30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting: **13 December 2007, London**

Project: **Financial Instruments – Derecognition research project**

Subject: **Two views on linked presentation (Agenda paper 9A)**

Background

1. Up to now the expected flow, or retention of, economic benefits on a financial asset has been a major factor in determining whether the financial asset should be derecognised in IAS 39 *Financial Instruments: Recognition and Measurement* (see paragraphs 19 - 23). The staff disagrees with this as the way forward on derecognition and proposes that an item should be derecognised if it ceases to meet the definition of an asset or if it ceases to meet the definition of a liability.

2. The derecognition principle identified in this research project is that a financial asset shall be derecognised when the entity's right in the contract that gave rise to the financial asset ceases to exist, and a financial liability shall be derecognised when the entity's obligation in the contract that gave rise to the financial liability ceases to exist. This means that a financial asset or financial liability should **not** be derecognised because of the likelihood of there being a future flow of economic benefits, the probable amount of those future inflows or outflows, or because of the power or ability of the entity to retain economic benefits on an asset. However these factors may affect the measurement of the

asset or liability's value, how the asset or liability is presented (eg linked presentation) and how the asset or liability is disclosed.

3. The staff believes that it is not enough for the staff report on derecognition to identify whether an asset or liability exists, but that it is also necessary to provide information that enables users of financial statements to identify relationships in the economic benefits between recognised financial assets and recognised financial liabilities. Thus in October the Boards heard how staff research proposes an integrated approach that combines a principle for derecognition and a principle for linked presentation.

4. In the staff's research, linked presentation provides gross and net information relating to assets and liabilities in order that users of financial statements can decide for themselves whether relationships in the economic benefits between recognised financial assets and recognised financial liabilities are relevant to their needs. The nature of the relationships between the economic benefits that trigger linked presentation is the subject of this paper in View 1 and View 2.

What is linked presentation?

5. The staff propose three types of linked presentation:

    a. Linked presentation in the statement of financial position occurs when a (1) recognised financial asset, a (2) recognised financial liability, and (3) the difference in the value between the recognised financial asset and the recognised financial liability- are presented together in the statement of financial position.

    b. Linked presentation in the statement of financial performance occurs when the (1) profit and loss effect of a recognised financial asset, the (2) profit and loss effect of a recognised financial liability, and (3) the difference in value between the profit and loss effects of the financial asset and financial liability – are presented together in the statement of financial performance.

    c. Linked presentation in the statement of cash flows occurs when (1) cash flow effect of a recognised financial asset, the (2) cash flow effect of a recognised financial liability, and (3) the difference in value between the cash flow effects of the financial asset and financial liability – are presented together in the statement of cash flows.

6. Linked presentation is not a second derecognition test and separate financial assets and separate financial liabilities continue to be recognised and presented.

7. Linked presentation should not be confused with offset. IAS 32 *Financial Instruments: Presentation and Disclosure* (see paragraph 42) discusses when separate financial instrument contracts should be offset because they operate as a single financial instrument ie. because of unconditional rights to offset amounts owing and because of simultaneous or net settlement. A linked financial asset and a linked financial liability do not operate as a single financial instrument contract, but merely indicates a relationship in the economic benefits between a recognised financial asset and a recognised financial liability (or vice versa).

What is linked to what?

8. There are two ways in which linked presentation may be applied (deciding on which way you choose to apply linked presentation is based on whether you choose View 1 or View 2).
9. The first way is when <u>a liability is linked to an asset</u>, which would be presented as follows:

Presentation 1- Liability linked to asset		
Assets		Liabilities
Receivables	£10 million	
<u>(Debt obligation)</u>	<u>(£10 million)</u>	
Net	£0 million	

10. The second way in which linked presentation may be applied is when <u>an asset is linked to a liability</u>, which would be presented as follows:

Presentation 2- Asset linked to liability

Assets	Liabilities	
	Debt obligation	£10 million
	(Receivables)	(£10 million)
	Net	£0 million

11. Although this paper and Paper 9B only illustrates linked presentation in the statement of financial position- it is assumed that linked presentation is also applied in the statement of financial performance and in the statement of cash flow.

Linked presentation View 1

Linked Presentation Principle View 1

An entity shall apply linked presentation in the financial statements when either:

a. an entity's obligation to a financial liability is satisfied **solely** by economic benefits generated by a financial asset. **In this case the total liability is linked to the asset.**

b. an entity is obliged to pay a financial liability **all** economic benefits generated by a financial asset. **In this case the total asset is linked to the liability.**

If a financial liability is satisfied solely by economic benefits generated by a financial asset (thus satisfying condition a.), and the entity is also obliged to pay all economic benefits on a financial asset to settle a financial liability (and also satisfies condition b.), **then the financial liability is linked to the financial asset in accordance with condition a.**

12. In View 1, the decision to link is determined by comparing the entity's total obligation to pay economic benefits generated by a financial asset with the entity's total right to receive economic benefits generated by the financial asset ie linked presentation is triggered if the entity's obligation to pay using the economic benefits generated by a financial asset is**:**

    a. **always** smaller than the economic benefits generated by the financial asset, or

b. **<u>always</u>** equal to the economic benefits generated by the financial asset, or

c. **<u>always</u>** greater than the economic benefits generated by the financial asset.

13. In condition in a. the <u>financial liability is linked to the financial asset</u> because its settlement is dependent only on economic benefits generated by the financial asset. If the cash flows of the debtor are insufficient to satisfy the obligation, the creditor incurs a loss and cannot look to the general assets of the entity to satisfy the deficiency; accordingly, a separate guarantee by the entity would invalidate linked presentation.

14. In condition b. the <u>financial asset is linked to the financial liability</u> since the total financial asset provides no benefit except to repay the obligation.

15. Users of financial statements can use gross and net information provided by View 1 to identify those obligations to creditors in which:

    a. financial liabilities are settled solely be economic benefits generated by a financial asset, or

    b. financial assets provide no benefit to the entity except to settle a financial liability obligation.

Linked presentation: View 2

<u>Linked Presentation Principle View 2</u>

An entity shall apply linked presentation in the financial statements when either:

a. an entity is obliged at the reporting date to settle a financial liability using economic benefits generated by a financial asset. **In this case it is the specific obligation to settle the liability using economic benefits generated by the financial asset that is linked to the financial asset, and other obligations of the entity to the debt holder will not qualify for linked presentation.**

b. an entity has a right at the reporting date to receive economic benefits on a financial asset equal to some or all of the economic resources to be sacrificed if a financial liability is settled. **In this case it is the specific right to receive economic benefits equal to some or all of the economic resources to be sacrificed if the financial liability is settled that is linked to the financial**

liability, and other rights of the entity to receive economic benefits will not qualify for linked presentation.

16. In View 2, the decision to link is driven by either an individual obligation to pay economic benefits received when a financial asset generates economic benefits, or an individual right to receive economic benefits that compensates the entity for outflows of economic benefits when a financial liability is settled; thus unlike View 1- the entity's total obligation to pay economic benefits on a financial liability is not compared with the entity's total rights to receive economic benefits on a financial asset.

17. In condition a. it is the <u>specific obligation</u> to pay economic benefits generated by the financial asset at the reporting date <u>that is linked to the financial asset</u> because the entity is committed to pass-through the economic benefits generated by a specific financial asset to the debt holder. Other obligations of the entity to the debt holder will not qualify for linked presentation- and should be presented as a liability as usual. For example in some cases a future event, that has not yet occurred at the time of <u>the reporting date</u>, needs to occur first (such as default of the entity in the case of a pledged asset) before the entity becomes obliged to settle a financial liability using economic benefits generated by a financial asset; in this case linked presentation is only applied when the future event occurs (such as default in the case of a pledged asset).

18. In condition in b. it is the <u>specific right</u> to receive economic benefits equal to the economic resources to be sacrificed if the financial liability is settled <u>that is linked to the financial liability</u> because the entity is exposed to net outflows of economic benefits on the financial liability once the linked asset pays. Consequently linked presentation is not triggered for a right at the reporting date that does **not** generate economic benefits if the financial liability is settled; for example a decision of the directors to set aside government bond securities to settle future outflows of economic benefits on a mortgage liability would not trigger linked presentation- because government bonds do not generate economic benefits if the mortgage liability is settled.

19. Users of financial statements can use the gross and net information provided by View 1 to identify:

a. those inflows of economic benefits generated by financial assets that the entity is required to pass-through to settle financial liabilities, and

b. those outflows of economic benefits for which the entity is only exposed to a net outflow once a linked asset pays.

Comparison of View 1 and View 2

20. Parts of financial assets and parts of financial liabilities **cannot** be linked according to View 1 ie View 1 requires either a total financial liability to be linked to a financial asset (if the liability is satisfied solely by economic benefits generated by the asset), or a total financial asset to be linked to a financial liability (if the asset provides no benefit to the entity except to repay the obligation). Conversely a part of a financial asset (ie a specific right to receive economic benefits) and a part of a financial liability (ie a specific obligation to pay economic benefits) can qualify for linked presentation according to View 2.

21. Linked presentation according to View 1 can only be triggered by an obligation to pay economic benefits ie either a debt holder looks solely to economic benefits generated by the asset or the debt holder looks to all the economic benefits generated by the asset. View 2 also permits linked presentation for rights to receive economic benefits ie when an entity has a right at the reporting date to receive economic benefits if a financial liability is settled.

22. Whether linked presentation is applied in View 1 is determined at the inception of a contract with a debt holder and does not change subsequently ie. linked presentation is triggered at inception and throughout the life of the contract since the entity's total obligation to pay using economic benefits generated by a financial asset is**:**

    a. **always** smaller than the economic benefits generated by the financial asset, or

    b. **always** equal to the economic benefits generated by the financial asset, or

    c. **always** greater than the economic benefits generated by the financial asset.

23. Whether linked presentation is applied in View 2 is based on the rights and obligations that exist at the reporting date, which may change over the life of the contract. For example if the entity pledges a trade receivable as security for debt, then linked presentation would not be triggered until the entity actually defaults; it is only when the entity defaults that the entity is obliged at the reporting date to settle the financial liability economic benefits generated by the financial asset.

Advantages and disadvantages of the two views

24. Advantages of View 1:

    a. View 1 proposes a high hurdle for linked presentation that always reflects an overall inflow or an overall outflow of economic benefits when a financial liability requires settlement using economic benefits generated by a financial asset.

25. Disadvantages of View 1

    a. View 1 provides such a high hurdle that it will seldom be applied in providing information to users of financial statements about relationships in the economic benefits between financial assets and financial liabilities.

    b. View 1 provides a high hurdle for linked presentation that might be confused with a second derecognition test or a new form of offset.

    c. Linked presentation according to View 1 can only be triggered by an obligation to pay that is dependent on economic benefits generated by a financial asset. Consequently View 1 does not permit a symmetrical approach to linked presentation when the generation of economic benefits of an asset are dependent on the payment of economic benefits required to settle a liability.

26. Advantages of View 2 include:

a. View 2 is designed to complement the proposed derecognition principle by providing information about relationships in the economic benefits in a wide variety of scenarios.

b. View 2 applies linked presentation symmetrically to relationships in which obligations to pay are dependent on economic benefits generated by a financial asset, and in which the generation of economic benefits on assets are dependent on the settlement of liabilities.

27. Disadvantages of View 2:

a. Linked presentation according to View 2 may make it difficult to compare the financial statements from one period to another when the relationships in economic benefits between financial instruments change.

Staff view

28. The staff supports View 2.

29. In the view of the staff, View 2 best complements the proposed derecognition principle in providing gross and net information to users of financial statements, so that they can decide for themselves whether relationships in the economic benefits between recognised financial assets and recognised financial liabilities are relevant to their needs. More specifically the staff favours View 2 because it identifies all:

a. obligations to pass-through economic benefits generated by financial assets. This should help users of financial statements to identify those assets for which the entity does not have a right to retain direct economic benefits, because once they are paid- they cannot be used in the general business activities of the entity.

b. rights to receive economic benefits that compensate the entity for outflows of economic benefits when a financial liability is settled. This should help users of financial statements to identify those liabilities for which the entity is exposed to net outflows of economic benefits once inflows of benefits are received on the linked asset, which reduces the entity’s reliance on general business assets to finance the settlement of the liability.