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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**20 September 2006, London**
Project:	**IAS 39 *Financial Instruments: Recognition and Measurement:* Derecognition application issues**
Subject:	**Evolution of the derecognition requirements of IAS 39 (Agenda Paper 13C)**

Purpose of this document

1. The Cover Paper introduced two issues:

    a. Issue 1: How should the derecognition provisions of IAS 39 be applied to groups of similar financial assets?

    b. Issue 2: Which types of transactions are required to be treated as pass-through transfers?

2. The purpose of this document is to relate the evolution of the derecognition requirements of IAS 39 to these two issues. The aim of doing this is to demonstrate, to the extent possible, the intention of the Board with respect to the two issues.

3. This Paper is divided into the following time periods:

    a. Prior to the IAS 39 Improvements Project Exposure Draft

    b. The IAS 39 Improvements Project Exposure Draft

c. Re-deliberations of the IAS 39 Improvements Project Exposure Draft in May 2003

d. Re-deliberations of the IAS 39 Improvements Project Exposure Draft in June 2003

Prior to the IAS 39 Improvements Project Exposure Draft

4. The original IAS 39 (deliberated in 1998) did not address the derecognition of groups of assets or pass through transactions.

The IAS 39 Improvements Project Exposure Draft

Groups of assets (Issue 1)

5. The IAS 39 Improvements Project Exposure Draft (IAS 39 ED) permitted the derecognition of groups of assets:

> *'A financial asset that is the subject of a transfer can be a single financial asset, <u>a group of financial assets</u>, or a subdivided portion thereof. A subdivided portion of a financial asset or group of financial assets consists of the rights to and related benefits and risks of a determinable portion of the underlying cash flows of a financial asset or group of financial assets. For purposes of applying this Standard, a transfer of a financial asset refers to the transfer of the contractual rights to all or a portion of the cash flows of a single financial asset or a group of financial assets that can be transferred under a contractual agreement or in the form of a security.' [Emphasis added]*

6. This paragraph appears to give flexibility in the use of groups of assets. The term 'groups of <u>similar</u> assets' was only added in the final standard.

Pass through test (Issue 2)

7. The IAS 39 ED introduced the pass through test:

> *If an entity transfers its contractual rights to all or a portion of the cash flows that constitute a financial asset and continues to collect cash flows from the transferred asset (a 'pass-through' arrangement), the transfer qualifies for derecognition to the extent that the transfer of all or a portion of the asset meets all of the following conditions and the transferor does not otherwise have a continuing involvement (see paragraph 37 (b)):*

> *(a) The transferor does not have an obligation to pay amounts to the transferee unless it collects equivalent amounts from the transferred asset or portion thereof that qualifies for derecognition (ie the transferee is entitled only to the cash flows of the underlying financial asset or the portion therefore that qualifies for derecognition).*
>
> *(b) The transferor is prohibited by the terms of the transfer contract or documents selling or pledging the transferred asset or otherwise using that asset for its benefit.*
>
> *(c) The transferor has an obligation to remit any cash flows it collects on behalf of the transferee without material delay. The transferor is not entitled to reinvest such cash flows for its own benefit.*

8. The IAS 39 ED introduced the wording '*transfers the contractual rights to all or a portion of the cash flows'* which is comparable to the wording 'transfers the contractual rights to receive the cash flows of the financial asset' in IAS 39 Par 18 (a).

9. Par 35 of the IAS 39 ED contained two classes of transactions which may qualify for derecognition, namely (1) when the entity's contractual rights to the cash flows that constitute a financial asset (or a portion of the financial asset) expire or are forfeited and (2) transfers of the contractual rights to the cash flows that constitute a financial asset (or a portion of a financial asset). Consequently it would appear that forfeiture of legal ownership of a financial asset was not required in order to qualify for a 'pass through' transaction.

10. The final IAS 39 contains three classes of transactions which qualify for derecognition: (1) if the contractual rights to the cash flows from the financial asset expire, (2) if the entity transfers the contractual rights to receive the cash flows of the financial asset, and (3) if 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 in an arrangement that meets the pass through conditions in IAS 39 Par 19. It is the extra category in the final IAS 39 which appears to create confusion as to whether transfer of legal ownership is a requirement in order to apply the pass through test.

Re-deliberations of the IAS 39 Improvements Project Exposure Draft in May 2003

Groups of assets (Issue 1)

11. In May 2003 the Board tentatively agreed not to proceed with the approach proposed in the Exposure Draft of proposed improvements to IAS 39, but to revert to the concepts in the original IAS 39 (e.g. control and substantially all the risks of ownership). More specifically, the Board tentatively agreed to clarify how and in what order those concepts should be applied. In the proposed model an entity would first evaluate whether an entire asset, a proportion of an asset or specifically identified cash flows from an asset had been transferred.

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

Pass through (Issue 2)

13. The Board considered whether certain contractual arrangements under which an entity collects cash flows on a financial asset and passes them through to another entity (a 'pass-through arrangement') should qualify as a transfer of the financial asset. The Board tentatively agreed to consider further the interaction between the approach for derecognition agreed by the Board and the guidance proposed on pass-through arrangements.

14. The Board tentatively agreed that contractual arrangements to pass through cash flows when the entity passes on a fully proportional share of the collections of all or specifically identified cash flows should qualify for pass-through accounting.

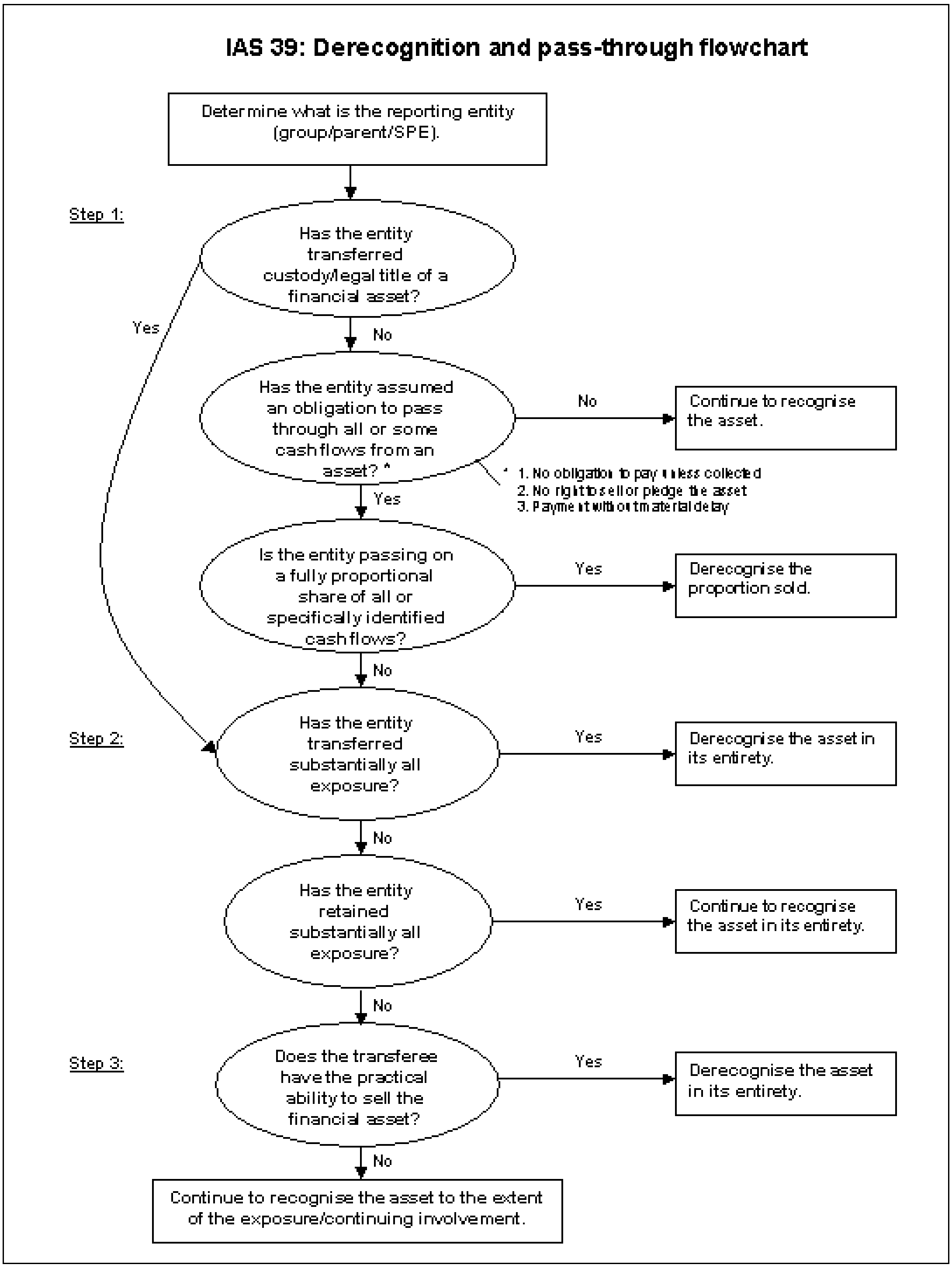
15. The Board also tentatively agreed to consider further the interaction with SIC-12 *Consolidation – Special Purpose Entities* for contractual arrangements if the entity does not have a fully proportional share (i.e. arrangements with disproportionate risk sharing such as an arrangement when the entity retains a subordinated residual interest).

Re-deliberations of the IAS 39 Improvements Project Exposure Draft in June 2003

Pass through (Issue 2)

16. In June 2003 the Board continued its discussion about pass-through arrangements when an entity does not have a fully proportional share of the collected cash

flows, i.e. arrangements with disproportionate risk-sharing such as an arrangement when the entity retains a subordinated residual interest. It also considered how the tests for pass-through arrangements interacted with the derecognition model agreed at the May meeting. The Board tentatively agreed the following model for derecognition and pass through arrangements:



17. In Step 1 it appears that an entity would apply the pass through test when the entity has not transferred custody/ legal title of the financial asset. *[Sentence omitted from observer note]*.

18. In Step 1 of this flowchart it appears that the pass through test would be applicable to all proportionate and disproportionate transfers. (Please refer to paragraphs 18-30 in Paper B).