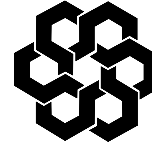

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International Accounting Standards Board

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:	**15 September 2008, London**
Project:	**Derecognition of Financial Assets**
Subject:	**Cover Note (Agenda Paper 7)**

INTRODUCTION

1. This paper sets out

   a. The background to the project

   b. A summary of the issue

   c. A summary of the existing guidance on financial asset derecognition in IAS 39, *Financial Instruments: Recognition and Measurement* and FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

2. This paper is accompanied by four other papers on derecognition of financial assets and the contents of those papers are summarised below:

a. Paper 7A - sets out the proposed derecognition model for financial assets (including the merits of the proposed approach) and a summary of the basis for the proposed approach.

b. Papers 7B – addresses circumstances in which the transferee does not have the practical ability to transfer all or a defined part (component) of a financial asset for its own benefit. The paper sets out two possible approaches to deal with those circumstances

c. Paper 7C - applies the two alternative approaches in paper 7B to selected transactions and compares the results to that of IAS 39 and FAS 140R (as proposed).

d. Paper 7D – sets out the proposed timetable for the project and resource requirements. The timetable is predicated on the Boards accepting one of the proposed approaches in Paper 7A and 7B or an approach not too dissimilar from the staff's proposals.

(A detailed road map to Papers 7A and 7B is attached (as appendix 1) for your convenience).

PURPOSE OF THIS MEETING

3. At the October 2007 meeting, the staff presented 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 required further analysis to assess its feasibility in regard to securitized assets and the treatment of servicing contracts.

4. Hence the staff was tasked by the Boards at the April 2008 meeting to develop further the staff research report and to consider other possible approaches to derecognition of financial assets to assess whether such approaches would gain the support of IASB and FASB board members.

5. The staff has consequently developed a derecognition model and two alternative approaches to extending the model (as explained in the accompanying papers).

6. At this meeting, the staff intends to ask the Boards:

   a. to decide on one derecognition approach to further develop (papers 7A – 7C); and

   b. to agree a timetable to issue an Exposure Draft (paper 7D).

BACKGROUND

7. Below are some of the factors the staff believes the boards should consider in deciding on a derecognition approach (and particularly as a filter in deciding whether to accept or reject any of the alternatives in Paper 7B):

   a. Current market conditions and concerns raised by regulatory authorities and others

   b. Complexity of existing derecognition guidance

   c. Convergence between IFRS and US GAAP

   d. Users request for transparency

   e. Diversity of views on an appropriate derecognition approach

Current market conditions and concerns raised by regulatory authorities and others

8. There is a widespread concern about the accounting standards for the derecognition of financial assets in light of recent developments in the financial markets. These events and market conditions have resulted in greater focus on the need to improve existing requirements and on convergence between IFRSs and US GAAP.

9. Many constituents have urged the Boards to undertake a comprehensive project on derecognition of financial instruments and consolidation of special purpose vehicles, notably, the Securities and Exchange Commission (SEC) and the Financial Stability Forum (FSF).

10. The President's Working Group on Financial Markets' (which comprises the SEC, the Federal Board, US Department of Treasury and the Commodities Futures Trading Commission) report on the current credit crises, analysed the underlying factors contributing to the recent and on-going market stress and makes the following recommendation, among others, to address those weaknesses:

"Authorities should encourage FASB to evaluate the role of accounting standards in the current market turmoil. This evaluation should include an assessment of the need for further modifications to accounting standards related to consolidation and securitization, with the goal of improving transparency and the operation of U.S. standards in the short-term. Additionally, authorities should encourage FASB and IASB to achieve more rapid convergence of accounting standards for consolidation of ABCP conduits and other off-balance sheet vehicles."

11. The Financial Stability Forum (in the 2008 report to the G7 Finance Ministers) also 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.

Complexity of existing derecognition guidance

12. The issue of financial asset and liability derecognition has been discussed for many years, but no satisfactory and durable solution has been found. The FASB addressed derecognition issues in FAS 77, 125 and 140, and is undergoing a project to amend FAS 140. The IASB has amended IAS 39 several times. Both Boards acknowledge that existing requirements need to be improved.

13. Constituents have told the Boards that for the more complex transactions the guidance in IAS 39 is complex, difficult to understand, difficult to apply and are internally inconsistent. Statement 140 is also deemed to be problematic despite ongoing repair and maintenance work.

Convergence between IFRS and US GAAP

14. Current IFRS requirements are not comparable with US GAAP. Therefore, there is a significant opportunity to increase convergence. As noted above, many are calling for the Boards to increase their efforts in this area.

15. The derecognition project is included in the Memorandum of Understanding (MoU) *A Roadmap for Convergence between IFRSs and US GAAP–2006 to 2008*. At the Joint Board meeting in April 2008, the Boards confirmed that derecognition of financial instruments should be regarded as a high priority. The Boards have subsequently confirmed their intention in the revised MoU to:

    a. decide in 2008 on a strategy to develop a common standard, and

    b. issue final standards in 2009 - 2010.

Users' requests for transparency

16. Users have consistently informed the Boards that many financial assets that are derecognized today should continue to be reported by transferors in their statements of financial position. Such users believe that derecognition should not be permitted if a transferor has any continuing involvement in the transferred financial assets.

17. Many of these users have told the Boards that they routinely add derecognised financial assets back to the statement of financial position when performing financial analysis of a transferor. The users have also told the Boards that they question the credibility of information provided by transferors about transferred financial assets given recent market events.

Divergent views on the most appropriate derecognition approach

18. To compound the problem, there is no consensus among the boards and constituents on the best approach to derecognition of financial assets in which the transferor maintains some interest (ie no agreement on the 'substance' of a transaction – whether it should be treated as a 'sale' or 'financing'). There is a wide spectrum of views. The staff believes that, if the Boards wish to improve the derecognition of financial assets in the foreseeable future, a line will inevitably have to be drawn between transfers of financial assets that are 'sales' and those that are 'financings'. Such an approach will not satisfy all constituents and board members - but to the extent that a model is less complex to understand and apply than today's requirements (in other words, the line drawn is unambiguous), it will arguably represent an improvement to financial reporting.

19. The divergent views to derecognition of financial assets tend to fall under one of two broad categories: an 'asset-liability (inventory)' approach or a 'history – matters' approach.

    (a) The 'asset-liability (inventory)' approach would require transferors and transferees to recognise and measure, after a transfer of financial assets, the

financial statement elements (assets, liabilities, revenues, and expenses) each has as a result of the transfer. This approach analyses a transfer of a financial asset by examining the component assets and liabilities that exist after the transfer.

(b) The 'history –matters' approach looks at potential derecognition events and ask whether circumstances are such that the previously recognised asset should be derecognised or the asset should continue to be recognised. Different 'History-matters' approaches assess the circumstances involved in different ways. For example, some ask which entity has all, or substantially all, the risks and rewards arising from the asset, while others try to determine which enterprise has overall control of the asset. However, the principle is the same: assets are 'sticky' and previous ownership of the asset matters in assessing which party should recognise the asset.

EXISTING GUIDANCE ON DERECOGNITION OF FINANCIAL ASSETS

Summary of IAS 39 Derecognition Requirements

20. 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 recognised financial asset should be derecognised. 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 derecognised.

(c) Otherwise the entity determines whether or not it has retained control of the asset. If control has been retained, the asset is not derecognised. If control

has not been retained, the asset is recognised only to the extent of the entity's 'continuing involvement' in the asset.

Summary of FAS 140 Derecognition Requirements

21. FAS 140 is based on a financial-components approach that focuses on control. Under that approach, after a transfer of financial assets, an entity recognises the financial and servicing assets it controls and the liabilities it has incurred, derecognises financial assets when control has been surrendered, and derecognises liabilities when extinguished.

22. Under FAS 140, a transfer of financial assets in which the transferor surrenders control over those assets is accounted for as a sale to the extent that consideration other than beneficial interests in the transferred assets is received in exchange. The transferor has surrendered control over transferred assets if and only if all of the following conditions are met:

(a) The transferred assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.

(b) Each transferee (or, if the transferee is a qualifying special-purpose entity (SPE), each holder of its beneficial interests) has the right to pledge or exchange the assets (or beneficial interests) it received, and no condition both constrains the transferee (or holder) from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor.

(c) The transferor does not maintain effective control over the transferred assets through either (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity or (2) the ability to unilaterally cause the holder to return specific assets, other than through a cleanup call.

Summary of the outcomes under FAS 140 and IAS 39

23. The requirements in IAS 39 are considered to be more restrictive (ie allow for fewer items to be derecognized) than FAS 140. However, the provisions of the proposed amendment to FAS 140 will make it more difficult to derecognize assets than the existing guidance in FAS 140 and presumably would bring the outcome (the results) under FAS 140 closer to the results obtained under IAS 39. It is however worth noting that the two standards approach the issue of derecognition in different ways.

APPENDIX 1

ROAD MAP TO THE ACCOMPANYING PAPERS

Paper 7A

- Sets out the proposed derecognition principle – "an entity should derecognise a transferred financial asset if the asset ceases to qualify as an asset of the entity".

- The paper then analyses the above principle as follows:

  a. An entity should derecognise a financial asset/component when the financial asset/component ceases to qualify as an asset of the entity.

  b. A financial asset/component ceases to qualify as an asset of the entity if the economic benefits no longer exist or the entity no longer controls the economic benefits underlying the asset/component.

  c. An entity no longer controls the economic benefits underlying a financial asset/component if the entity no longer has the ability to (a) obtain the future economic benefits inherent in the asset/component and (b) restrict others' access to those benefits.

- The paper then discusses in detail the above conclusions.

- The paper concludes by presenting the pros and cons and implications of the proposed model.

Paper 7B

- Picks up from the conclusions made in Paper 7B (in particular criterion (c) above.

- The paper presents one approach to assessing control if criterion (c) above is not met.

- It then presents a second alternative which recognises that it is difficult to assess control where the criterion (c) is not met by concluding if that test is not met an entity should not derecognise the transferred asset

- To provide additional information to users of financial statements, it suggests the use of linked presentation to show the relationship between the asset not derecognised and the proceeds (classified as a liability) of the transfer.

- The Paper concludes with a recommendation of one of the above approaches to the Board