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**International
Accounting Standards
Board**

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These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting: 20 September 2006, London

Project: **IAS 39 *Financial Instruments: Recognition and Measurement*: Derecognition application issues**

Subject: **Issue 2- Pass through transfers (Agenda Paper 13B)**

Purpose of this paper

1. This paper discusses which transfers of financial assets are required to satisfy the 'pass through' tests in IAS 39 Par 19.

Background

2. Par 18(b) states the pass through tests in Par 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'¹. Conversely, the pass through tests are not applicable when the entity 'transfers the contractual rights to receive the cash flows of the financial asset' (Par 18 (a)).
3. This paper discusses whether the following types of transfers are considered to be pass through transactions:
 - a. Transfers which do not result in a change of legal ownership of the transferred financial asset
 - b. Conditional transfers of financial assets

¹ Steps 4-5 in the Derecognition Flowchart included at the end of this document

Transfers and legal ownership of the transferred asset

4. In some securitisation or similar schemes to transfer financial assets the debtor may not be notified that all cash flows will be transferred to a new eventual recipient (that is, the debtor continues to pay the transferor who, acting as servicer, passes the cash flows on to the transferee).
5. In such cases legal ownership of the financial asset is not transferred to the transferee. However, cash flows on the financial asset are.
6. Examples of such transfers include situations in which:
 - a. The buyer of the receivable is given details about the underlying receivables (amount, identity of the debtor etc), but the underlying debtor is not notified of the transaction (for example, to preserve a customer relationship).
 - b. The buyer is not given details about the underlying receivables (for example, because of local banking secrecy laws). However, the transaction includes a third party 'data trustee' who is given these details and whose role is to ensure that cash collected is passed to the buyer and the servicing is carried out as specified in the contract.
 - c. There is no legal transfer to the buyer until a pre-specified event occurs, such as the bankruptcy of the seller or the servicer. Until such bankruptcy occurs the 'buyer' cannot enforce payment against the debtor (and may not even know the identity of the debtor).
7. As previously discussed, an entity will apply the pass through tests in IAS 39 Par 19 to a transfer if the entity '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'.
8. IAS 39 does not provide guidance on what is meant by a 'transfer of the contractual rights to receive cash flows of the financial asset'. The contractual rights to receive cash flows of a financial asset are established by legal ownership of the financial asset. Therefore, if legal ownership of a financial asset has not changed, then there has been no change to the contractual rights to receive the cash flows of the financial asset. Consequently, in practice some interpret that unless a transfer of the legal rights to the financial asset has occurred the transfer would be considered a pass through transaction.

9. Others argue that an entity would not necessarily have to apply the pass through test when a debtor is not notified of the new eventual recipient because the focus in IAS 39 Par 18 is on the contractual rights to receive cash flows and not on the contractual rights to the financial asset itself.

Conditional transfers of financial assets

10. Financial assets may be transferred with certain conditions attached.

11. Such conditions may include:

- a) Warranties as to the condition of the asset at the date of transfer (e.g. that the counterparty is X, that the loan has a specified maturity, interest rate etc, is backed by specified collateral, is not in arrears at the date of transfer etc).
- b) For trade receivables, warranties covering credit notes issued because the goods delivered that gave rise to the receivable were faulty or because there was a mistake in the original invoice. (Some see these may also fall in(a)).
- c) For trade receivables, guarantees covering volume discounts which, if met, are offset against the receivables balance at (say) the end of the year.
- d) For trade receivables, guarantees covering credit notes issued at the discretion of the seller (e.g. as a goodwill gesture in the case of disputes).
- e) Other guarantees covering the existence and the accuracy of the amount of the receivable (e.g. a tax receivable transferred to a bank when the bank is indemnified for any loss incurred if the amount of the receivable is decreased by the Tax Authorities², or guarantees of documentation risk, i.e. the risk that the debtor cannot be made to pay because of mistakes in the documentation that established the receivable).
- f) Guarantees covering future performance that might invalidate the receivable, e.g. in a long term contract if past work has been invoiced, but failure to complete the next stage to defined standards could result in a reduction in the receivable; or assets/goods have been delivered and invoiced, but failure to perform future maintenance could result in a reduction of the receivable.
- g) Guarantees covering changes in tax, legal or regulatory requirements. These may take the form of either the transaction being ‘reversed’ in the event of

² Tax receivables are not in the scope of IAS 39, but we have included this example illustrate the point.

such changes, or additional payments being made to cover any increased costs of the buyer that result from such changes.

- h) Guarantees covering future default/late payment/ credit downgrade of the debtor.
- i) Offset arrangements if the original debtor has the right to offset amounts that it owes to 'seller' against its receivables from seller, with the seller compensating the buyer if such offset occurs.
- j) Offset arrangements if a third party (e.g. a sub-contractor) has the right to offset amounts it is owed by the 'seller' against the receivable (even though the receivable is to the seller and not to the sub-contractor), with the seller compensating the buyer if such offset occurs.

12. An entity will apply the pass through tests in IAS 39 Par 19 to a transfer if the entity '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'. What is not clear from IAS 39 is whether conditions at the time of the transfer could indicate that an entity has actually retained the contractual rights to receive the cash flows of the financial asset.

13. One view is that the existence of conditions may indicate that a valid 'transfer of all the rights to receive cash flows of the financial asset' has not occurred because some of the rights to receive cash flows of the financial asset have been retained. In this case the conditions may indicate that the entity should apply the pass through tests to such transfers.

14. Alternatively, it could be argued that such conditions would not affect whether a transfer of the contractual rights to receive cash flows under paragraph 18(a) has occurred. Under this view the existence of conditions arising as a result of the transfer may affect whether substantially all risks and rewards are transferred (paragraph 21 of IAS 39) and the extent of any continuing involvement by the transferor (paragraph 20(c)(ii) of IAS 39) in the transferred asset, but does not affect whether a valid 'transfer of the contractual rights to receive cash flows on a financial asset' has occurred.

Existing guidance in IAS 39

15. There is little guidance in IAS 39 on which IFRIC could base on an interpretation as to what the Board intended by ‘transfer the contractual rights to receive cash flows of a financial asset’.
16. IAS 39 discusses the following:
- a. Application of the pass through tests to part of an asset
 - b. Disproportionate transfers
17. This guidance does not in itself answer the two questions included in this paper, but may provide the basis for an interpretation as to when the pass through test in IAS 39 is applicable. This guidance may also specifically help address the first issue as to whether a transfer of legal ownership is important for the purposes of Par 18.

Application of the pass through tests to part of an asset

18. The Board discussed how the pass through tests should be applied to proportionate/ disproportionate transfers of assets as part of the Improvements project. (The evolution of the derecognition requirements are discussed in more detail in Paper C).
19. IAS 39 Par 18 requires consideration of the ‘contractual rights to receive cash flows of a financial asset’. It is relatively easy to identify ‘cash flows’ when a financial asset is considered for derecognition in its entirety. This is not necessarily the case when a part of a financial asset, or a part of the cash flows, are being considered for derecognition.
20. IAS 39 Par 18 states that an entity will apply the pass through test if the entity 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.
21. IAS 39 Par 16 defines the term financial asset as:
- ...In paragraphs 17–26, the term ‘financial asset’ refers to either a part of a financial asset (or a part of a group of similar financial assets) as identified in (a) above or, otherwise, a financial asset (or a group of similar financial assets) in its entirety. (Emphasis added)*
22. IAS 39 Par 16 indicates that a part of a financial asset (or a part of a group of similar financial assets) which could qualify for derecognition is:

- a. Specifically identified cash flows (e.g. the interest cash flows in a bond)
 - b. A fully proportionate share of the cash flows from a financial asset (e.g. 90% of total cash flows)
 - c. A fully proportionate share of specifically identified cash flows from a financial asset (e.g. 90% of the interest cash flows on a bond).
23. An entity would not normally transfer the legal rights of ownership to a financial asset if it only transfers a part of the financial asset (i.e. specifically identifiable cash flows and/ or a fully proportionate share of cash flows). IAS 39 Par 18 states that an entity will not have to apply the pass through test if it ‘transfers the contractual rights to receive the cash flows of the financial asset’. Consequently, a literal reading of IAS 39 Par 18 would indicate that transfer of legal title is not required in order to qualify for IAS 39 Par 18 (a).
24. IAS 39 BC 61 states that *if the three pass through conditions are met and the entity passes on a fully proportional share, either of all cash flows (as in the example in paragraph BC55) or of specifically identified cash flows (eg 10 per cent of all interest cash flows), the proportion sold is derecognised, provided the entity has transferred substantially all the risks and rewards of ownership.*
25. This paragraph seems to indicate that the pass through test is applicable to transfers of fully proportional shares of cash flows and to transfers of proportions of specifically identifiable cash flows. It is not clear whether by extension the pass through provisions would also be applicable to transfers of specifically identifiable cash flows. If the pass through test is applicable to transfers of parts of assets, this could indicate that transfer of legal title is required in order to qualify for IAS 39 Par 18 (a). This would contradict the conclusion in paragraph 23 above.

Disproportionate transfers

26. IAS 39 AG 37 provides the following guidance on those arrangements which should be considered for pass through as per IAS 39 Par 18 (b):

AG37 The situation described in paragraph 18(b) (when an entity retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients) occurs, for example, if the entity is a special purpose entity or trust, and issues

to investors beneficial interests in the underlying financial assets that it owns and provides servicing of those financial assets. In that case, the financial assets qualify for derecognition if the conditions in paragraphs 19 and 20 are met.

27. This paragraph refers to beneficial interests in the underlying financial assets.

28. IAS 39 Par 16 (b) provides examples of transfers when it is necessary to consider an asset in its entirety for derecognition. *For example, when an entity transfers (i) the rights to the first or the last 90 per cent of cash collections from a financial asset (or a group of financial assets), or (ii) the rights to 90 per cent of the cash flows from a group of receivables, but provides a guarantee to compensate the buyer for any credit losses up to 8 per cent of the principal amount of the receivables, paragraphs 17–23 are applied to the financial asset (or a group of similar financial assets) in its entirety.* We refer to these examples as disproportionate transfers of financial assets. We presume that a disproportionate transfer occurs when one or more parties hold a beneficial interest in a transferred asset.

29. Arguably in the case of disproportionate transfers of parts of financial assets it is not possible to identify the ‘contractual rights to receive cash flows of the financial asset’ which have been transferred. This view is supported in the Basis of Conclusions to IAS 39:

BC62 To illustrate a disproportionate arrangement using a simple example, assume the following. Entity A originates a portfolio of five-year interest-bearing loans of CU10,000. Entity A then enters into an agreement with Entity C in which, in exchange for a cash payment of CU9,000, Entity A agrees to pay to Entity C the first CU9,000 (plus interest) of cash collected from the loan portfolio. Entity A retains rights to the last CU1,000 (plus interest), ie it retains a subordinated residual interest. If Entity A collects, say, only CU8,000 of its loans of CU10,000 because some debtors default, Entity A would pass on to Entity C all of the CU8,000 collected and Entity A keeps nothing of the CU8,000 collected. If Entity A collects CU9,500, it passes CU9,000 to Entity C and retains CU500. In this case, if Entity A retains substantially all the risks and rewards of ownership because the subordinated retained interest absorbs all of the likely variability in net cash flows, the

loans continue to be recognised in their entirety even if the three pass-through conditions are met. (Emphasis added)

30. Therefore it appears that disproportionate transfers of financial assets should be subject to the pass through criteria. This guidance does not in itself answer the two questions included in this paper, but may provide the basis for an interpretation as to when the pass through test in IAS 39 is applicable. The problem with this approach to an interpretation is that it is not clear whether disproportionate and proportionate transfers are the only examples of transfers which were intended to be within the scope of the pass through test, or whether these examples are part of a broader ‘principle’ in identifying a transfer of the ‘contractual rights to receive cash flows of a financial asset’.

Question 2 for the Board

31. **The staff considers that there are two questions the Board needs to answer:**

- **Question 2A: How does IAS 39 require the pass through test to be applied to transfers of financial assets where (i) legal ownership has not changed, and (ii) the transfer is conditional?**
- **Question 2B: Does the Board believe that such requirements result in an appropriate accounting result?**

32. *[Paragraph omitted from observer note].*