Project **Derecognition – Financial Instruments**

Topic **Comment Letter Analysis – Cover Note**

Introduction

1. In March 2009, the Board published an exposure draft ('Derecognition ED') to replace the derecognition requirements of IAS 39 *Financial Instruments: Recognition and Measurement* and to improve the disclosure requirements in IFRS 7 *Financial Instruments: Disclosures* relating to the transfer of financial assets and liabilities.
2. The comment deadline for the Derecognition ED ended on 31 July 2009. The Board has so far received in total 118 comment letters from a wide range of respondents (both by type, region and industry).
3. The Board held public round tables to discuss the proposals in the Derecognition ED in June 2009 in Toronto, Tokyo and London.
4. In addition to the round tables, the IASB staff also undertook an extensive outreach programme with users, preparers, auditors, trade associations, regulators and others.

Contents and purpose of this paper

5. The Board noted in the Derecognition ED that it expects to issue final derecognition accounting requirements and amendments to IFRS 7 in the first half of 2010.
6. The Derecognition ED is intended to be a long-term solution for derecognition of financial instruments.

7. The Board was divided on the appropriate approach to derecognition of financial assets. A majority of the Board supported the derecognition approach proposed in the ED. However, five Board members preferred a different approach to derecognition of financial assets. The approach supported by those dissenting Board members was set out in the Derecognition ED as the 'alternative approach'.

8. The purpose of this set of papers is to detail and discuss the feedback received from respondents to the Derecognition ED as well as from the extensive outreach program undertaken by the staff.

9. This paper also sets out the *broad* possible approaches available to the Board. The paper does not discuss the approaches in detail and does **not** ask the Board for a decision as to their preferred approach. The staff will ask the Board to take that decision at a later meeting. However, the staff believes that setting out the possible approaches will help board members put the comments received into context. This set of papers also provides board members with analysis that will be useful to the board when they are asked for a decision as to how the project should proceed.

10. The set of papers are as follows:

    (a) **Paper 16A**: Analysis of the comments on the proposed approaches for derecognition of financial assets and financial liabilities

    (b) **Paper 16B**: Analysis of the comments on the alternative approach for derecognition of financial assets

    (c) **Paper 16C**: Analysis of the problems with and weaknesses in the current guidance for derecognition of financial assets in IAS 39

    (d) **Paper 16D**: Statistical analysis of the comments received on the Derecognition ED

Background

11. The derecognition model in IAS 39 was first introduced as part of the revisions to IAS 39, in 2000. Under that revised version of IAS 39, several concepts

(primarily risk and rewards and control) governed when a financial asset should be derecognised. It was not always clear when and in what order to apply those concepts. As a result, the derecognition requirements in the original IAS 39 were not applied consistently in practice.

12. In June 2002, the Board issued an Exposure Draft to amend the provisions of IAS 39. The ED proposed an approach to derecognition under which a transferor of a financial asset continues to recognise that asset to the extent the transferor has a continuing involvement in it. Under that approach, continuing involvement could be established in two ways: (a) a reacquisition provision (such as a call option, put option or repurchase agreement) and (b) a provision to pay or receive compensation based on changes in value of the transferred asset (such as a credit guarantee or net cash settled option).

13. The purpose of that approach was to eliminate conflicting concepts and establish an unambiguous, more internally consistent and workable approach to derecognition and to facilitate consistent implementation and application of the requirement of IAS 39. That proposed approach was also expected to clarify IAS 39 and provide transparency on the face of the balance sheet about any continuing involvement in a transferred asset.

14. In response to that Exposure Draft, many respondents agreed that there were inconsistencies in the existing derecognition requirements in IAS 39. However, there was limited support for the continuing involvement approach proposed in the Exposure Draft. Respondents expressed conceptual and practical concerns. Many respondents then expressed the view that the basic approach in the original IAS 39 should be retained in the revised standard and the inconsistencies removed.

15. In response to the comments received, the Board decided to revert to the derecognition concepts in the original IAS 39 and to clarify how and in what order the concepts should be applied.

16. In 2003, the Board revised the derecognition guidance in IAS 39, as part of the improvements project, with the objective of reducing complexity by clarifying and adding guidance, eliminating some of the internal inconsistencies and

incorporating into the standard elements of Standing Interpretations Committee (SIC) Interpretations and Questions and Answers published by the IGC.

17. The revised guidance (that is, the current guidance in IAS 39) retained the two main concepts of risks and rewards and 'control' but clarified that the evaluation of the transfer of risks and rewards of ownership precedes the evaluation of the transfer of control for all derecognition transactions.

18. In April 2005 the Board and the FASB added a project to their respective research agendas to improve and potentially bring to convergence the derecognition requirements in IAS 39 Financial Instruments: Recognition and Measurement and FASB Statement No. 140 Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SFAS 140). **The boards made this decision because of the complexity of the current requirements and the resulting difficulty in applying them in practice.**

19. The Board moved the project from its research agenda to its active agenda and decided to proceed directly to the publication of an exposure draft in response to the global financial crisis and the recommendations of the Financial Stability Board.

Feedback on Derecognition ED (Some key messages)

Convergence

20. One issue that has commonly been raised during the outreach programme and in the comment letters is that of convergence.

21. At the joint meeting in March 2009, the Boards agreed that:

    (a) the FASB would complete its short-term project of amending Statement 140 by issuing a final statement in 2009;

    (b) the Boards would jointly deliberate (with the objective of reaching common conclusions) the comments the IASB receives on the IASB exposure draft on derecognition; and

(c) at the conclusion of those deliberations, the IASB would issue a standard amending the derecognition requirements in IAS 39, and the FASB would expose the IASB's amendment of IAS 39 to its constituents for public comment.

22. Many constituents appear to support convergence of the derecognition guidance under IFRS and US GAAP, but consider the 'leapfrogging' approach set out in paragraph 14 to be sub-optimal.

23. Some constituents prefer that the IASB delays the publication of a final standard, and that the Boards should use the Derecognition ED and the comments to be received as the basis for a **new exposure draft** to be published simultaneously by both boards. They argue that this is the only feasible approach that:

(a) ensures a common standard on derecognition;

(b) avoids the 'leapfrogging' approach that requires continuous catch up by both boards; and

(c) avoids the increased costs that arise for entities and others.

24. To ensure that the lessons and experiences from the recent amendments to the derecognition and related disclosure requirements in the US are taken into account, the Board decided in July 2009, not to issue a final standard on derecognition of financial instruments until two quarters of implementation of FASB Statement 166 (the replacement of FAS 140).

Sale and repurchase/Stock lending transactions

25. There is an overwhelming disagreement with the proposed treatment (under both approaches) for sale and repurchase ('repo') and similar transactions. Under both approaches, repos would generally be treated as sales as opposed to collateralised lending as required under IAS 39 and FAS 166. The proposed approach would however treat repos of non-readily obtainable financial assets as collateralised lending arrangements. Interestingly, investors that the staff consulted were, generally, in support of the proposed treatment of repo

transactions. The staff also notes that a few banks support or are indifferent to the proposed treatment for repo transactions.

Alternative approaches to replacing the IAS 39 guidance on derecognition of financial assets

26. Based on work done previously by the staff, previous efforts by the Board and others in addressing the issue of derecognition, comments received on our outreach efforts and the comment letters, the staff believes the following are possible approaches the Board could take:

    (a) **Approach 1**: Focus solely on enhancing the disclosure requirements in respect of transfer of financial assets

    (b) **Approach 2**: Amend the derecognition requirements in IAS 39 to address known practice issues and internal inconsistencies (with or without improvements to the disclosure requirements relating to transfer of financial assets)

    (c) **Approach 3**: Develop the proposed approach in the Derecognition ED and address the problems and inconsistencies identified by respondents

    (d) **Approach 4**: Develop the alternative approach to derecognition of financial assets and address the issues with that approach identified by respondents

Approach 1: Focus on enhancing the disclosure requirements in IFRS 7

27. Some respondents question the need for, and the pace, of the replacement project. Those respondents disagree that the current derecognition requirements in IAS 39 are flawed and as such prefer that the amendments be limited to enhancing the disclosure requirements (which they believe has been the area needing urgent attention).

Approach 2: Amend current guidance in IAS 39 (with or without changes to the disclosure requirements)

28. Many respondents to the ED state that, contrary to US GAAP provisions on derecognition, the IAS 39 requirements have withstood the test of the financial crisis.

29. Those respondents also believe that the IAS 39 requirements are well understood and consistently applied by preparers and auditors, and results in accounting that is consistent with the economics of transactions. Those respondents disagree that the derecognition requirements in IAS 39 are flawed. They are not convinced that the removal of the explicit risks and rewards test would result in an improved accounting model.

30. Some of those respondents believe that IAS 39 has proven to be reasonable in concept and operational in practice and thus the approach should not be changed until the Board develops an alternative comprehensive approach. Those respondents expressed the view that the basic approach in IAS 39 should be retained in revised new standard and the inconsistencies removed.

    Paper 16C discusses the issues that the Board would have to address if such an approach was to be pursued.

31. The staff notes that many more respondents, including preparers, auditors and regulators, were in agreement that the IAS 39 requirements are inconsistent, complex and do not always yield the right accounting outcomes.

Approach 3: Develop the proposed approach for derecognition of financial assets in the Derecognition ED

32. The Board could develop the proposed approach in the Derecognition ED and address the problems and inconsistencies identified by respondents

33. Except for a handful of respondents, respondents generally did not agree with the proposed approach in the ED to be adopted as the new approach to derecognition of financial assets. An overwhelming majority of respondents did not agree that the proposed approach should be established as the new approach for derecognition of financial assets.

34. Constituents expressed concerns about almost every question in the derecognition flowchart in the proposed approach. Many point to inconsistencies in the proposed guidance, possible operational difficulties, need for more application guidance and clarification of the wording. Many have expressed the view that the proposed approach is not a significant improvement to the derecognition guidance in IAS 39 and that the proposed approach inherits many of the deficiencies in the existing guidance. Many also argued that any benefits of the proposed changes did not outweigh the burden of adopting a different approach that had its own set of (as yet unidentified and unsolved) problems and that the proposal is not consistent with the *Framework*.

Approach 4: Develop the alternative approach for derecognition of financial assets

35. The Board could develop the alternative approach to derecognition of financial assets and address issues identified by respondents in respect of that approach.

36. A significant number of the respondents prefer the alternative approach to the proposed approach. Those who prefer the alternative approach note the simplicity of that approach and assert that it has strong conceptual merits.

37. However some of those respondents would prefer an amended alternative approach that addresses the perceived opportunity to manipulate earnings under the alternative approach (as a result of a mixed-measurement model for financial instruments) and to possibly make an exception for sale and repurchase agreements (‘repos’) and stock lending transactions (to treat those transactions as financing arrangements).

38. Other respondents cautioned against proceeding with the alternative approach as it is only suitable for a full fair value system and might introduce measurement complexities into the standard.

39. Others believe that the alternative approach is not fully developed (or not fully described) in the ED and hence if the Board decides to pursue that approach, it should be re-exposed for comments.

40. Some respondents argued that the Board should complete its work on replacing the Framework before developing a replacement derecognition guidance. Those respondents believe that the Board needs to establish the purpose of the balance sheet and the role of risk and rewards in financial reporting before addressing the issue of derecognition.

Question for the Board:
Does the Board believe that the information and analysis in papers 16A – 16C) is sufficient to enable the Board to decide **at a future meeting** an approach for this project? If not, what other information or analysis does the Board require to be able to decide on the way forward and why is that information necessary to help you in making this decision?