise.

11. The application of the risks-and-rewards test tends to generate inconsistent accounting outcomes for identical economic positions. For example, one entity might enter sell a financial asset and agree to repurchase it at a fixed price. That entity would not derecognise the financial asset (because it has retained substantially all the risks and rewards of ownership), and would recognise a financial liability for the consideration received.

12. Another entity, that never owned the asset, might enter in a forward contract to buy the same asset, and would account for that contract as a derivative. Both entities are in an identical economic position, but the accounting is very different – because the accounting model is highly dependent on the sequence of transactions rather than the final economic position.

13. Other issues that have been raised with the IFRIC or the staff include:
    - the meaning of 'transfer' (IAS 39.18)
    - treatment of contingent obligations attached to transfers
    - application of derecognition rules to derivatives that can be either asset or liability (eg whether it is possible to apply the asset derecognition rules to a swap if they are "passed through")

- the application of continuing involvement requirements (for example, the treatment of the retention of the most junior tranche of a securitisation vehicle).

Work performed in the project to date

14. The initial research stage of the project has been led by the IASB staff, in conjunction with a small group of IASB and FASB Board advisors. This resulted in a draft staff paper setting out a possible approach to derecognition based on the existence or otherwise of the legal rights to a financial asset by the reporting entity. That approach requires further analysis to assess its feasibility in regard to securitized assets and the treatment of servicing contracts.

15. The team is also considering other possible approaches to derecognition of financial assets to assess whether such approaches would gain the support of IASB and FASB board members.

16. In that regard, the staff held small group sessions with Board members to discuss some of the conceptual issues pertaining to the project in June 2008. The feedback received will inform the staff's work on developing alternative approaches.

17. The team expects to present an approach to derecognition of financial assets and liabilities to the Board in September and an update of their work to the Boards at their joint meeting in October 2008.

IASB'S AGENDA CRITERIA

18. The IASB due process handbook sets out five criteria to be considered in deciding whether to add a potential item to the agenda.

Criterion 1: The relevance to users of the information involved and the reliability of information that could be provided

19. Criterion 1 considers whether the project addresses the needs of users across difference jurisdictions. The criterion takes into account the following factors:

    (a) international relevance

    (b) pervasiveness

    (c) urgency

(d) consequences of not adding the project to the agenda

20. The decision as to whether to derecognise a financial instrument has widespread relevance. The issue affects various types of reporting entities (and especially financial institutions) in every jurisdiction. Furthermore, today's requirements result in much structuring of transactions to achieve a particular accounting outcome. This impairs comparability between different entities.

21. Moreover, determining whether to derecognise a financial has an effect on both the statement of financial position and the statement of comprehensive income. First, that determination establishes the financial instruments included in the statement of financial position. Second, it affects the statement of comprehensive income because gains and losses may arise as a result of a decision to derecognise (this is especially true in a mixed – measurement model).

22. As noted previously, constituents have urged the IASB to improve the accounting requirements for financial instruments and have criticised the derecognition requirements in IAS 39.

23. Recent events and market conditions have also resulted in greater focus on this issue, and greater urgency to address these criticisms. For example, the Financial Stability Forum (in the 2008 report to the G7 Finance Ministers) identified addressing off-balance sheet exposures as an urgent priority, in light of the ongoing credit crisis, and urged standard setters to make improvements on an accelerated basis -

> *"The IASB should improve the accounting and disclosure standards for off-balance sheet vehicles on an accelerated basis and work with other standard setters toward international convergence The build-up and subsequent revelation of significant off-balance sheet exposures has highlighted the need for clarity about the treatment of off-balance sheet entities and about the risks they pose to financial institutions. The use of off-balance sheet entities created a belief that risk did not lie with arrangers and led market participants to underestimate firms' risk exposures. Risk exposures and potential losses associated with off-balance sheet entities should be clearly presented in financial disclosures, and the accounting standards affecting these entities should be enhanced and their international convergence accelerated based on the lessons learned.*
>
> *Off-balance sheet treatment in financial reports can arise as a result of the standards for derecognition (e.g., removing assets from balance sheets through securitisations) and consolidation (e.g., special purpose entities). The standards of the IASB and the US Financial Accounting Standards Board*

(FASB) differ for both topics and with respect to the required disclosures about off-balance sheet vehicles. The IASB and FASB have projects underway to converge their standards in these areas and this work should be accelerated so that high-quality, consistent approaches can be achieved. In doing so, and consistent with their required due process, the IASB and the FASB should consider moving directly to exposure drafts on off-balance sheet issues, rather than discussion papers, to meet the urgent need for improved standards. Standards should require the risk exposures and potential losses associated with off-balance sheet entities to be clearly identified and presented in financial disclosures. The IASB and FASB should consult investors, regulators, supervisors and other stakeholders for their views during this process, and should take note of issues that have come to light during the current market turmoil and the progress reflected in 2007 annual reports and other disclosures.

24. In addition, any eventual adoption of IAS 39 and SIC 12 by the US marketplace would likely trigger an avalanche of application inquiries and put a spotlight on inconsistent practices. (The US securitization market is several multiples the size of the market in other parts of the world.)

25. If the IASB does not add the derecognition project to its technical agenda, practice problems will persist. The Board and IFRIC will continue to receive requests to clarify and interpret the requirements in IAS 39. Staff resources will be necessary to address those requests.

26. This topic is internationally relevant. Moreover, practice problems related to the existing requirements in IAS 39 are pervasive and urgent, especially in relation to structured and more complex transactions. Hence the staff thinks the derecognition project meets Criterion 1.

Criterion 2: Existing guidance available

27. Criterion 2 considers whether the project will address an area on which existing guidance is insufficient.

28. As previously noted in this paper, IAS 39 provides the relevant requirements and constituents have told the IASB that for the more complex transactions those requirements are difficult to understand, difficult to apply and are internally inconsistent. For example, the IFRIC has had an item relating to particular aspects of the IAS 39 derecognition model on its agenda for several years. In addition, anecdotal evidence suggests that the derecognition requirements of IAS 39 are

inconsistently applied in practice. Hence the staff thinks the derecognition project meets Criterion 2.

Criterion 3: The possibility of increasing convergence

29. Criterion 3 considers whether undertaking the project would increase the possibility of achieving convergence of accounting standards in different jurisdictions. As noted in paragraphs 3 and 4, the derecognition project is included in the MoU between the IASB and FASB. At their joint meeting in April 2008, the Boards confirmed that derecognition of financial instruments should be regarded as a high priority.

30. Current IFRS requirements are not comparable with US GAAP. Therefore, there is a significant opportunity to increase convergence with US GAAP. Hence the staff thinks the derecognition project meets Criterion 3.

Criterion 4: The quality of the standards to be developed

31. Criterion 4 considers the qualitative aspects of the standards that are proposed to be developed. This criterion takes the following factors into account:

    (a) availability of alternative solutions

    (b) cost/benefit considerations

    (c) feasibility

32. There are a number of possible solutions. Elements of these are included in today's IFRS and US GAAP requirements. However, current requirements are often internally inconsistent, reflecting the desire of some to achieve particular accounting outcomes in particular situations.

33. The staff believes it would be difficult to achieve a solution that is totally internally consistent. Hence the objective is to either develop an internally consistent model or (if that is not possible) a solution that improves financial reporting by minimising the number of internal inconsistencies and that is easier to understand and apply than today's requirements.

34. Additionally, appropriate presentation mechanisms and disclosure requirements would form an important part of such a solution. Achieving such an objective

would have many benefits. Preparers would be able to easily and consistently apply the requirements and users would be able to better understand the financial reporting.

35. The costs of implementing the change will depend on how different the solution is to today's requirements. For a large number of straightforward transactions involving financial instruments little is likely to change. However, for more complex structured transactions today's requirements are difficult to apply. As noted above, the objective of the project is to develop a solution that is more straightforward to apply.

36. The staff thinks that it is feasible to develop a technically sound solution within a reasonable time period. This project does not have to await completion of other projects. While there is an overlap between this project and the IASB's project on the conceptual framework, the staff does not think that it is necessary (or prudent) to delay the derecognition project until the completion of the conceptual framework project. The staff thinks that there are practice problems that need to be resolved at a standards-level before the completion of the conceptual framework project.

37. Likewise with the project on consolidation. The interaction between the consolidation and derecognition question has to be considered, although they are two separate questions.

38. The staff believes that it is possible for the Board to develop an improved approach to derecognition of financial instruments in a reasonable amount of time. Hence the staff thinks that the derecognition project meets Criterion 4.

Criterion 5: Resource constraints

39. Criterion 5 considers whether there are sufficient resources to undertake the project. The criterion considers the following factors:

    (a) availability of expertise outside the IASB

    (b) amount of additional research required

    (c) availability of resources

40. This project addresses a complex and difficult area, and staff with relevant experience and expertise are not easily recruited or retained. However, the IASB does have staff assigned to this project with experience in the securitisation market, although those staff members have limited standard setting experience. As it is envisioned that this project will be a joint project between the IASB and the FASB, FASB staff with experience in this area may be allocated to the project in due course.

41. There is other expertise outside the IASB. For example, there are some members of the Financial Instruments Working Group (FIWG) that have extensive practice experience in this area, and the staff would seek to leverage that experience in whatever way possible.

42. The staff thinks that resourcing this project in a satisfactory way will be a challenge. However, on balance, the staff believes that we have adequate resources to undertake the project.

FEEDBACK FROM SAC

43. The proposal to add this project to the Board's active agenda was discussed at the June 2008 SAC meeting and there was a unanimous support that the project be added to the Board's active agenda. There was also a consensus that the objective of developing a replacement derecognition model should be pursued expeditiously.

STAFF RECOMMENDATION

44. The staff believes that the project meets the agenda criteria. Therefore, the staff recommends that the project is moved from the research agenda to the IASB's technical agenda.

QUESTION FOR THE BOARD

45. **Does the Board agree that the derecognition project should be added to the active agenda? If not, why?**

PROPOSED PROJECT PLAN

46. The staff will prepare a project plan for the joint October meeting of the IASB and the FASB. That plan will set out the proposed scope of the project, expected timing of publication of the due process documents and resource requirements.