IASB Meeting | Agenda reference **15D**

Staff Paper | Date **December 2009**

Project **Derecognition**

Topic **Issues to be addressed**

Contents and purpose of this paper

1. This paper details the issues to be addressed over the next few months in the derecognition project, on the basis of the tentative October decision to develop a modified version of the alternative derecognition approach for financial assets (as detailed in ED/2009/3 *Derecognition*).
2. This paper is for information only and we do not plan to discuss it at the Board meeting unless Board members have particular questions.
3. This paper does not address the question of whether the Board should issue another exposure draft. The staff will ask the Board to consider that issue at a future meeting.
4. This paper contains an appendix, which tables those comments by respondents to the ED about the proposed derecognition requirements for financial liabilities that we believe do not need to be discussed by the Board (the table includes the staff's response to each of the comments).

Issues to be discussed at future meetings

5. The staff plans to address the following issues (see next page):

This paper has been prepared by the technical staff of the IASB for the purposes of discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper and do not purport to represent the views of any individual members of the Board or the IASB.

Decisions made by the Board are reported in IASB *Update*.

Official pronouncements of the IASB are published only after the Board has completed its full due process, including appropriate public consultation and formal voting procedures.

Timing	Subject
December 2009 (this meeting)	**Derecognition of financial liabilities.** Issues raised by the respondents to the ED with respect to (a) the derecognition requirements in IAS 39 for financial liabilities, and (b) the proposed changes to those requirements. See Agenda Papers 15A-C.
January 2010	**Derecognition of financial assets.** Open issues with respect to the derecognition approach for financial assets, including: • Repos, securities lendings and collateral provisions • Transfer definition
February 2010	**Disclosures, transition and presentation**. Issues raised by the respondents to the ED with respect to the proposed changes to the disclosures in IFRS 7 *Financial Instruments: Disclosures*, and also the proposed transition requirements. Also, the staff will ask the Board whether it wants to consider (as part of the derecognition project) the concern raised by some respondents to the ED about the lack of convergence of the offsetting (netting) requirements for financial assets and liabilities between IFRS and US GAAP.

Appendix

Comment	Staff response
'We do not see the benefit of deleting "…intends to resell it in the near term" from paragraph AG58 [of the *Derecognition* ED, which states: If an issuer of a debt instrument repurchases that instrument, ~~the debt is extinguished~~ it derecognises that liability (because it no longer has a present obligation to transfer economic resources to a third party) even if ~~the issuer~~ it is a market maker in that instrument or ~~intends to resell it in the near term~~.] The acquisition of debt with the intention to resell is not limited to a market maker and therefore we consider the inclusion of the words still useful'.	The staff agrees with this comment and will address it as part of the drafting of the next due process document.
'We do not believe that the debt instruments purchased by a market making unit of the financial institution, with the business objective to resell those instruments to third parties in the near future, have been extinguished. Recording extinguishment gains and losses, and subsequent 'debt issuance' at a premium or discount, is both operationally challenging and not representational faithful'.	The majority of the staff disagrees with this comment. By repurchasing a debt instrument, an entity no longer has a present obligation to transfer economic resources to a third party. As such, it is representationally faithful for the entity to derecognise the liability associated with the debt instrument. In fact, it would not be representationally faithful for the entity to continue to recognise the liability because the liability no longer meets the definition of a liability in the IASB *Framework*. Paragraph 33 of the Framework states: 'To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in assets, liabilities and equity of the entity at the reporting date which meet the recognition criteria'.
'The discharge requirement should not be in the application guidance but should be in the main standard itself'. [This comment is directed at the guidance in AG57 of the *Derecognition* ED, which states: 'An entity shall derecognise a financial liability (or part of it) if the present	The staff disagrees with this comment because the discharge requirement in AG57 of the *Derecognition* ED is an application of the derecognition principle for financial liabilities in paragraph 39A. The staff also notes that the application guidance is an integral part of IAS 39.

obligation is eliminated and the entity is no longer required to transfer economic resources in respect of that obligation. For example, a debtor would derecognise a financial liability (or part of it) if it either: (a) discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services […]'.]	
'The second sentence of paragraph 39A [of the *Derecognition* ED] appears to be driven by the definition of a liability in the Framework and IAS 37 rather than the definition of a financial liability in IAS 32. For example, an obligation to deliver the entity's own equity instruments may cease to meet the definition of a financial liability in IAS 32 where the number of equity instruments becomes fixed subsequent to initial recognition. Such obligations should also be derecognised as they no longer meet the definition of a financial liability'.	The staff disagrees with this comment in that by logic a financial liability must be consistent with the definition of a liability in the IASB *Framework*. Putting this aside, the staff notes that the issue of reassessment of liability and equity classification highlighted in the example is outside the scope of the derecognition project.
'The financial element liability definition requires a present obligation, the settlement of which is expected to result in outflow from an entity of resources embodying economic benefits. In effect two characteristics must both be met for there to be a liability [those two characteristics being (a) the existence of a present obligation and (b) the requirement to transfer economic resources in respect of that obligation]. By implication, taking into account the financial element definition of a liability, only one of those characteristics does not have to be met for a liability to not exist. This means that derecognition should occur if only one not both characteristics are not met'.	The staff acknowledges that if both conditions – the existence of a present obligation and the requirement to transfer economic resources in respect of that obligation – must be met for an entity to recognise an item as a liability, by logic if one of the two conditions no longer is satisfied the entity should no longer continue to recognise that liability. However, when the Board discussed this issue at the IASB meeting in December 2008, some Board members were concerned that changing the derecognition principle to the elimination of the present obligation **or** the lack of a requirement to transfer economic resources in respect of that obligation might result in some entities interpreting the principle as to allow for derecognition of a financial liability in an 'in-substance defeasance' transaction. A majority of the staff shares that concern. Thus, the staff does not plan to address the comment further.
'Paragraph 39A [of the *Derecognition* ED] refers to a financial liability ceasing to qualify as a liability of an entity if the present obligation is eliminated. It should be clear that present obligation is referring to the obligations inherent in the contractual terms of the instrument which	The staff disagrees with this comment. The staff believes that the notion of 'present obligation', which is part of the definition of a liability in the IASB *Framework*, is clear. Thus, the staff does not plan to address this comment further.

may include obligations that are contingent. The introduction of the term present could imply that only obligations inherent in the contractual terms of the instrument that are payable at present, ie at the date of the assessment of derecognition. We believe IAS 39.39 is clearer as it refers to when the obligation specified in the contract'.	
'We note that a literal reading of the proposed amendment text of paragraph 14(c) of IFRS 4 could yield unusual results. For instance, in structured settlement arrangements, a property and casualty (F&C) insurer with the obligation to make weekly or monthly indemnity payments often settles or discharges such obligations by acquiring an annuity from a life insurer and directing that payments be made directly to the beneficiary. A literal reading of the requirements could be taken to mean that until an entity fully settles the liability ie until the annuity is fully paid out and the P&C insurer is no longer secondarily liable to make payments - the original obligation should remain on the insurer's statement of financial position. Hence rather than use of the words "is eliminated" in paragraph 14(c) of the proposed amendments to IFRS 4, we suggest use of words such as when the obligation is "discharged, cancelled or expired" [The proposed amendment to IFRS 4 Insurance Contracts is as follows: '[...an] insurer […] shall derecognise an insurance liability (or a part of it) when it (or the part) no longer qualifies as a liability of the insurer. An insurance liability ceases to qualify as a liability of the insurer if the present obligation is eliminated and the insurer is no longer required to transfer economic resources in respect of that obligation'.]	The staff disagrees with this comment. Absent further facts, in the example used by the respondent, it appears as if the acquisition of the annuity has not resulted in the elimination of the insurer's present obligation to transfer economic resources to the beneficiary of the policy. The staff believes the derecognition principle is clear in this regard and, therefore, does not plan to address the comment further, unless the Board identifies issues at a future meeting with respect to the interaction of the derecognition principles for financial assets and those for financial liabilities (eg assets that serve as collateral for a non-recourse obligation).

'We note one drafting point with respect to paragraph 42B which implies that liabilities are only ever accounted for on an amortised cost basis. This needs to be extended to address liabilities held at fair value'. [Paragraph 42B of the *Derecognition* ED states: 'If an entity derecognises a financial liability as a result of an exchange of debt instruments or modification of terms, it includes any costs or fees incurred in the gain or loss recognised. If an entity does not derecognise a financial liability in connection with an exchange or modification, it adjusts the carrying amount of the liability for any costs or fees incurred and amortised the new carrying amount over the remaining term of the liability.]	The staff agrees with this comment. The proposed guidance in paragraph 42B of the ED applies to modifications in the context of a financial liability that is carried at other than at fair value through profit or loss (FVTPL). If the liability were carried at fair value through profit or loss, any modification costs would have to be expensed as opposed to adjusting the carrying amount (fair value) of the liability. The staff will address this comment as part of the drafting of the next due process document.