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**International  
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*This document is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. It does not represent an official position of the IFRIC. IFRIC positions are set out in Interpretations.*

*Note: These notes are based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because these notes are less detailed, some paragraph numbers are not used.*

## **INFORMATION FOR OBSERVERS**

**IFRIC meeting:**      **March 2006, London**

**Project:**              **Overview of the derecognition requirements of IAS 39 *Financial Instruments: Recognition and Measurement* (Agenda Paper 11A)**

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## **Introduction**

1. The purpose of this document is:
  - a. To provide an overview of the derecognition provisions of IAS 39, and
  - b. To outline the questions that the IFRIC has been asked to address and position those questions within the context of the IAS 39 derecognition model.
2. For ease of reference, the paragraphs that outline and position the questions are bold italicised.

## **Overview of the IAS 39 derecognition model**

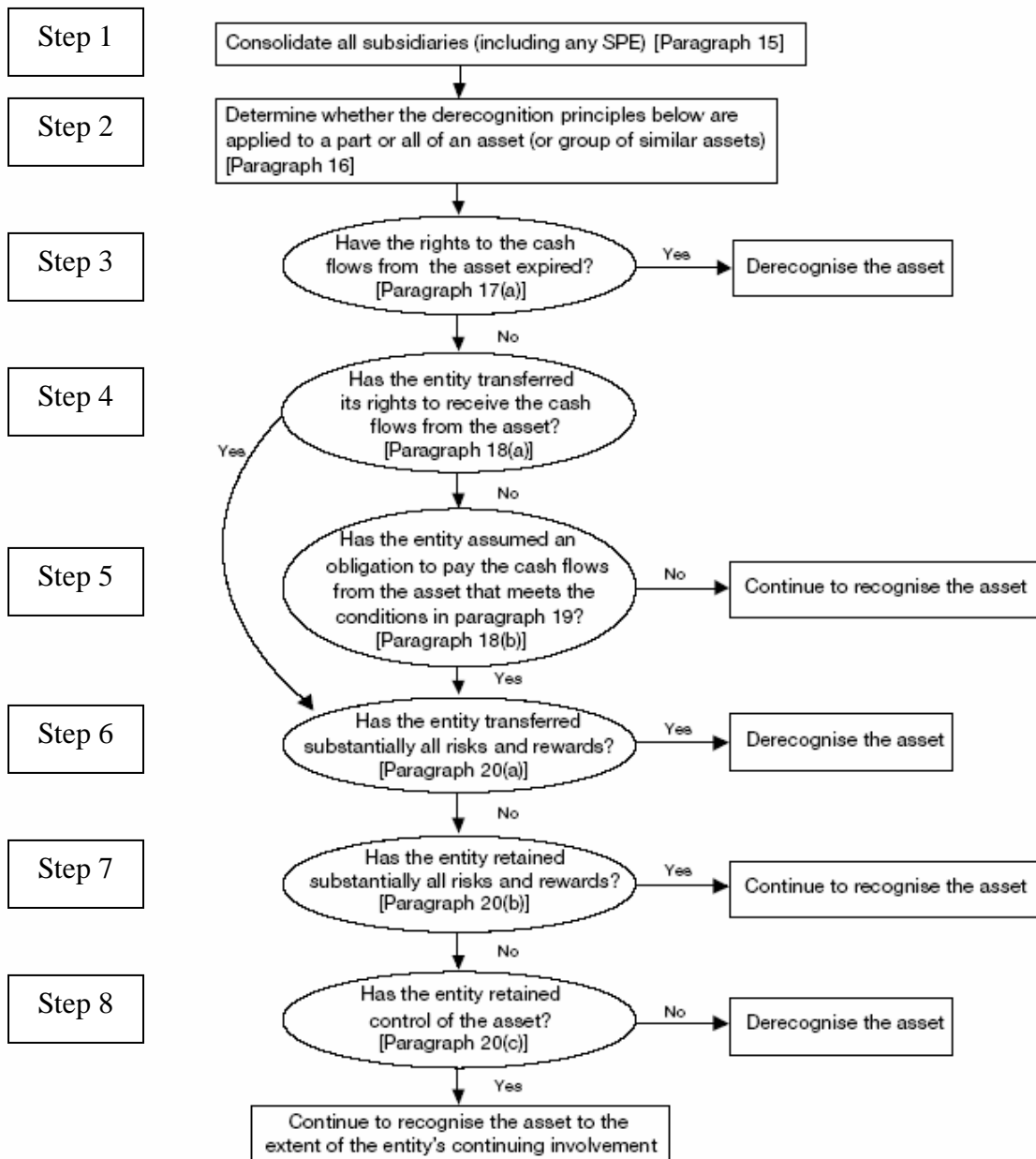
### *Initial recognition of financial instruments*

3. IAS 39 Par 14 states that an entity shall recognise a financial asset or financial liability on its balance sheet when the entity becomes party to the contractual provisions of the instrument.

4. IAS 39 contains derecognition provisions for financial assets (IAS 39 Par 15 -38) and derecognition provisions for financial liabilities (IAS 39 Par 39 - 42).
5. In this document we focus on derecognition of financial assets. The steps for derecognition of financial assets are illustrated in the Flowchart from IAS 39 AG 36, which have been included on the next page.

## Derecognition of a Financial Asset (paragraphs 15-37)

AG36. The following flow chart illustrates the evaluation of whether and to what extent a financial asset is derecognised.



*Derecognition Flowchart Step 1 – Which financial statements are the derecognition requirements going to be applied to?*

6. Step 1 in the flowchart (IAS 39 Par 15) focuses on whether the derecognition requirements are applied in the consolidated financial statements or in the separate financial statements of the entity. For consolidated financial statements, an entity first consolidates subsidiaries in accordance with *IAS 27: Consolidated and Separate Financial Statements* and *SIC 12: Consolidation- Special Purpose Entities* and then applies the derecognition provisions in Par 16-23.

*Derecognition Flowchart Step 2 – To which asset or group of assets (or part of asset or group) are the derecognition requirements going to be applied to?*

7. The second step in the flowchart (IAS 39 Par 16) considers whether the derecognition principles are applied to a part or all of an asset, or group of similar assets. For example an entity could derecognise the interest part of an interest-paying financial asset when the interest cash flows are specifically identifiable.
8. In this paper we do not discuss further when it is appropriate to derecognise a part of a financial asset.
9. ***However, the IFRIC has been asked what is meant by ‘a group of similar financial assets’ in Par 16 [emphasis added].***
10. ***This is an important question as it affects whether all or some of the financial assets which are transferred as a group will qualify for derecognition i.e. this paragraph may determine whether the pass through test (Derecognition Flowchart Step 5) and the risks and rewards test (Derecognition Flowchart Step 6) is applied to an entire group of transferred financial assets or only to a subset of the group of financial assets which are transferred.***
11. A mortgage indemnity guarantee (MIG) may be a condition of a mortgage contract and would guarantee overall payments on a specific mortgage. For example a bank may transfer a portfolio of mortgages and the MIGs to another entity. It may appear that by their nature, cash flows and purpose that the guarantee and the underlying mortgages may not be ‘similar’ in nature. If this is the case then it would appear that separate derecognition tests may be

required for the mortgages and the MIG even though the cash flows are combined and the risks and rewards of both instruments are inter-linked.

12. The implications of not bundling the MIG with the underlying receivable is that the IAS 39 derecognition provisions would be applied separately to the underlying receivable and the MIG. This may mean that the receivable qualifies for derecognition but the MIG derivative does not (or vice versa), or that both the receivable and the MIG will fail the derecognition test.

*Derecognition Flowchart Steps 3 to 8 – The requirements that must be met to derecognise a financial asset*

13. Once steps 1-2 have been completed, Par 17 states that a financial asset can be derecognised when:
- a. the contractual rights to the cash flows from the financial asset expire (Step 3 in the Flowchart); or
  - b. the entity
    - i. transfers the financial asset as set out in Par 18 and Par 19 (Step 4 and Step 5 in the Flowchart), and
    - ii. the transfer qualifies for derecognition in accordance with Par 20 (Steps 6 – 8 of the Flowchart).

*Derecognition Flowchart Step 3 – Contractual rights to the cash flows expired*

14. In the first case it is normally relatively straight forward to determine that a financial asset should be derecognised when the contractual rights to the cash flows from the financial asset expire. For example when a debtor pays in full then the contractual rights to the cash flows from the financial asset may be considered to have expired.

*Derecognition Flowchart Step 4 to 5 – An eligible transfer of a financial asset*

15. The second case (when a ‘transfer’ occurs) is the subject of the remainder of the derecognition provisions for financial assets (i.e. Step 4 – Step 8 in the Flowchart).

16. Par 18 defines two types of transfers:

- a. Where an entity transfers the contractual rights to receive the cash flows of the financial asset (referred to in this document as ‘Par 18(a)’ transfer) - Step 4 in Flowchart. For example an entity may unconditionally legally transfer all rights to future payment in respect of a debtor to a third party.
- b. Where the entity retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay cash flows to one or more recipients in an arrangement that meets the conditions in Par 19 (referred to in this document as ‘Par 18(b)’ transfer) - Step 5 in Flowchart.

***17. The second question which has been posed to IFRIC relates to whether an entity should apply Par 18(a) or Par 18(b) to transfers.***

18. For example, an entity may without notifying the debtor enter a contract to transfer any cash flows received on the debtor to another party; in this case, has the entity ‘transferred the contractual rights to receive cash flows’ in IAS 39 Par 18 (a)?

19. An entity may also transfer the contractual rights to cash flows subject to conditions; for example, the contractual rights associated with trade receivables may be ‘transferred’ subject to warranties covering credit notes if goods are returned. These issues are discussed further in Paper 11B.

20. The relevance of applying either IAS 39 Par 18(a) or 18(b) is that the requirements in IAS 39 Par 19 (‘the Pass Through’ tests – step 5 in the flowchart) are applicable to ‘Par 18(b)’ transfers – and the transfer can only be considered further for derecognition if these requirements (which are referred to as the ‘Pass-Through’ test) are met. (i.e. if the pass-through tests are not met for an 18(b) transfer, the asset continues to be recognised in full.) These requirements are:

- a. The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset.

- b. The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows
- c. The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay,

However, these pass-through tests do not need to be met for an 18(a) transfer to be considered for derecognition.

*Derecognition Flowchart Step 6 –Risks and rewards test*

- 21. Step 6 of the flowchart applies a risks and rewards tests to those transfers of financial assets that qualified under either Par 18(a), or Pars 18(b) and 19.
- 22. Par 21 of IAS 39 states that the transfer of risks and rewards (see paragraph 20) is evaluated by comparing the entity's exposure, before and after the transfer, with the variability in the amounts and timing of the net cash flows of the transferred asset.
- 23. Par 21 continues by saying that an entity has retained substantially all the risks and rewards of ownership of a financial asset if its exposure to the variability in the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer (e.g. because the entity has sold a financial asset subject to an agreement to buy it back at a fixed price or the sale price plus a lender's return). An entity has transferred substantially all the risks and rewards of ownership of a financial asset if its exposure to such variability is no longer significant in relation to the total variability in the present value of the future net cash flows associated with the financial asset.
- 24. As mentioned in paragraph 10 above, the IFRIC has been asked whether risk management instruments (such as guarantees and offsetting derivatives) can be included with groups of similar non-derivatives in the IAS 39 in the same derecognition test (i.e. what does 'similar' means in the context of paragraph 16).***

25. If MIG contracts and mortgages are deemed to be part of a group of similar financial assets, the risks and rewards test may be more likely to be failed<sup>1</sup>. The reason for this is because the guarantee reduces significant variability in respect of credit risk. Therefore when the entity compares its ‘exposure, before and after the transfer’ it may find that variability in the present value of the future net cash flows from the financial asset does not change significantly as a result of the transfer. In this case the financial asset should not be derecognised in Step 7 of the Flowchart.
26. Conversely, if the guarantee is deemed not to be part of the ‘group of similar financial assets’ then the financial asset is an (uninsured) mortgage which will have greater credit risk. Transferring such a high-risk asset is more likely to result in a transfer of significant credit risk, with the result that the risks and rewards test is more likely to be passed.
27. Step 6 in the flowchart states that where the entity has transferred substantially all of the risks and rewards that the entity shall derecognise the asset.
28. Conversely, Step 7 in the flowchart states that where the entity has retained substantially all of the risks and rewards, the entity shall continue to recognise the asset.

*Derecognition Flowchart Step 8 – Has ‘control’ passed?*

29. Step 8 in the flowchart considers the circumstance when an entity neither transfers nor retains substantially all of the risks and rewards of ownership of the financial asset. In this case:
- a. If the entity has not retained control, it shall derecognise the financial asset and recognise separately as assets or liabilities any rights and obligations created or retained in the transfer
  - b. If the entity has retained control, it shall continue to recognise the financial asset to the extent of its continuing involvement in the financial asset.

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<sup>1</sup> The portfolio may nevertheless qualify for derecognition if the entity transfers remaining variability, for example interest rate risk and prepayment risk.

*Derecognition Flowchart Step 9 – Continuing Involvement*

30. In this paper we do not consider continuing involvement or what it means to control a financial asset. As a result we do not go into detail on these issues.

## **Summary of the derecognition requirements of IAS 39**

31. In summary, a financial asset can be derecognised under IAS 39 if:

- a. The contractual rights to the cash flows from the financial asset have expired, or
- b. There is an eligible transfer (for example- a pass-through), AND the entity either
  - i. Transfers significantly all risks and rewards; or
  - ii. Transfers some significant risk and rewards and control.