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**International Accounting Standards Board**



**INFORMATION FOR OBSERVERS**

**IFRIC meeting:** **November 2006, London**

**Project:** **IAS 39 *Financial Instruments: Recognition and Measurement* Derecognition Application Issues (Agenda Paper 10)**

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## Introduction

1. The IFRIC have previously discussed two issues relating to the derecognition requirements of IAS 39. The first issue relates to how the derecognition requirements should be applied to transfers of groups of assets. The second issue relates to whether certain transfers of financial assets should be treated as 'pass-through' arrangements.

2. At its July meeting, the IFRIC agreed to refer both issues to the Board to clarify their intentions and to seek input regarding the most effective way to proceed.

3. The purpose of this paper is to summarise the feedback received from the Board and ask the IFRIC how they would like to proceed.

4. Background to both issues is included in an appendix to this paper.

## Summary of Board Discussions

5. The Board discussed both issues at its September 2006 meeting. The Board indicated that they believe that IAS 39 is clear with respect to these issues and that the requirements of IAS 39 do not conflict with the intention of the Board.

*Issue 1 – Groups of similar assets*

6. The first issue discussed by the Board was the meaning of the word ‘similar’ in paragraph 16 of IAS 39 and its implications for the subsequent derecognition tests.

7. The Board stated that derivative instruments (which are often transferred together with non-derivative financial assets) are not ‘similar’ to non-derivative financial assets for the purposes of IAS 39 paragraph 16. Therefore, an entity would apply the derecognition tests in IAS 39 to non-derivative financial assets (or groups of similar non-derivative financial assets) separately from derivative financial assets (or groups of similar derivative financial assets).

8. The Board also indicated that transferred derivatives that could be assets or liabilities (such as interest rate swaps) would have to meet both the financial asset and financial liability derecognition criteria.

*Issue 2 – Pass through transfers*

9. The Board then discussed when transfers are required to be treated as pass through transfers.

10. The Board discussed whether the pass-through test is applicable to all transfers in which legal title to the financial asset is not transferred. The Board indicated that a transaction in which an entity transfers all the contractual rights to receive the cash flows (without transferring legal ownership of the financial asset), would not necessarily be assessed as a potential pass through. For example, if an entity transfers all the legal rights to specifically identified cash flows of a financial asset (for example, the legal rights to interest or principal of a debt instrument), this could qualify as a transfer under 18a and hence the pass through tests of paragraph 19 would not have to be applied. Conversely, the pass through tests in paragraph 19 would be applied when the entity does not transfer all the legal rights to the cash flows of a financial asset, such as in a disproportionate transfer. (see IAS 39 paragraph 16(b)).

11. The Board also discussed whether conditional transfers should be treated as pass-through transactions. Conditions attached to a transfer could include provisions ensuring the existence and value of transferred cash flows at the date of transfer or conditions relating to the future performance of the asset.

12. The Board indicated that such conditions would not affect whether the entity has transferred the contractual rights to receive cash flows (under paragraph 18(a)). However, the existence of conditions relating to the future performance of the asset might affect the degree to which risks and rewards associated with the asset have been transferred as well as the extent of any continuing involvement by the transferor in the transferred asset.

## Summary of possible ways forward

13. The IFRIC must now consider how they would like to take this issue forward.

14. The Board have indicated that they believe that the standard is clear on both issues and that the requirements of IAS 39 in this area do not conflict with their original intention. Therefore, the Board believes that it is <u>not</u> necessary to amend IAS 39 with respect to these issues.

15. Consequently, the staff believe that there are two options available to the IFRIC:

- The IFRIC could decline to take these issues on to its agenda. The reason for rejection would be that, the IFRIC does not expect significant diversity in practice in the future. [Rest of paragraph omitted];
- The IFRIC could develop an Interpretation. Based upon the Board's discussions the Interpretation would state:

    a. Derivative instruments are not 'similar' to non-derivative financial assets for the purposes of IAS 39 paragraph 16;

    b. Derivatives that can be assets or liabilities (such as interest rate swaps) must meet both the financial asset and financial liability derecognition criteria;

    c. Transactions in which an entity transfers all the contractual rights to receive the cash flows (without necessarily transferring legal ownership of the financial asset), are not required to be assessed as a potential pass-through. However, the pass through test must be applied when the entity does not transfer all the contractual rights to cash flows of the financial asset;

d. Conditions attached to the transfer of assets do not necessarily affect whether the entity has transferred the contractual rights to receive cash flows (under paragraph 18(a)). However, the existence of conditions relating to the future performance of the asset might affect the degree to which risks and rewards associated with the asset have been transferred as well as the extent of any continuing involvement by the transferor in the transferred asset.

- **Which of the two approaches (Rejection or Interpretation) described above does the IFRIC wish to take?**
- **If the IFRIC believe that an Interpretation is necessary, do the IFRIC agree with the staff's analysis of the conclusions to be included in the Interpretation (a. – d. above)?**

## Appendix – Summary of issues

1. The two issues raised in this paper were previously discussed at IFRIC meetings held in May and July of this year. This appendix summarises these two issues.

*Issue 1 – Groups of similar assets*

2. IAS 39 Par 16 states that the derecognition provisions in Par 17-23 should be applied to a part of a financial asset (or a part of a group of *similar* financial assets) or a financial asset (or a group of *similar* financial assets). IAS 39 does not discuss what is meant by 'similar', nor does it discuss how the derecognition requirements apply to a group of financial assets which are 'not similar'.

3. Derivative contracts are used to hedge risks in financial assets. In some cases there is a close 'link' between the specific risks in the financial asset and the derivative, such as the specific credit risk exposure on a particular debtor. In other cases the derivative will hedge more generic risks of the financial asset, such as interest rate risk or foreign exchange rate risk.

4. These derivative contracts are often transferred in a derecognition transaction at the same time as non-derivative assets. For example, mortgage indemnity guarantees are often transferred at the same time as the associated mortgages; interest rate swaps are often transferred with interest bearing assets.

5. Therefore it has been asked whether derivatives can be 'similar' to non-derivative financial assets, and therefore be included in the same derecognition test.

6. It makes a difference whether assets are grouped together or assessed separately in the derecognition test in IAS 39. If a derivative and the related financial asset are seen as 'similar' and grouped together in the derecognition test, then the group (that is the financial asset and the derivative) would either be derecognised or remain on the entity's balance sheet. If a derivative is seen as 'not similar' to the related financial asset, and the derivative and the financial asset are assessed separately in the derecognition test, then either the derivative or the financial asset may pass or fail the separate derecognition test.

*Issue 2 – Pass through transfers*

7. Paragraph 18(b) of IAS 39 states that the pass through tests in Paragraph 19 have to be met when an entity transfers a financial asset and 'retains the contractual rights to receive cash flows of the financial asset, but assumes a contractual

obligation to pay the cash flows to one or more recipients'. Conversely, the pass through tests are not applicable when the entity 'transfers the contractual rights to receive the cash flows of the financial asset' (Paragraph 18 (a)).

8. The pass through tests in paragraph 19 impose additional restrictions on when an asset would qualify for derecognition. Consequently, if an entity is required to apply the pass through tests in paragraph 19, it is more likely that the financial asset will fail to be derecognised.

9. The IFRIC have been asked the following questions:

   - Must the pass through tests in paragraph 19 of IAS 39 be applied to all transfers that do not result in a change of legal title of the transferred asset?

   - Must the pass through tests in paragraph 19 of IAS 39 be applied when conditions are attached to the transfer of a financial asset (for example conditions and warranties regarding the existence of the transferred asset)?