IFRIC Meeting Agenda reference **7A**

Staff Paper Date **March 2010**

Project	**Annual Improvements Exposure Draft August 2010**
Topic	**IFRS 1 *First-time Adoption of International Financial Reporting Standards* – fixed date in derecognition exemption**

Introduction

Objective of this paper

1. The objective of this paper is to document the staff's analysis and recommendation on this issue. The staff will ask the IFRIC to debate whether the fixed date in IFRS 1 *First-time adoption of International Financial Reporting Standards* relating to the derecognition exception should be replaced with a relative date.

Background

2. Paragraph B2 of IFRS 1 provides an exception from full retrospective application of the requirements for derecognition of financial assets and financial liabilities in IAS 39 *Financial Instruments: Recognition and Measurement.* Therefore, the derecognition requirements shall be applied prospectively by first-time adopters for transactions occurring on or after January 1, 2004. The reason the transition date was changed (from January 1, 2001) was to place entities then adopting IFRS for the first time in the same position as existing IFRS users at that time. The

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

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 IFRIC or 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.

Decisions made by the IFRIC are reported in IFRIC *Update*.

Interpretations are published only after the IFRIC and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in IASB *Update*.

transition provisions of the amended standard in respect of derecognition requirements allowed prospective application for existing IFRS users[1].

3. Paragraph B3 of IFRS 1 permits retrospective application of the derecognition principles from a date earlier than January 1, 2004, provided that the information needed for the adjustment was obtained at the time of initially accounting for those transactions (the same permission was provided in the amended IAS 39 for existing IFRS users[2]).

4. Appendix A includes an extract of paragraphs BC20 – BC23 of IFRS 1, which provide the rationale for and history of the exemption.

What is the issue?

5. There are a number of jurisdictions that will be adopting IFRSs in the future. As time passes, the transition date of 1 January 2004 that is 'hard-wired' into the exception becomes more remote from the date these jurisdictions will adopt IFRSs. Therefore, for an entity with a date of transition any time after January 1, 2004, this will mean:

    (a) Derecognition transactions occurring before 1 January 2004 do not have to be retrospectively adjusted in terms of the derecognition principles in force at the date of transition, and

    (b) Derecognition transactions between January 1, 2004 and the date of transition to IFRS might require retrospective adjustment (depending on the derecognition principle in force at the time). Where the requirements for derecognition of financial assets in IAS 39 are quite different from previous GAAP, the retrospective restatement is likely to raise many practical difficulties for these entities.

History of Board deliberations

March 2008

[1] Paragraph 106 of IAS 39

[2] Paragraph 107 of IAS 39

6. This issue was brought to the Board in March 2008 (*IFRS 1: First-time Adoption of IFRSs*, Agenda paper 5), as a result of consultations by the Canadian Accounting Standards Board (AcSB) staff with Canadian constituents preparing to adopt IFRSs in 2011, as well as consultation with other jurisdictions expecting to adopt IFRSs in the near future.

7. At that meeting, two alternatives were suggested to try to resolve this issue:

   (a) Revise the exception to IFRS 1 to refer to transactions that occurred 'on or after the date of transition to IFRS'; or

   (b) Revise the exception to IFRS 1 to refer to transactions that occurred on a fixed date, revised forward from January 1, 2004, eg January 1, 2008. This date may also require periodic updating.

8. It was noted by the staff at that meeting that alternative (a) may allow an entity to structure transactions immediately before the date of transition, to achieve a desired accounting result; however that principle-based standards should not be written with an anti-abuse focus.

9. Alternative (b), it was noted, would reduce any structuring opportunities, since the date would always be anchored in the past. However, this approach would mean more work for the Board – the date would need to continually be revised as jurisdictions adopted IFRS. Further, if regular revisions became a pattern, structuring may happen anyway.

10. The staff recommended alternative (a). The Board then asked the staff to consider this recommendation in light of another general amendment to IFRS 1 the staff were proposing; that is to introduce a principle prohibiting retrospective estimates that could be affected by hindsight. The staff agreed to return to the Board with wording for all the proposed amendments in May 2008.

May 2008

11. During the May 2008 meeting, there was no agreement on the proposal to change the date of January 1, 2004 to 'date of transition to IFRSs', for the reason that the 'hard-wired' date was originally included in the derecognition exemption of IFRS

1. As previously mentioned, this was done as a result of the revision of IAS 39 in 2003, as explained in paragraphs 2 - 3, above. The revision of IAS 39 happened to coincide with the wave of transition to IFRSs in 2005. Whether or not the date was expected to act as a relief mechanism for entities transitioning to IFRSs in the future, was not a debate or a consideration at the time.

Recent developments

12. The staff are aware that this hard-wired date continues to be a concern for jurisdictions that are due to transition to IFRSs in the next few years. In addition, within the next 12 months, IAS 39 is due to be replaced by IFRS 9 *Financial Instruments,* and amendments to the derecognition guidance in IAS 39 will be published. It is unclear at this stage whether the transition requirements of these new pronouncements will provide the required relief from retrospective adjustments to future first-time adopters.

13. For these reasons, the staff think the issue is worth debating again, without losing sight of the reasoning behind the insertion of the date. Some points to consider:

    (a) Retrospective adjustment would require an entity to determine what fair values would have been in the past – this means that entities must use hindsight. In some cases, it may be very difficult to determine the fair value at all, especially if a number of years have passed.

    (b) Complicated structures, such as securitisation products, may be difficult to reconstruct. Further, depending on the difference in principles between previous GAAP and IFRS, restating such structures could also mean that there is a significant gross-up to the balance sheet of these entities. This would in turn affect the capital ratios of the entity.

    (c) However, on the other hand, the basic principle underlying IFRS 1 is that an entity should recognise all assets and liabilities on transition to IFRS, unless there is a compelling reason not to do so. This is to protect the comparability over time of an entity's results, on transition to IFRSs.

Staff recommendation

14. The staff accept that there may be practical difficulties in reconstructing complicated transactions. The staff note, however, that IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* provides general relief for retrospective application when it is 'impracticable' to do so[3].

15. The staff are also aware that some of these reconstructed transactions may have the same (or similar) accounting effect under IFRSs as they had under their previous GAAP principles. However, the reverse is also true – some transactions may have been structured around principles of previous GAAP in order to achieve a particular result – which may be quite different when the principles of IFRS are applied to the same transaction.

16. Further, the amendments to the derecognition guidance due within the next 12 months may provide relief for first-time adopters of IFRSs.

17. The staff recommend that that the fixed date in IFRS 1 relating to the derecognition exception is not amended to a relative date, but should remain as January 1, 2004.

Questions for the IFRIC
Question 1 - Does the IFRIC agree with the staff's recommendation in paragraph 17?
Question 2 – Does the IFRIC have any other comments or suggestions for the staff to consider in this regard?

[3] IAS 8 paragraphs 23 - 25

Appendix A – Extracts from IFRS 1 *First-time adoption of International Financial Reporting Standards*

Derecognition in accordance with previous GAAP

BC20

An entity may have derecognised financial assets or financial liabilities in accordance with its previous GAAP that do not qualify for derecognition in accordance with IAS 39. ED 1 proposed that a first-time adopter should recognise those assets and liabilities in its opening IFRS balance sheet. Some respondents to ED 1 requested the Board to permit or require a first-time adopter not to restate past derecognition transactions, on the following grounds:

(a) Restating past derecognition transactions would be costly, especially if restatement involves determining the fair value of retained servicing assets and liabilities and other components retained in a complex securitisation. Furthermore, it may be difficult to obtain information on financial assets held by transferees that are not under the transferor's control.

(b) Restatement undermines the legal certainty expected by parties who entered into transactions on the basis of the accounting rules in effect at the time.

(c) IAS 39 did not, before the improvements proposed in June 2002, require (or even permit) entities to restate past derecognition transactions. Without a similar exemption, first-time adopters would be unfairly disadvantaged.

(d) Retrospective application would not result in consistent measurement, as entities would need to recreate information about past transactions with the benefit of hindsight.

BC21

The Board had considered these arguments in developing ED 1. The Board's reasons for the proposal in ED 1 were as follows:

(a) The omission of material assets or liabilities would undermine the understandability, relevance, reliability and comparability of an entity's financial statements. Many of the transactions under discussion are large and will have effects for many years.

(b) Such an exemption would be inconsistent with the June 2002 exposure draft of improvements to IAS 39.

(c) The Board's primary objective is to achieve comparability over time within an entity's first IFRS financial statements. Prospective application by a first-time adopter would conflict with that primary objective, even if prospective application were available to entities already applying IFRSs.

(d) Although a new IFRS may have unforeseen consequences if another party uses financial statements to monitor compliance with a contract or agreement, that possibility does not justify prospective application (paragraph BC13(a)).

BC22

Nevertheless, in finalising the IFRS, the Board concluded that it would be premature to require a treatment different from the current version of IAS 39 before completing the proposed improvements to IAS 39. Accordingly, the IFRS originally required the same treatment as the then current version of IAS 39 for derecognition transactions before the effective date of the then current version of IAS 39, namely that any financial assets or financial liabilities derecognised in accordance with previous GAAP before financial years beginning on 1 January 2001 remain derecognised. The Board agreed that when it completed the improvements to IAS 39, it might amend or delete this exemption.

BC22A

The Board reconsidered this issue in completing the revision of IAS 39 in 2003. The Board decided to retain the transition requirements as set out in IFRS 1, for the reasons given in paragraph BC20. However, the Board amended the date from which prospective application was required to transactions that occur on or after 1 January 2004 in order to overcome the practical difficulties of restating transactions that had been derecognised before that date.

The Board also noted that financial statements that include financial assets and financial liabilities that would otherwise be omitted under the provisions of the IFRS would be more complete and therefore more useful to users of financial statements. The Board therefore decided to permit retrospective application of the derecognition requirements. It also decided that retrospective application should be limited to cases when the information needed to apply the IFRS to past transactions was obtained at the time of initially accounting for those transactions. This limitation prevents the unacceptable use of hindsight.

BC23

The Board removed from IAS 39 the following consequential amendments to IAS 39 made when IFRS 1 was issued, because, for first-time adopters, these clarifications are clear in paragraphs IG26–IG31 and IG53 of the guidance on implementing IFRS 1. These were:

(a) the clarification that an entity is required to apply IAS 39 to all derivatives or other interests retained after a derecognition transaction, even if the transaction occurred before the effective date of IAS 39; and

(b) the confirmation that there are no exemptions for special purpose entities that existed before the date of transition to IFRSs.

Appendix B – Extracts from comments received from constituents

B1 The following are extracts from comments received by staff and some Board members in respect of the hard-wired date issue:

a. Retrospective application would be 'difficult and onerous in practice', as entities would have to 'obtain' information for at least 8 years already past.

b. Some entities (financial institutions) account for securitisation activities under a model similar to the requirements found in US GAAP's FAS 140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*. This would mean that determining whether or not the securitisation and subsequent sale of the relevant assets represent a sale for accounting purposes is driven by the determination of whether 'the transferred assets have been legally isolated from the transferring banks and whether the transferee obtains control of the assets'. According to the commentator, the 'bulk of' the mortgage securitisations in certain jurisdictions, which are 'critical to the functioning' of 'retail lending markets, have been structured to obtain "sale" accounting under these rules'.

c. However, the 'majority' of transactions discussed in b 'would not be afforded derecognition accounting under existing IFRS', and would therefore 'be treated as on balance sheet financing transactions'. This would, in turn, result in a 'significant gross-up to the balance sheets of most' of the financial institutions in this jurisdiction adopting IFRS.