Project	**Derecognition – Financial Instruments**
Topic	**Comment Letter Analysis – Existing derecognition guidance in IAS 39**

Contents and purpose of this paper

1. This paper addresses a common issue raised by respondents. Many respondents commented that the Board did not set out clearly in the Derecognition Exposure Draft ("ED") the problems and weaknesses of the derecognition requirements of IAS 39, and why there is a need to replace the existing guidance. Some respondents question the need for, and the pace of, the replacement project.

2. They also argue that, contrary to US GAAP provisions on derecognition, the IAS 39 requirements have withstood the test of the financial crisis and they are not convinced that the removal of the explicit risks and rewards test would result in an improved accounting model.

3. Such respondents 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 and hence recommend that the project be limited to enhancing the disclosure requirements (which they believe has been the area needing urgent attention).

4. Some of the respondents that disagreed that the derecognition requirements in IAS 39 are flawed stated that, in addition to improving disclosures, the Board should address and clarify aspects of the derecognition requirements. That is obviously one possible route the Board could take. The last section of this paper lists the issues that the Board would have to or could address if such an approach was pursued.

5. The staff also 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.

6. The staff notes that this paper is not an exhaustive list of all problems with the current requirements. The paper does however incorporate many of the issues that have been brought to IFRIC's attention (by auditors, preparers and others) and those raised by audit firms to the Board directly.

Summary of the derecognition requirements of IAS 39

7. Under the requirements, an entity first determines what asset is to be considered for derecognition. The guidance requires a part of a larger financial asset to be considered for derecognition if, and only if, the part is one of:

   (a) specifically identified cash flows from a financial asset; or

   (b) a fully proportionate (pro rata) share of the cash flows from a financial asset; or

   (c) a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset.

   In all other cases, the standard requires the financial asset to be considered for derecognition in its entirety.

8. Under the current guidance, a financial asset is derecognised when (a) an entity has transferred a financial asset and (b) the transfer qualifies for derecognition.

9. The guidance states that an entity has transferred a financial asset if, and only if, it either:

   (a) retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay those cash flows to one or more recipients in an arrangement that meets three specified conditions; or

   (b) transfers the contractual rights to receive the cash flows of a financial asset.

10. If an entity has transferred a financial asset, it assesses whether it has transferred substantially all the risks and rewards of ownership of the transferred asset. If an entity has retained substantially all such risks and rewards, it continues to recognise the transferred asset. If it has transferred substantially all such risks and rewards, it derecognises the transferred asset.

11. The guidance specifies that if an entity has neither transferred nor retained substantially all the risks and rewards of ownership of the transferred asset, it assesses whether it has retained 'control' over the transferred asset. If it has retained 'control', the entity continues to recognise the transferred asset to the extent of its continuing involvement in the transferred asset. If it has not retained 'control', the entity derecognises the transferred asset.

12. Under the current guidance, 'control' is evaluated by looking to whether the transferee has the practical ability to transfer the asset.

Weaknesses of the IAS 39 requirements

13. In this section, the staff attempts to highlight some of the inconsistencies and weaknesses in the derecognition guidance in IAS 39. To facilitate discussion and understanding, the staff has divided the comments under three headings - internal inconsistencies, conceptual weaknesses and practice (application) issues.

Comments: Internal inconsistencies

14. Some of the criticisms of the IAS 39 requirements in terms of internal inconsistencies were cited by the dissenting members in the dissenting opinion in the ED. The staff has restated some of the criticisms in the following paragraphs.

15. Under the current guidance, risk and rewards and 'control' govern when a financial asset should be derecognised. The use of both concepts makes the application of the guidance confusing.

16. Some believe that the provisions of the IAS 39 requirements relating to risks and rewards and to control are internally inconsistent. This is obvious if the two concepts are applied separately (not in sequence). The concepts yield opposite conclusions when applied separately (Note: IAS 39 requires that the evaluation of the transfer of risks and rewards of ownership precedes the evaluation of the transfer of control). Hence the argument is that a model incorporating criteria that which on their own gives opposite conclusions mean the model is not internally consistent and it is logically not based on any reasoned principle.

17. Moreover, many argue that IAS 39 is founded primarily on a control model. The recognition criteria in IAS 39 focuses on control and look to each of the rights and obligations of the parties to a financial contract to determine whether an asset or liability should be recognised and at what amount. On the contrary, the derecognition model in IAS 39 combines the requirements of a 'control' approach with those of a risks and rewards approach. Hence many believe that the combination of risk and rewards in the derecognition model introduces complexity and inconsistency into IAS 39.

18. Under the IAS 39 derecognition requirements for financial liabilities, if a creditor releases a debtor from its present obligation to make payments, but the debtor assumes a guarantee obligation to pay if the party assuming primary responsibility for the obligation defaults, the debtor derecognises the original liability and recognises a new financial liability based on the fair value of its obligation for the guarantee. However, if an entity transfers a previously recognised financial asset and writes a guarantee to cover any losses relating to the asset, the transfer would fail the derecognition criteria and hence the transferor would continue to recognise the asset. Many argue that the financial liability derecognition model is conceptually sound and it is consistent with IAS 39 as a whole, but question why the same approach is not applied to financial assets. They emphasise that the derecognition model in IAS 39 is therefore internally inconsistent.

19. It is also believed that the IAS 39 requirements result in very different accounting by two entities with identical contractual rights and obligations only because one of those entities once owned part or all of the transferred financial

asset. Under IAS 39, a derivative such as a fixed price option that entitles the holder to acquire an asset it has never owned would be accounted for simply as a call option (asset). Yet under IAS 39, if that option pertains to an asset previously recognised by the transferor, the transferor and transferee would be required to determine whether the transferor has retained substantial risk and rewards and if not whether the asset is fungible or readily obtainable to determine whether the transferred asset should or should not be derecognised by the transferor and recognised by the transferee. Only if the transferred asset is derecognised would the call option derivative be recognised. As a result, ownership history affects the accounting. This is seen by many as having made the guidance internally inconsistent.

20. Under the IAS 39 requirements, only fully proportionate cash flows or specifically identified cash flows or a fully proportionate part of a specifically identified cash flows or an entire financial asset qualify as a unit of account for derecognition purposes (i.e. an item that can be assessed for derecognition). Hence, the item that may be assessed for derecognition might not be the same as the asset recognised by an entity prior to the transfer. Hence the IAS 39 derecognition requirements are seen to invoke a unit of account that is not consistent with IAS 39 as a whole. As such many believe that the current guidance adds to the complexity of the standard and creates inconsistencies in the standard.

Comments: Conceptual Weaknesses

21. Most of the criticisms of the IAS 39 requirements (in terms of conceptual merit) are not dissimilar to that set out in the ED by the dissenting Board members. Hence the staff reproduces below some of the dissenting comments that are frequently cited as weaknesses of the IAS 39 derecognition guidance.

22. Many believe that the derecognition requirements are not supported by *The Framework*. They believe that IAS 39 results in recognising assets and liabilities that do not meet the definitions of those elements in the Framework.

23. Many argue, for example, that a right to receive a cash flow does not represent a future economic benefit to the holder of that right when the holder of that right also has an obligation to pay the amount it will receive to a third party and cannot otherwise use the cash received for its benefit. For example, in a transfer of the first 90 per cent of the cash flows from a loan receivable, the transferor does not control all of the economic benefits or cash flows that constitute the asset previously recognised by the transferor. The transferor has no right to the first 90 per cent of the cash flows from the loan; it is merely acting as servicer. The transferee controls access to that cash and the right to the cash if collected.

24. Similarly, the *Framework* definition of a liability refers to a present obligation that is expected to result in an outflow of resources embodying economic benefits. Retention of a subordinated interest in an asset previously recognised does not constitute a liability of the transferor because doing so does not create an obligation for the transferor. If the asset fails to generate returns, the transferor has no obligation to the transferee. The transfer of the first 90 per cent of the cash flows of the previously recognised asset results in the transferor retaining a disproportionate share of any risks associated with the asset, but does not result in incurring a liability because there is no present obligation to transfer economic benefits. Rather, the value of the excess risks retained (i.e., the risks in excess of a pro rata sharing) reduces the value of the retained interest in the transferred asset. Hence many believe that the current model necessitates the recognition of 'non-existent' liabilities because a transfer has failed the derecognition criteria.

25. Also, many argue that the current guidance on initial recognition of financial assets is fundamentally different from the requirements for derecognising financial assets. The IAS 39 derecognition guidance requires entities to continue to recognise financial assets after initial recognition even though those same assets would no longer qualify for initial recognition, and vice versa.

26. Paragraph 85 of the *Framework* specifies that <u>an item that meets the definition of an element should be recognised if</u>:

(a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and

(b) the item has a cost or value that can be measured with reliability.

27. Under the *Framework*, an asset qualifies as an asset of a particular entity if the entity controls the economic benefits underlying that asset. Future economic benefit and control of that benefit are therefore the essence of an asset.

28. The *Framework* explains that an item of property is an asset of an entity if the future economic benefits are expected to flow from them to the entity and if they are controlled by the entity. For example, know-how obtained from a development activity may meet the definition of an asset when, by keeping that know-how secret, an entity controls the benefits that are expected to flow from it.

29. Thus if the economic benefits underlying the financial asset ceases to exist or is extinguished, the entity should remove the asset from its financial statement. Also, if control over the future economic benefits has been relinquished, the asset or a component thereof has been sold and should be derecognised and vice versa. Hence many argue that many transfer transactions that are accounted for as secured borrowings under current requirements (because of the risks and rewards test) results in entities continuing to recognise items that have ceased to meet the recognition criteria and vice versa.

30. Many also believe that the IAS 39 requirements confuse the purpose of the statement of financial position and how risk is to be reflected in financial statements. They disagree with the basis (implied) of the current derecognition guidance i.e. the purpose of the balance sheet is to show the risks that an entity is exposed to and that the appropriate manner to reflect risk in financial statements is to recognise on the balance sheet items ('assets') to which an entity is exposed to the risk thereof.

31. The Board's definition of asset and liability limits the population of assets and liabilities to the underlying economic resources and obligations of an entity and not the item to which the entity is exposed to the risks thereof. The definition of

assets, liabilities and equity therefore imposes a limit or restraint on what can be included in the balance sheet.

32. The staff notes that the Board's definition of assets does not incorporate the concept of risks and rewards. The staff also notes that the Framework's recognition criteria does not include the concept of risk and rewards and it is logically not part of the recognition and derecognition process (i.e. that concept is not relevant in determining when to recognise an 'asset' in a financial statement and thus when that item ought to be derecognised).

33. The staff notes that a risks and rewards test might not even be necessary or sufficient test for derecognition, because a derivative can be used to pass on some or all of either or both the risk and reward of an asset to a party that has no ownership claim on that asset. For example, an entity which owns a financial asset could enter into a total return swap with a counterparty referencing those assets and would receive a fixed return in exchange for paying all the movements (risk and rewards) of the underlying asset to the counterparty.

34. On the other hand, Paragraph 21 of the *Framework* explains that in addition to the elements of financial statements, financial statements also contain notes and supplementary schedules and other information. For example, they may contain additional information that is relevant to the needs of users about the items in the balance sheet and income statement such as disclosures about the risks and uncertainties affecting the entity, information about geographical and industry segments and the effect on the entity of changing prices**.**

35. Moreover, in paragraph 37, the *Framework* acknowledges that preparers of financial statements have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that may occur. It explains that such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements.

36. It also defines prudence as the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of

uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. In the same paragraph, it also explains that the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because by so doing the financial statements would not be neutral and, therefore, not have the quality of reliability.

37. Thus many believe that the *Framework* establishes that the purpose of the balance sheet is to provide information about financial position of an entity and that the elements of financial statements which are directly related to the measurement of financial position and are thus shown in the balance sheet are assets, liabilities and equity (as so defined in the *Framework*). It also establishes that the purpose of the balance sheet is not to show the risks that an entity is exposed to and that the appropriate manner to reflect risk in financial statements is to reflect the risks in measuring financial assets and liabilities and to fully disclose the nature and extent of the risks associated with recognised financial assets and liabilities.

38. Under current requirements, a part of a financial asset (or of a group of financial assets) qualifies as the asset to be assessed for derecognition only if it represents a right to identifiable cash flows or a proportionate share of the cash flows from that asset (or group of assets). Many believe that the Board drew an arbitrary line to identify the part of a financial asset that is eligible to be assessed for derecognition.

39. Many argue that the ‘part’ of an asset criteria is rule-based and without any conceptual merits and that it is neither necessary nor desirable to create arbitrary rules to determine what qualifies as part of an asset that can be assessed for derecognition They argue that ‘bright-line’ tests are inherently contrary to any principled objective. They emphasise that a slight shift in the form or structure of a transaction can cause it to move across the threshold, resulting in profoundly different accounting for transactions that are economically similar.

40. They also argue that most financial instruments comprise bundles of contractual rights and/or contractual obligations, and transfer transactions unbundle those rights and obligations and rebundle them in different ways. They therefore believe that the current derecognition guidance does not reflect fully this unbundling and rebundling and thus does not give a faithful representation of transactions and events. They also argue that the current guidance is not consistent with the way participants in financial markets structure financial instruments to manage risk and hence does not reflect the economics of the market place.

41. Finally, many believe that the current guidance in IAS 39 is not consistent with how financial instruments are accounted for in accordance with IAS 39 today. For example, if an entity writes a guarantee on a receivable, even though the value of the guarantee is dependent on the value of the receivable, the guarantor does not recognise the receivable as its asset.

Comments: Practical difficulties

42. There is controversy about, and much complexity in, the application of the existing derecognition requirements in IAS 39. There are concerns and practical difficulties in applying the various steps in the flowchart that accompanies the requirements. As it is rules based and combines different criteria to determine whether an asset should be derecognised, it offers opportunities for structuring and creates a check – box approach to accounting. For ease of analysis we will address the various steps in the flowchart bottom up.

Continuing Involvement test

43. This step is undoubtedly the least understood and least intuitive aspect of the derecognition hierarchy. Many preparers and auditors do not understand this concept and in practice many transactions are structured such that the determination as to whether an asset should be derecognised can be made using the earlier steps in the flowchart. One accounting firm states in its IFRS guide that – ‘One of the most difficult derecognition issues relates to transfers of financial assets in which the transferor has some continuing interest in the

asset……However the accounting becomes complex when such arrangements give rise to continuing involvement accounting'. Many of the respondents who support retaining the current guidance noted that it will be most helpful if this criterion can be deleted from the standard.

44. The staff notes the frustration with this concept (and the grossing up of the statement of financial position that it generates), but we note that this criterion serves a useful purpose as it lessens the undue effect of the risk and rewards test (a transferor would not have to record the entire asset and an associated proceeds on its books just because it is not conclusive whether it has transferred substantial risk and rewards relating to the asset).

Control test

45. Under the current guidance, 'control' is evaluated by looking to whether the transferee has the practical ability to sell the asset. If the transferee can sell the asset (e.g. because the asset is readily obtainable in the market and the transferee can obtain a replacement asset should it need to return the asset to the transferor), the transferor is considered not to have retained 'control'. If the transferee cannot sell the asset (e.g. because the transferor has a call option and the asset is not readily obtainable in the market, so that the transferee cannot obtain a replacement asset), the transferor is considered to have retained 'control'.

46. As demonstrated in almost all the comment letters received, there are significant and challenging problems in using this concept in determining whether a financial asset ought to be derecognised by a transferor. As this test has been extensively analysed in Paper 16A, the staff will not be commenting further but it suffices to say that there is an overwhelming disagreement with this test among respondents.

Risks and rewards test

47. Another area of complexity and diversity in practice is the application of the risk and rewards test in the derecognition hierarchy. This is even more problematic

as the standard provides little guidance about how the ‘substantially all the risks and rewards’ test should be applied.

48. Some believe that such a test cannot be applied in an objective and consistent manner as it is not clear how to identify, measure, and aggregate different risks and returns, and how risks and returns should be weighed against each other.

49. Another issue related to the risks and returns approach is that a transferor may retain on its balance sheet a portion of a transferred asset to which it has no exposure to gains or losses. This can arise because the transferor has an exposure to the risks and returns of another portion of the transferred asset and that portion contains substantively all of the risks and returns of the transferred asset.

50. The following are some of the specific issues that have arisen in practice with respect to the risks and rewards criterion in IAS 39 and have been brought to the attention of the Board or IFRIC (worth noting that both the Board and IFRIC have been unsuccessful in tackling many of these issues):

- whether each identified risk and reward should be substantially surrendered to allow for derecognition
- whether all risks should be aggregated separately from all rewards
- whether risks and rewards should be offset and then combined for evaluation
- how ‘substantially all’ should be interpreted in the evaluation of those risks and rewards
- What is the meaning of the term ‘original assets’ as used in paragraph 19(a) of IAS 39, particularly, whether interest rate swaps, credit guarantees or other risk management tools, acquired by a transferor before a transfer to economically hedge transferred assets, be included with the transferred asset in the risks and rewards test.
- What is the meaning of ‘similar’ financial assets? Are “a group of similar financial assets” (IAS 39.16) and “original assets” (IAS 39.19) supposed to be the same?

- What is the "financial asset" in IAS 39.20 –in particular if an entity transfers into an SPE both non-derivative assets and guarantees or derivatives, how are new guarantees or derivatives entered into by the SPE treated in the assessment?
- How to analyse risks and rewards for cash flows that are based on a market price or index? For example a floating rate asset that is transferred at the same time as the seller enters into a vanilla interest rate swap with the buyer (SPE) to take back the floating rate and pay fixed. Should the risks and rewards that form part of the analysis be only those specific to the asset such as credit risk or prepayment risk and market-based interest rate cash flow risk and foreign exchange risk be excluded?
- What methodology should be used to measure variability (IAS 39 does not provide an example of such model)
- In the individual accounts of a transferor that must consolidate the transferee in accordance with IAS 27, is the transferor's continuing interest in the risks and rewards of the asset that arise only from its participation in the SPE, included in the IAS 39.20 risks and rewards test?
- Does the choice of risk management tools (hedging strategy) matter? eg the use of a fixed rate liability to offset the risk of floating rate assets as opposed to an interest rate swap.

51. Answers to all the above questions could have significant effect on the assessment of whether substantial risks and rewards have been transferred. For example, the incorporation or exclusion of risk management products in original assets may have a significant impact on the paragraph 21 derecognition test. It is in the entity's favour to have variable interest rates included in computing the risk exposure before the transfer and a fixed interest rate in the post transfer risk exposure evaluation, as the total variability in cash flows would be clearly reduced. It is also in the entity's favour to exclude a credit guarantee in the before transfer exposure and include a credit guarantee in the post transfer exposure. The incorporation of credit guarantees in the before scenario may be perceived as penalising companies with effective risk management strategies.

Other practice issues – transfer definition, interaction with consolidation etc

52. We list below some of the other issues that constituents have consistently asked for clarification from IFRC and the Board. All these attest to the complexity of the current requirements, the inability of many constituents to understand the provisions, the consequential diversity that have resulted in practice and the nature of the issues needed to be addressed by the Board, should the Board decide to retain the current guidance:

- What is the meaning of ‘transfer’
- How should contingent obligations attached to transfers be treated
- Does retention of a junior securitisation tranche prevent the pass-through test from being satisfied?
- What does continuing involvement mean?
- What is the treatment of the retention of the most junior tranche of a securitisation vehicle? Note that IAS 39.AG52 treats the ‘excess spread’ as a new asset, not as a continuing involvement – is this correct? If so, why?
- Can the pass-through test be satisfied if there are immaterial expenses (e.g. audit fees) that must be paid out of the collection from the original assets in priority to the “eventual recipients”? Or are the auditors an “eventual recipient”?
- Can there be “empty” SPEs? i.e. can/should the pass through test be applied to the stand-alone assets of the SPE? How should an SPE apply the derecognition tests in its separate financial statements?
- How should a transferor/transferee account for derecognition transactions in its separate financial statements?

- Can assets qualify for derecognition when after a transfer the transferee is obligated to make net payments to the eventual recipients, which effectively include the proceeds from original transferred assets and the proceeds from other risk management tools (such as interest rate swaps, credit guarantees etc).

- What is the impact of the requirement, in paragraph 19(c)), that an entity must be obliged to remit any cash flows it collects on behalf of the eventual recipients without material delay, on revolving structures where cash flows are generally used to purchase new assets?.

- The interpretation of the requirement in paragraph 18(a) as to when an entity has transferred the contractual rights to receive the cash flows of a financial asset.