Financial Accounting Standards Board

International Accounting Standards Board

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INFORMATION FOR OBSERVERS

IASB/FASB Meeting:	**March 2009, London**
Project:	**Consolidation and Derecognition**
Subject:	**Strategy for the boards (Agenda paper 5)**

Introduction

1 The purpose of this paper is to discuss the options available to the boards in meeting their Memorandum of Understanding (MOU) commitments relating to derecognition and consolidation.

2 The objective of the discussion is to agree upon a strategy that will meet those MOU commitments and, at the same time, address concerns and requests received by both boards from external parties.

3 The MOU progress report and timetable for completion issued by the IASB and the FASB in September 2008 stated the following regarding derecognition and consolidation:

Ongoing projects—both Boards to issue exposure drafts in 2008/2009 and final standards in 2009/2010.

Next steps—decision in 2008 on a strategy to develop a common standard.

4 In September 2008, the FASB published exposure drafts on consolidation (proposed amendments to FIN 46(R) *Consolidation of Variable Interest Entities*) and derecognition of financial assets (proposed amendments to SFAS 140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*). The FASB plans to publish final amendments to both standards in the second quarter of 2009. The FASB view these exposure drafts as short-term projects, with the intention of developing longer-term solutions for both topics on completion of their short-term objectives.

5 In December 2008, the IASB published an exposure draft on consolidation (ED10 *Consolidated Financial Statements*), and expects to publish an exposure draft on derecognition of financial assets and liabilities (amendments to IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures*) early in April 2009. The IASB plans to publish final requirements by the end of 2009 (consolidation) and in the first half of 2010 (derecognition). The IASB view these projects as longer-term solutions for both topics.

6 For information purposes, the appendix to this paper sets out the main features of each of the exposure drafts on derecognition and consolidation and a high level assessment of the differences between the IASB and FASB proposals.

Strategic options for the boards—derecognition and consolidation

7 In this section of the paper we describe the approaches the boards could take to achieve the same accounting requirements for consolidation and derecognition.

8 We have not included a staff recommendation in the paper because the decision the boards need to make is not a technical decision. Rather, the boards need to make a decision about how quickly they wish to achieve the same requirements and the best way to achieve that objective.

Background

9 As noted in paragraph 3, both boards committed to completing their ongoing projects on derecognition and consolidation in 2009/2010 and to deciding upon a strategy to develop common standards on both topics.

10 The MOU commitments to complete the ongoing projects separately, rather than proceeding immediately to developing common standards, reflect the fact that both boards:

(a) need to make improvements to their respective requirements for derecognition and consolidation;

(b) have been asked to make those improvements on an accelerated basis in light of the global financial crisis; and

(c) are at different stages in the development of their standards.

11 In addition to the MOU commitments, there is demand for improvements to the requirements for derecognition and consolidation. The IASB/FASB public roundtables held at the end of 2008, the Financial Crisis Advisory Group, users, respondents to the FASB exposure drafts and regulators have all emphasised the urgent need for one set of global accounting requirements for both topics. A common theme is that those requirements should be the same—having similar requirements is simply not good enough.

12 The Financial Stability Forum (FSF) and others have also asked both boards to improve accounting and disclosure relating to off balance sheet activities on an accelerated basis.

Current state

13 The FASB is scheduled to complete its short-term projects on derecognition and consolidation in the first half of this year. Both projects are at an advanced stage and completion will result in improvements to US GAAP financial reporting.

14 The improvements to IFRS need to be made by mid-2011. The IASB is scheduled to complete the consolidation project towards the end of this year and derecognition early next year. The IASB has a 2011 target for all major

improvements to standards because of Board member turnover and the timing of adoption of IFRS by a number of countries.

15 It is clear that there are competing imperatives. The ideal situation would be for the IASB and FASB to develop common requirements in the short term. Unfortunately this is, in our view, not achievable. We think there are, realistically, only two basic approaches available to the boards in the context of working towards a converged solution for both derecognition and consolidation.[1]

Possible options for the boards

A joint project in 2009

16 The FASB could complete its short-term projects on consolidation and derecognition, and then join the IASB in developing common standards for both topics. The IASB would probably need to slow down its work to permit the FASB to deliberate the IASB proposals and issue an exposure draft. Both projects would be developed jointly—ie the IASB and FASB would redeliberate issues raised by respondents to the exposure drafts concurrently, and develop common standards together.

17 This approach would, or could, result in common standards for derecognition and consolidation earlier than the alternative approach (described next). This approach would be responsive to the calls highlighted earlier in this paper to produce the same accounting requirements according to IFRS and US GAAP for derecognition and consolidation.

18 However, having the IASB delay the projects to allow the FASB to join in would mean the IASB would not meet its short term objectives and could even put at risk the 2011 deadline for making major improvements to standards. Missing this latter deadline would result in a significant delay before any changes to

[1] One option would be for one of the boards to abandon their current projects and put their efforts into the projects of the other board. We did not consider this option because such an approach would result in one or both of the boards failing to meet its short term objective of improving financial reporting, mainly because the board abandoning its own project would need to expose the other proposals.

consolidation and derecognition IFRS requirements eventually become effective because of the need to give jurisdictions adopting IFRS a period of relative stability.

The FASB follows the IASB

19 The FASB could complete its short-term projects on consolidation and derecognition and then use the IASB exposure drafts as the starting point for its long-term projects on both topics. (This is similar to the IASB's fair value measurement project that used SFAS 157 *Fair Value Measurements* as its starting point). Following this approach, the IASB would continue to work on its respective projects on derecognition and consolidation to finalise the standards. Both boards would take into account the decisions and conclusions of the other as they develop requirements, including considering comments from the other Board's respondents. For example, if the FASB publishes exposure drafts on its long-term projects before the IASB publishes its final requirements, the IASB would consider the FASB proposals in developing its requirements and vice versa.

20 Taking this approach would see both boards working towards a converged solution for both topics, whilst also meeting both the FASB's short-term objectives and the IASB's short term and 2011 objectives.

21 If the FASB was to use the IASB's exposure drafts as the starting point for its long-term projects, there is a higher probability that many of the requirements developed would be the same according to both GAAPs, rather than merely being similar (even small differences can cause difficulties of interpretation and on implementation). The IASB's fair value measurement project, which uses SFAS 157 as its starting point, has demonstrated that this is the case.

22 However, even with this second approach there is a risk of differences between IFRS and US GAAP that almost inevitably will result in the 'leap-frogging' approach seen in other projects. Given the IASB's 2011 objective, there could be a significant delay in making any subsequent amendments to IFRS that are identified during the FASB deliberations to converge the requirements.

Question for the boards

23 **How do the boards wish to proceed in working towards a converged solution for derecognition and consolidation?**

Appendix: Current status of the consolidation and derecognition projects

Consolidation projects

IASB consolidation project

24 The IASB consolidation exposure draft is a replacement for the consolidation requirements in IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation—Special Purpose Entities*. It applies to all entities. The comment period for the exposure draft ends on 20 March 2009. The IASB plans to publish a final standard in the second half of 2009.

25 The main features of the proposals in ED10 *Consolidated Financial Statements* are as follows:

(a) One entity consolidates another when it <u>controls</u> that other entity. A reporting entity controls another entity when it has the <u>power</u> to direct the activities of that other entity to generate <u>returns</u> for the reporting entity.

(b) The exposure draft includes guidance on assessing control in areas that have proven difficult in the past—eg power with less than a majority of voting rights, options, agent/principal, protective rights, assessing control of a structured entity.[2]

(c) The exposure drat proposes additional disclosure requirements mainly relating to the control decision and an entity's involvement with unconsolidated structured entities.

FASB consolidation projects

26 The FASB exposure draft proposes amendments to FIN 46(R). It applies only to variable interest entities, and not to voting interest entities that are within the scope of ARB No.51 *Consolidated Financial Statements*. Qualifying special purpose entities (a concept from SFAS 140) are within the scope of the exposure draft.

[2] A structured entity is similar to what US GAAP describes as a variable interest entity, and what SIC-12 described as a special purpose entity.

Appendix

27 The exposure draft of amendments to FIN 46(R) is a short-term project to improve financial reporting by entities involved with variable interest entities in an expeditious manner. The FASB is currently redeliberating issues raised by respondents to the exposure draft. The FASB plans to publish final amendments to FIN 46(R) in the second quarter of 2009. The FASB has already finalised disclosures relating to involvement with variable interest entities by publishing a FASB Staff Position in December 2008.

28 The FASB has a long-term project on consolidation on its agenda to develop comprehensive guidance on accounting for affiliations between entities, including reconsideration of ARB No.51.

29 The main features of the proposed amendments to FIN 46(R) *Consolidation of Variable Interest Entities* are as follows:

(a) One entity (the 'primary beneficiary') consolidates a variable interest entity when it has a <u>controlling financial interest</u> in that variable interest entity. An entity has a controlling financial interest in a variable interest entity when it has:

i <u>power</u> to direct matters that most significantly impact the activities of a variable interest entity, including but not limited to, activities that impact the entity's economic performance; and

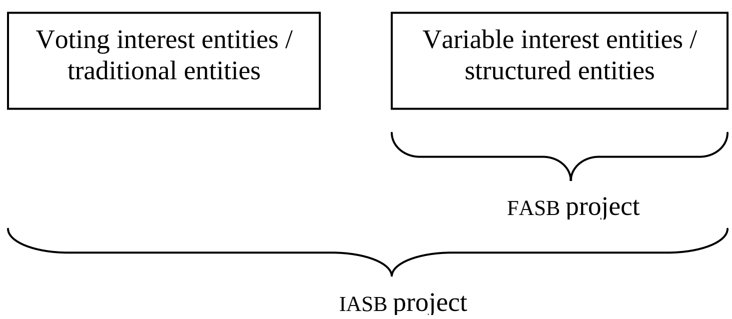
ii the right to receive <u>benefits</u> from the variable interest entity that could potentially be significant to the variable interest entity or the obligations to absorb <u>losses</u> of the entity that could potentially be significant to the variable interest entity.

(b) Determining whether an enterprise has a controlling financial interest typically is achieved through a qualitative analysis of the entity's interest and the characteristics of the variable interest entity, including the involvement of other variable interest holders. If an entity cannot determine whether it meets both the power and benefits/losses criteria, the entity performs a quantitative analysis on the basis of expected losses and expected residual returns (ie the quantitative model included in FIN 46(R) today).[3]

(c) The exposure draft proposed additional disclosure requirements mainly relating to the control decision and an entity's involvement with variable interest entities. The disclosure package was published as a FASB Staff Position (FSP) in December 2008.

Main areas of difference in the IASB and FASB exposure drafts on consolidation

30 The major difference between the IASB and FASB exposure drafts on consolidation is the scope of the projects—the IASB exposure draft applies to all entities; the FASB exposure draft applies only to variable interest entities.



31 Within that scope, the proposals relating to variable interest entities / structured entities are similar. Both exposure drafts propose a control model that requires both power and benefits/loss.[4][5] Within that model, there are some differences in the application guidance, mainly relating to agent/principal guidance, protective rights and implicit financial support. Other differences could be inferred from differences in the wording used in both documents.

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[3] On redeliberation, the FASB has decided remove the quantitative analysis on the basis of expected losses/expected residual returns.

[4] The IASB's use of 'returns' equates to what FIN 46(R) describes as 'benefits' and 'losses'.

[5] The FASB's decision on redeliberations to remove the quantitative second test brings the proposed models closer.

Appendix

Derecognition projects

IASB derecognition project

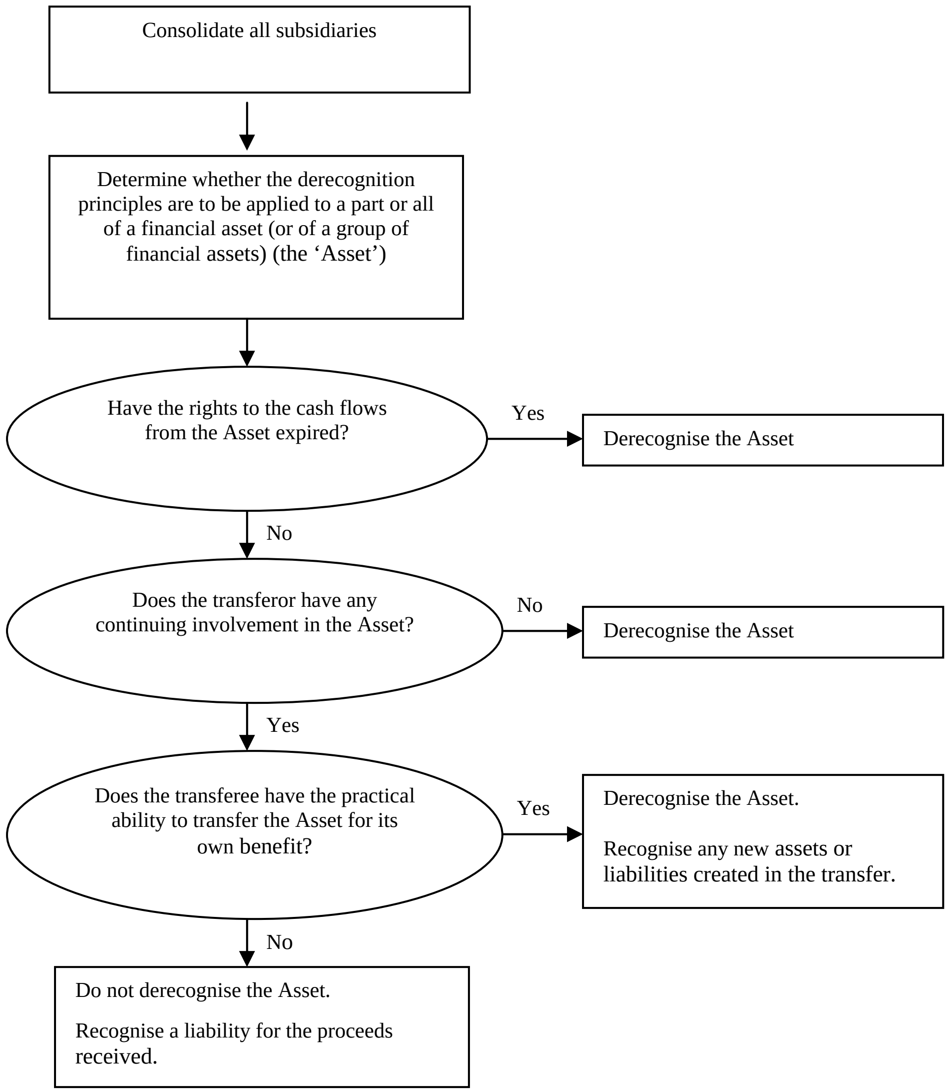
32 The IASB's exposure draft proposes amendments to the derecognition requirements of IAS 39 and related disclosure requirements of IFRS 7. The proposed amendments to IAS 39 address the derecognition of both financial assets and financial liabilities. The exposure draft is planned for publication at the end of March or early April, with a comment period ending on 31 July 2009. The IASB plans to publish final amendments in the first half of 2010.

33 The main features of the proposed amendments to IAS 39 and IFRS 7 are as follows.

(a) An entity derecognises a financial asset (or part thereof[6]) if the contractual rights to the cash flows from the asset expire, or the entity transfers the asset and has no continuing involvement in the asset, or the entity transfers the asset and has continuing involvement but the transferee has the practical ability to transfer the asset for its own benefit.

[6] Part of a financial asset is assessed for derecognition if that part comprises specifically identifiable cash flows and/or a proportionate share of the cash flows from that financial asset.

Appendix



(b) The exposure draft will propose additional disclosure requirements mainly relating to assets that have been derecognised but in which the entity has continuing involvement.

34 Five Board members voted against the proposed guidance for derecognition of financial assets. Those Board members prefer an alternative approach to derecognition of financial assets. The alternative approach will be published as part of the exposure draft for consideration by constituents.

Appendix

FASB derecognition project

35 The FASB's exposure draft proposes amendments to the requirements for derecognition of financial assets in SFAS 140. The project is a short-term project to amend guidance on accounting for derecognition of transferred financial assets. The FASB is currently redeliberating issues raised by respondents to the exposure draft. The FASB plans to publish final amendments to SFAS 140 in the second quarter of 2009. The FASB has already finalised disclosures relating to involvement in transferred financial assets by publishing a FASB Staff Position in December 2008.

36 The FASB has a long-term project on derecognition of financial instruments on its agenda to develop a new approach to derecognition.

37 The main features of the proposed amendments to SFAS 140 are as follows.

SFAS 140 (both existing and draft amended standard) is based on a *financial-components approach* that focuses on control. Under that approach, a transfer of financial assets is accounted for as a sale if the transferor surrenders control over those assets. 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. The transferor, its consolidated affiliates included in the financial statements being presented, or its agents does not maintain effective control over the transferred assets through for example, (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 or (3) a restriction on the transferee's right to pledge or exchange the transferred financial asset it receives unless such constraint is designed primarily to provide the transferee with a benefit, or (4) an agreement that permits the transferee to require the transferor to repurchase the transferred financial assets at a price that is so favourable to the transferee that it is probable that the transferee will require the transferor to repurchase the transferred financial assets.

38 The exposure draft proposed additional disclosure requirements mainly relating to assets that have been derecognised but in which the entity retains continuing involvement. The disclosure package was published as a FASB Staff Position (FSP) in December 2008.

39 The FASB has started redeliberating some of the proposed amendments on the basis of comments received from respondents to the exposure draft.

Main areas of difference in the IASB and FASB exposure drafts on derecognition

40 Both the IASB and FASB derecognition models are control-based models—an entity derecognises a financial asset when it no longer controls that asset. However, the derecognition models work in different ways. The main differences are as follows:

(a) The IASB proposals do not include a legal isolation test; this is a fundamental part of the FASB model.

(b) There are differences in what qualifies as a part of a financial asset to be assessed for derecognition.

(c) The FASB derecognition model focuses on control of the legal title to a financial asset, whereas the IASB derecognition model focuses on control of the economic benefits underlying a financial asset.