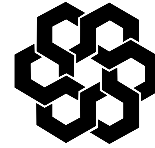

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International Accounting Standards Board

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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: **13 December 2007, London**

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

Subject: **Illustrating the two Views using case studies (Agenda paper 9B)**

Summary of this paper

1. This paper applies the two Views to five case studies. A summary of the conclusions are as follows:

	Case 1: **80% Loan participation**	**Case 2:** **80% Loan participation with a guarantee**	**Case 3:** **100% Loan participation with a guarantee**	**Case 4:** **In-substance loan defeasance**	**Case 5:** **Pledged trade receivables**
View 1	Liability is linked to asset	No linked presentation	Asset is linked to liability	No linked presentation	No linked presentation
View 2	Liability is linked to asset	Liability is linked to asset	Liability is linked to asset	Asset is linked to liability	No linked presentation

Case 1: Loan participation

Description of Case Study

The entity owns a portfolio of mortgage loan assets worth ¥100. A single investor pays ¥80 to the entity in exchange for a loan participation (see description below) in which the entity agrees to pass 80% of all cash flows that are received (i.e. not the first or last 80%[1]) on the mortgage portfolio to the investor. The entity is not permitted to commingle for any significant period of time collections on the mortgage loans with collections on other loans. The entity agrees to act on behalf of the investor in holding any collections on the mortgage loans assets that are due to the investor.

The loan participation above is a bilateral agreement between the entity and the investor in which the entity agrees to allow the investor to participate in the benefits of the contract with the mortgage loan assets. There is no transfer of mortgage loan assets; the entity remains legally entitled to the mortgage loan assets. The investor has no real relationship with the mortgage loan assets. However, the investor obtains a right against the entity to benefits from contracts to the mortgage loan assets.

The investor does not have a right of recourse to assets of the entity in excess of the cash flows received on the mortgage loan ie if the mortgage loan assets fail to make payments then the entity has no obligation to pass additional cash flows to the investor.

Applying the Derecognition Principle

2. The entity should not derecognise the mortgage loan assets because it controls the contractual promises and has an asset ie the entity has the power or ability to insist that the debtors pay.

3. The entity should not derecognise a liability to the investor because it has a present obligation to pay the investor and has a liability ie the entity has the present obligation to pay 80% of cash received on the mortgage loan assets to the investor.

[1] However the same conclusion would be reached if the entity promised the first or last 90% of cash flows to the investor.

Applying linked presentation View 1

4. The obligation to the investor is linked to the mortgage loan assets because the liability is satisfied solely by economic benefits generated by the assets. The statement of financial position would be presented as follows:

View 1 Case 1- Liability linked to asset		
Assets		Liabilities
Mortgage loan assets	¥100	
(Obligation to investor)	(¥80)	
Net	¥20	

Applying linked presentation View 2

5. The entity is obliged at the reporting date to pay the investor 80% of economic benefits generated by the mortgage loan assets. That obligation is linked to the mortgage loan assets in the statement of financial position as follows:

View 2 Case 1- Liability linked to asset		
Assets		Liabilities
Mortgage loan assets	¥100	
(Obligation to investor)	(¥80)	
Net	¥20	

Conclusion Case 1

6. According to View 1 and View 2- linked presentation is applied in Case 1. Furthermore according to View 1 and View 2- the financial liability should be linked to the financial asset.

Case 2: Loan participation with a guarantee

Description of Case Study

7. This case study is the same as Case 1 except for the following:

   The investor from Case 1 also pays ¥2 for a guarantee of the first ¥4 of the investors losses on the ¥80 investment (ie the entity guarantee 5% of the ¥80 investment). What this means is that if the overall portfolio of mortgage loan assets pay between ¥95 and ¥100 (ie 5% of the portfolio), then the investor will continue to receive ¥80, and if the overall mortgage loan assets pay less than ¥95, then the entity will pass through 80% of the actual cash flows received on the mortgage loan assets plus the ¥4 guarantee. Apart from the guarantee- the investor does not have a right of recourse to assets of the entity in excess of the cash flows received on the mortgage loans ie if the mortgage loan assets fail to make payments then the entity has no other obligation to pass additional cash flows to the investor.

Applying the Derecognition Principle

8. The entity should not derecognise the mortgage loan assets because it controls the contractual promises and has an asset ie the entity has the power or ability to insist that the debtors pay.

9. The entity should not derecognise a liability to the investor because it has a present obligation to pay the investor and has a liability ie the entity has the present obligation to pay 80% of cash received on the mortgage loan assets to the investor and has a further obligation to compensate the investor for the first ¥4 of any losses.

Applying linked presentation View 1

10. Linked presentation is not triggered because the liability is not satisfied solely by economic benefits generated by the assets ie the entity has an additional obligation in respect of the guarantee. The statement of financial position would be presented as follows:

View 1 Case 2- No linked presentation			
Assets		Liabilities	
Mortgage loan assets	¥100	Obligation to investor	¥82

Applying linked presentation View 2

11. The entity is obliged at the reporting date to pay the investor 80% of economic benefits generated by the mortgage loan assets. That obligation is linked to the mortgage loan assets in the statement of financial position as follows:

View 2 Case 2- Liability linked to asset			
Assets		Liabilities	
Mortgage loan assets	¥100	Guarantee obligation to investor)	¥2
(Obligation to investor)	(¥80)		
Net	¥20		

12. Additional obligations of the entity to pay economic benefits payable in terms of the entity's obligation in respect of the guarantee (ie ¥2) does not trigger linked presentation.

Conclusion Case 2

13. View 1 proposes that linked presentation should not be applied in Case 2 because the entity's obligation to the investor is not funded solely by economic benefits generated on the mortgage loan assets.

14. View 2 proposes that linked presentation should still be applied in Case 2, because there has been no change from Case 1 in the entity's obligation to pay

80% of economic benefits received on mortgage loan assets to the investor. However the additional obligation to pay economic benefits not generated by the mortgage loan assets in respect of the guarantee- does not qualify for linked presentation.

Case 3: 100% Loan participation with a guarantee

Description of Case Study

15. This case study is the same as Case 1 except for an obligation to pay 100% of the cash flows received on the mortgage loan assets and the highlighted last paragraph:

The entity owns a portfolio of mortgage loan assets worth ¥100. A single investor pays ¥100 to the entity in exchange for a loan participation (see description below) in which the entity agrees to pass 100% of all cash flows that are received on the mortgage portfolio to the investor. The entity is not permitted to commingle for any significant period of time collections on the mortgage loans with collections on other loans. The entity agrees to act on behalf of the investor in holding any collections on the mortgage loans assets that are due to the investor.

The loan participation above is a bilateral agreement between the entity and the investor in which the entity agrees to allow the investor to participate in the benefits of the contract with the mortgage loan assets. There is no transfer of mortgage loan assets; the entity remains legally entitled to the mortgage loan assets. The investor has no real relationship with the mortgage loan assets. However, the investor obtains a right against the entity to benefits from contracts to the mortgage loan assets.

The investor also pays ¥3 for a guarantee of the first ¥5 of the investor's losses on the ¥100 investment. What this means is that if the overall portfolio of mortgage loan assets pay between ¥95 and ¥100, then the investor will continue to receive ¥100, and if the overall mortgage loan assets pay less than ¥95, then the entity will pass through 100% of the actual cash flows received on the mortgage loan assets plus the ¥5 guarantee. Apart from the guarantee- the investor does not have a right of recourse to assets of the

entity in excess of the cash flows received on the mortgage loans. If the mortgage loan assets fail to make payments then the entity has no obligation to pass additional cash flows to the investor.

Applying the Derecognition Principle

16. The entity should not derecognise the mortgage loan assets because it controls the contractual promises and has an asset ie the entity has the power or ability to insist that the debtors pay.

17. The entity should not derecognise a liability to the investor because it has a present obligation to pay the investor and has a liability ie the entity has the present obligation to pay 100% of cash received on the mortgage loan assets to the investor and has a further obligation to compensate the investor for the first ¥5 of any losses.

Applying linked presentation to View 1

18. The mortgage loan assets are linked to the obligation to the investor because the mortgage loan assets provide no benefit to the entity except to repay the obligation. The statement of financial position would be presented as follows:

View 1 Case 3- Asset linked to liability		
Assets	Liabilities	
	Obligation to investor	¥103
	(Mortgage loan assets)	(¥100)
	Net	¥3

Applying linked presentation View 2

19. The entity is obliged at the reporting date to pay the investor 100% of economic benefits generated by the mortgage loan assets. That obligation is linked to the mortgage loan assets in the statement of financial position as follows:

View 2 Case 3- Liability linked to asset			
Assets		Liabilities	
Mortgage loan assets	¥100	Guarantee obligation to investor)	¥3
(Obligation to investor)	(¥100)		
Net	¥0		

20. Additional obligations of the entity to pay economic benefits payable in terms of the entity's obligation in respect of the guarantee (ie ¥3) does not trigger linked presentation.

Conclusion Case 3

21. View 1 **and** View 2 proposes linked presentation in Case 3.

22. View 1 links the total financial asset to the financial liability because the mortgage loan assets do not provide benefit to the entity except to repay the obligation to the investor. View 2 proposes that the entity's obligation to the investor to pay 100% of economic benefits generated by the mortgage loan assets should be linked to the mortgage loan assets- since that obligation is dependent on the mortgage loan assets generating economic benefits. However the additional obligation to pay economic benefits **not** generated by the mortgage loan assets in respect of the guarantee- does not qualify for linked presentation.

Case 4: In substance loan defeasance

Description of Case Study

The entity has an obligation to pay on demand interest bearing liabilities worth £100. If the entity prepays the liabilities then it would incur a substantial prepayment penalty. Consequently the entity acquires a guarantee from Party X in which the entity has a right to receive reimbursement for amounts paid when creditors demand repayment of their loan. The guarantee does not reimburse the entity for ongoing interest payments made to the creditors, except when the creditors also demand repayment of the capital outstanding. The cost of the guarantee is £90, which reflects the present value of the expected amounts to be paid when creditors demand repayment.

The guarantee above is a bilateral agreement between the entity and the guarantor in which the entity has the right to receive compensation for outflows of economic benefits when creditors demand repayment of their loans. There is no transfer of the entity's obligation in respect of the interest bearing liabilities; the entity remains legally obligated to the interest bearing liabilities. The guarantor has no real relationship with the interest bearing liabilities.

Applying the Derecognition Principle

23. The entity should not derecognise the guarantee because it controls the contractual promise and has an asset ie the entity has the power or ability to insist that the X pays.

24. The entity should not derecognise a liability because it has a present obligation to pay on demand and has a liability ie the entity has the present obligation to pay the balance of the loan owing when required by the creditors.

Applying linked presentation to View 1

25. Linked presentation according to View 1 is not triggered because the creditor does not look to economic benefits generated by the guarantee. The statement of financial position would be presented as follows:

View 1 Case 4- No linked presentation			
Assets		Liabilities	
Guarantee	£90	Interest bearing liabilities	£100

Applying linked presentation View 2

26. The entity has a right at the reporting date to receive economic benefits on the guarantee for the economic resources to be sacrificed if the interest bearing loans are settled. That right is linked to the interest bearing liabilities in the statement of financial position as follows:

View 2 Case 4- Asset linked to liability		
Assets	Liabilities	
	Interest bearing liabilities	£100
	Guarantee	£90
	Net	£10

Conclusion Case 4

27. Linked presentation according to View 1 can only be triggered by an obligation to a debt holder to pass-through economic benefits generated by a financial asset ie either the 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. In Case 4 linked presentation is not triggered according to View 1 because the entity is not obliged to the interest bearing liability to pass-through economic benefits collected on the guarantee.

28. View 2 proposes that the entity's right to receive economic benefits on the guarantee should be linked to the interest bearing liabilities - because the entity has the right to receive economic benefits that compensates outflows of economic benefits when the interest bearing liabilities are settled.

Case 5: Trade receivables pledged in connection with existing debt

Description of Case Study

The entity's credit rating is downgraded. As a result of the downgrade the entity agrees to amend the terms of existing debt by entering a pledge agreement. The fair value of existing debt before the amendment to the debt contract is €97 and after the amendment of the contract is equal to €100. The debt agreement entitles debt holders to a first claim on trade receivables in the event of failure to fulfil debt service on the loan. The debt agreement states that the debt holders will agree not to demand payment on loans for a specified period of time as long as payments on the loan are being made and the level of unsecured trade receivables do not fall below a minimum level of

€130. The debt agreement does not place restrictions on specific trade receivables. The entity continues to have the contractual rights to the receivables and receives all cash flows.

Applying the Derecognition Principle

29. The entity should not derecognise the trade receivable because it controls the contractual promise and has an asset ie the entity has the power or ability to insist that the debtors pay.

30. The entity should not derecognise a liability because it has a present obligation to pay the loan.

Applying linked presentation to View 1

31. Linked presentation is **not** triggered because the entity is obliged to settle debt holders irrespective of the economic benefits generated by the trade receivables, and because the debt holder are not solely satisfied by economic benefits generated by the trade receivables.

Applying linked presentation View 2

32. Linked presentation in View 2 is **not** triggered because the debt holder does not have a right <u>at the reporting date</u> to receive economic benefits generated by the receivables ie the entity first needs to default before debt holders have a claim to economic benefits generated by the financial asset.

Conclusion: Case 5

33. Linked presentation is not applied in Case 5 according to View 1 and View 2.