WSS Meeting

Staff Paper

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Project **Derecognition – Financial Instruments**

Topic **Update on Derecognition Project and Exposure Draft**

Contents and purpose of this paper

1. In addition to some background information, this paper summarises a number of issues identified by respondents to the Derecognition Exposure Draft ('Derecognition ED') (see Agenda paper 3A). The paper also asks for the views of WSS on some of the issues identified by respondents to the Derecognition ED. The staff notes that a detailed comment letter analysis is in progress and the staff intends to present its findings to the Board in September 2009. This paper does not reflect all the comments received from respondents to the ED, and is simply intended to highlight some particular issues to facilitate a focussed discussion.

Background

2. In February 2006 the IASB and FASB published a Memorandum of Understanding (MoU). The MoU set out the relative priorities within the Boards' joint work programme in the form of milestones to be reached by 2008. The MoU included the derecognition project and aimed for a due process document relating to the staff's research on this subject to be published by 2008.

3. At the joint meeting in April 2008 the Boards affirmed their commitment to developing common, high quality standards and agreed on a pathway to

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

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

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRIC or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

completing the MoU projects. For the derecognition project, the Boards set as targets:

(a) the publication of IASB and FASB exposure drafts in 2008 or early 2009;

(b) the issue of final standards in 2009 or 2010; and

(c) a decision in 2008 on a strategy to develop a common standard.

4. However, in response to the financial crisis and requests by the US Securities and Exchange Commission to address urgently inconsistencies in how some concepts in SFAS 140 are applied in practice, the FASB decided to publish an exposure draft proposing amendments to SFAS 140.

5. Similarly, in response to the global financial crisis and the recommendations of the Financial Stability Forum, the IASB moved the project from its research agenda to its active agenda and proceeded directly to issuing an exposure draft.

6. FASB has since issued Statement No. 166 *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*. Statement 166 is applicable for annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter.

7. In March 2009, the IASB published an exposure draft ('Derecognition ED') to replace the derecognition requirements of IAS 39 and to improve the disclosure requirements in IFRS 7 *Financial Instruments: Disclosures* relating to transfer of financial assets and liabilities. The comment deadline for the Derecognition ED was 31 July 2009. The IASB noted in the Derecognition ED that it expects to issue final amendments to IAS 39 and IFRS 7 in the first half of 2010.

8. The Derecognition ED is meant to be a long-term solution for derecognition of financial instruments whilst FASB Statement 166, the amendment to FASB Statement 140, is intended to be a short term solution.

Summary of the derecognition approaches in the ED

9. The IASB was divided on the appropriate approach to derecognition of financial assets. A majority of the Board favoured (and decided on) 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 is referred to in the Derecognition ED as the 'alternative approach'. The alternative approach was set out in the Derecognition ED as part of the five Board members' dissenting opinion.

Proposed approach

10. Under the proposed approach in the Derecognition ED, an entity derecognises a financial asset if
    (a) the contractual rights to the cash flows from the asset expire;
    (b) the entity transfers the asset and has no continuing involvement in it; or
    (c) the entity transfers the asset and retains a continuing involvement in it but the transferee has the practical ability to transfer the asset for the transferee's own benefit.

11. The ED defines continuing involvement as either the retention of any of the contractual rights or obligations inherent in the asset that is subject of the transfer or acquisition of any new contractual rights or obligations relating to the asset which is the subject of the transfer.

12. Under this approach, a transferee is deemed to have the practical ability to transfer an asset for its own benefit, if it is in a position immediately after the transfer from the transferor, to transfer for its own benefit, the asset to an unrelated third party unilaterally and without having to impose additional restrictions on that transfer.

13. A major implication of the 'practical ability to transfer for its own benefit' test is that if that test is met, the transferor will derecognise the asset, irrespective of the nature of the transferor's continuing involvement in the asset. Because most sale and repurchase agreements involving financial assets (repo transactions) concern the transfer of one readily obtainable security in exchange for another

readily obtainable security, an implication of this test is that most repo transactions will be treated as a sale of the transferred assets. On the contrary, as many transferee vehicles would be restricted from transferring the assets placed in them, most securitisations and conduit arrangements would fail the derecognition test, as would most factoring arrangements.

Alternative view

14. Under the alternative approach, an entity derecognises a financial asset when the economic benefits no longer exist or the economic benefits exist but the entity ceases to have the ability (a) to obtain all of the future economic benefits inherent in the asset and (b) to restrict others' access to those benefits. An entity no longer has that ability if it ceases to have present access, for its own benefit, to all of the cash flows or other economic benefits of the asset.

15. Hence, under the alternative approach, when the rights to identified cash flows are transferred, the transferor derecognises the previously recognised asset and recognises all the rights and obligations either retained or obtained in the transfer transaction. For example, forward contracts, puts, calls, guarantees or disproportionate involvement with respect to transferred cash flows would not result in failed sales or result in the recognition of a liability for the proceeds received. Any involvement would be recognised and measured at the date of transfer at fair value.

Summary of some issues identified by ED respondents

16. The IASB held public round tables to discuss the proposals in the Derecognition ED in June 2009 in Toronto, Tokyo and London. In addition to the round tables, the IASB staff has also undertaken an extensive outreach programme with users, preparers, auditors, trade associations, regulators and others.

17. The comment deadline for the Derecognition ED was 31 July 2009. As noted, a detailed comment letter analysis is in progress and the staff intends to present its findings to the Board in September 2009. Below are some of the major issues the staff has identified from the responses received so far:

Convergence

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

19. 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.

20. Many constituents appear to support convergence of the derecognition guidance under IFRS and US GAAP, but consider the 'leapfrogging' approach set out in paragraph 19 to be sub-optimal.

21. 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.

22. 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 in the Boards consideration of a converged standard on derecognition, the Boards agreed at the joint meeting in July 2009 to begin the joint

deliberation of the comments on Derecognition ED two quarters after the implementation of FASB Statement 166 (the replacement of FAS 140).

Derecognition Approaches

23. Almost all respondents specified whether they agree with the derecognition approaches outlined in the Derecognition ED and their suggestions on what the appropriate derecognition approach should be. Below are the derecognition approaches that received significant support or on which most comments were received:

    (a) **Proposed Approach:** Constituents have 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.

    (b) **Alternative Approach:** 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. 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 repos and stock lending transactions (to treat those transactions as financing arrangements).

    (c) **Current guidance in IAS 39:** Some respondents question the need for and the pace of the replacement project. Those respondents believe that the current model is well understood and consistently applied by constituents and results in accounting that is consistent with the

economics of transactions. Those respondents disagree that the current derecognition requirements in IAS 39 is 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). They are not convinced that the removal of the explicit risks and rewards test would result in an improved accounting model. They also argue that, contrary to US GAAP provisions on derecognition, the current requirements of IAS 39 have withstood the test of the financial crisis.

Sale and repurchase/Stock lending transactions

24. Overall, 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. A few banks also support or are indifferent to the proposed treatment for repo transactions.

Other issues

25. Some respondents also identified a number of fundamental issues that they believe should be addressed before concluding on whether, and what, amendments to the existing requirements should be made, including:

    (a) **Risks and rewards test:** Some constituents expressed concerns about the elimination of the risk and rewards concept from the derecognition guidance. Those respondents consider the sharing of risks and rewards as a key factor in the determination of control and consequently as a vital component of any derecognition analysis. Hence they argue that the removal of the risks and rewards test from the derecognition guidance would lead to inappropriate accounting under IAS 39. The

key questions here are - should derecognition requirements be based on control, risks and rewards, continuing involvement or some combination of these, or another model? Are risks and rewards best reflected in measurement and disclosure rather than in the derecognition decision? What is the purpose of the balance sheet?

(b) **Unit of Account:** The issue here is whether the item that can be assessed for derecognition should only be a financial contract as whole or it could be identifiable components, portions, proportions of a financial contract, or a combination of these, or the accounting should reflect practice in which market participants unbundle and rebundle parts of financial assets in any number of ways to suit the demands of investors. Both the proposed approach for derecognition and the Alternative Approach in the ED and the current guidance in IAS 39 invoke a ‘unit of account’ of some sort.

Under the proposed approach and the current guidance in IAS 39 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 under both the proposed approach and the current guidance in IAS 39, the item that may be assessed for derecognition might not be the same as the asset recognised by an entity prior to the transfer.

The unit of account under the Alternative Approach is to effectively derecognise the rights transferred and apply IAS 39 in recognising obligations and rights assumed or acquired as part of the transfer. Hence the alternative view is seen by some as invoking a unit of account that is already embodied in IAS 39, whereas the proposed and the existing guidance apply a unit of account that is beyond the scope of a standard on derecognition. As such some respondents suggest that the Board resolves this fundamental issue at a conceptual level as part of the framework project.

Issues for discussion

26. To help address concerns raised by respondents, the staff would like feedback from WSS on the issues discussed below.

Issue 1: What is the purpose of the balance sheet?

27. As noted in paragraph 25(a), some respondents suggested that the Board first set out the purpose of the balance sheet before developing a derecognition guidance. This they argue will ensure that the appropriate items are always reflected on the balance sheet.

28. Paragraph 12 of the Framework states that the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. In paragraph 15, it explains that the economic decisions that are taken by users of financial statements require an evaluation of the ability of an entity to generate cash and cash equivalents and of the timing and certainty of their generation. It further explains that a better evaluation of that cash generation ability is achieved through provision of information that focuses on the financial position, performance and changes in financial position of an entity.

29. In paragraph 16, the Framework states that – the financial position of an entity is affected by the economic resources it controls, its financial structure, its liquidity and solvency, and its capacity to adapt to changes in the environment in which it operates.

30. <u>Paragraph 19 of the Framework establishes that information about financial position is primarily provided in a balance sheet.</u> Further, in paragraph 47, the Framework explains that financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are referred to in the same paragraph as the elements of financial statements. <u>In paragraph 19, the Framework concludes that of these elements those directly related to the measurement of financial position in the balance sheet are assets, liabilities and equity (as so defined in the Framework).</u>

31. Thus the staff believes that the Framework discusses in detail the purposes of the balance sheet.

Question for the Group:
Does the Group agree that the Framework clearly establishes the purpose of the balance sheet (the statement of financial position) and hence it is not an issue to be resolved by the Board prior to setting guidance for derecognition of financial assets? If not, why not?

Issue 2: How and where should the risks faced by an entity be reported or reflected in the financial statements?

32. As explained in paragraph 25(a), some respondents argue that 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.

33. As noted earlier, paragraph 19 of the Framework establishes that the purpose of the balance sheet is to provide information about financial position of an entity. Further, in paragraph 19, the Framework concludes that of the elements of financial statements, those 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).

34. 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.

35. 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. <u>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</u>

uncertainties affecting the entity, information about geographical and industry segments and the effect on the entity of changing prices.

36. 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.

37. 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.

Question for the Group:
Does the Group agree that the Framework clearly establishes how and where risks associated with an asset or operations of an entity be reflected in the financial statements and hence it is not an issue to be resolved by the Board prior to setting guidance for derecognition of financial assets? If not, why not?

Issue 3: Should control of economic benefits or exposure to risks and rewards be the basis for derecognition of assets?

38. As noted in paragraph 25(a), some respondents consider the sharing of risks and rewards as a key factor in any derecognition analysis. Hence they argue that removing an asset from the statement of financial position of an entity where the asset no longer qualifies as an asset of the entity (as defined under the

Framework) does not provide a true picture of the risks or exposures of the entity, if the entity is still exposed to the risks associated with that asset.

39. Paragraph 85 of the Framework specifies that an item that meets the definition of an element should be recognised if:

    (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.

40. The staff notes that it is well recognised and accepted in finance and in capital markets pricing practices that the likelihood of there being a future flow of economic benefits arising from the financial instrument, and the probable amount of those future inflows or outflows, is a matter that enters into the measurement of its value. The staff also believes that it is generally possible to measure all financial assets resulting from or associated with or are subject of a transfer with sufficient reliability.

41. Therefore the factor that determines whether, and when, a financial asset should be recognised (or continue to be recognised) is whether the item involved has the essential conditions of an asset. Thus, an entity wishing to determine whether to recognise or derecognise a financial instrument need only ask whether it has an asset. Similarly, when considering whether to derecognise a financial asset, all it needs to ask is whether it still has that asset.

42. That is to say, an entity should derecognise a financial asset when the financial asset ceases to qualify as an asset of the entity.

43. Based on the definition of an asset in the Framework, an asset has two essential characteristics and an item does not qualify as an asset if it lacks one or both of those essential characteristics:

    (a) it represents "future economic benefits

    (b) the expected future benefits are the "results of past events"

44. Under the Framework, an asset qualifies 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.

45. 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.

46. Therefore to assess whether a particular item constitutes an asset of a particular entity at a particular time requires a consideration of:

    (a) whether the item obtained by the entity embodied future economic benefits in the first place;

    (b) whether all or any of the future economic benefits to the entity remain at the time of assessment; and

    (c) if the future economic benefits exist, whether the entity controls them.

47. 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.

48. Control as demonstrated in paragraph 45 means the ability to obtain and restrict others access to the economic benefits of an asset.

49. Paragraph 53 of the Framework explains that the future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. It emphasises that that potential may be a productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production.

50. The future economic benefit embodied in a financial asset is the contractual right to future cash flows. For example, receivables are expected to generate cash, which is their only function.

51. The staff notes that the Board's definition of assets however 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 (ie that concept is not relevant in determining when to recognise an 'asset' in a financial statement).

52. 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 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.

Question for the Group:
Does the Group agree that the essence of an asset is the existence of economic benefits and control over those economic benefits? If so does the Group agree that control over economic benefits should be the basis for recognising and derecognising an asset? If not, why not?

Issue 4: What is an appropriate unit of account for financial instruments?

53. As noted earlier, some respondents suggested that the Board resolves first the issue of unit of account at a conceptual level, as part of the framework project, before deciding on an appropriate derecognition approach. As explained earlier, both the proposed approach for derecognition and the Alternative Approach in the ED and the current guidance in IAS 39 invoke a 'unit of account' of some sort.

54. Under the proposed approach and the current guidance in IAS 39 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 under both the proposed approach

and the current guidance in IAS 39, the item that may be assessed for derecognition might not be the same as the asset recognised by an entity prior to the transfer.

55. The unit of account under the Alternative Approach is to effectively derecognise the rights transferred and apply IAS 39 in recognising obligations and rights assumed or acquired as part of the transfer. Hence the alternative view is seen by some as invoking a unit of account that is already embodied in IAS 39, whereas the proposed and the existing guidance apply a unit of account that is beyond the scope of a standard on derecognition. As such some respondents suggest that the Board resolves this fundamental issue at a conceptual level as part of the framework project.

Question for the Group:

a) Does the Group suggest that the issue of unit of account should be concluded at the Framework level, before the same can be established at the standard level? If so, why?

b) Which of the following, does the Group suggest will be an appropriate unit of account for financial assets, for purposes of derecognition:

(i) the unit of account allowed for recognition purposes under IAS 39

(ii) a unit of account that reflects how market participants deal in and structure financial instruments

(iii) something else (and if so why and what is the principle)