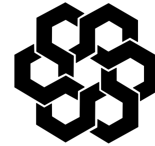

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International Accounting Standards Board

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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: **16 November 2007, London**

Project: **Consolidation**

Subject: **Education session: Application of the Proposed Consolidation Framework to Structured Entities (Agenda paper 8A)**

Introduction

1. The Board has asked the staff to develop an IFRS to replace IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation—Special Purpose Entities* for all entities, including those commonly referred to as special purpose entities (SPEs). Our initial due process document will be a discussion paper. The purpose of this paper is to provide the Board with an update on the direction we are taking on accounting for interests in entities structured as securitisations, conduits, and other arrangements commonly referred to as SPEs.

2. We are not asking the Board to make any tentative decisions in relation to the issues raised in this paper. Rather, the paper is designed to be informative. We seek feedback from the Board about the principles for assessing the rights one entity has in another. In particular, is the approach likely to be helpful in identifying when one entity should recognise all of the assets and liabilities of another entity (ie consolidate) as opposed to recognising only those assets and liabilities in which it has a direct interest?

3. We note the importance of keeping in mind that one of the primary purposes of this project is to ensure that users of financial statements have information that is relevant in making decisions and that an entity should recognise its (and only its) assets and liabilities. A consequence of the recent financial instability in the market appears to be a tendency (at least, in the financial press) to say that more is better—everything should be consolidated; if more assets and liabilities are reported in statements of financial position, that will provide better information to investors and prevent banks and others from 'hiding' risks 'off balance sheet'. We must, however, ask whether consolidation always provides users with more meaningful information. There is little disagreement among users and other interested parties about whether investments in these arrangements should be reflected in financial statements. The question that we must address is how best to reflect those investments.

4. Our focus in the consolidation project is on ***recognition*** of assets and liabilities. We ask what assets and liabilities an entity should recognise, rather than asking whether assets and liabilities should be derecognised. Clearly, there is a close link between the derecognition project and the consolidation project—in Appendix A of this paper, we highlight similarities and differences in our approach compared to both derecognition in IAS 39 *Financial Instruments: Recognition and Measurement* and the derecognition project being undertaken by the IASB staff. However in considering the proposed approach to consolidation, we would ask you to concentrate on what assets and liabilities should be **recognised**, not on whether particular assets should be derecognised.

5. Paper 8B discusses some of the characteristics of securitisations and similar arrangements, and how those characteristics might indicate whether a party controls the entity or has rights to and obligations for some aspects of the entity.

Overview of our approach to consolidation

6. The overriding principle that we are following in the consolidation project is as follows:

   > An entity should include in its financial statements the assets that it controls and the obligations for which it is responsible.

   This approach is the same as the principle underlying ED 9 *Joint Arrangements* published by the Board in September 2007.

7. There are two ways that an entity can control an asset:

   (a) directly, such that the entity has specified rights to some of the benefits of an individual asset and the ability to prevent others from accessing those benefits, or

   (b) indirectly, by controlling an entity that controls the asset directly or indirectly.

8. In discussions to date, the Board has tentatively decided that a parent entity has a controlling interest in another entity when an entity:

   (a) has the ability to direct the strategic financing and operating policies of the other entity (the *power* criterion).

   (b) has the ability to access benefits flowing from the entity (the *benefits* criterion).

   (c) is able to use its power so as to increase, maintain or protect the amount of its benefits.

9. If an entity meets all three criteria, it controls the other entity and should consolidate all of the assets and liabilities of that entity. Through its *strategic power* to direct the policies of the entity, it has the ability to direct the use of *all* of the assets, and can determine when to settle, transfer or increase *all* of the liabilities.

10. Therefore, when the activities of an entity are governed by financing and operating policies, and the entity can be controlled through voting rights, we believe that asking 'who controls the entity?' is an appropriate surrogate for asking 'who controls each of the assets and liabilities of the entity?'. We refer to this as the traditional control model.

11. This paper focuses on those arrangements that do not fit as comfortably within the traditional control model. Or, more accurately, the types of arrangements that have developed in practice to circumvent the traditional control model. Two of the mechanisms used in financial engineering are the predetermination of the financing and operating decisions, and giving the majority of the voting rights to a party but not the other economic characteristics that go with ownership.

12. The IASB 'response' to this financial engineering has included SIC-12, which focuses primarily on the predetermination of the financing and operating

policies. The FASB response includes the publication of FIN 46(R), and SFAS 140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.* All three of these interpretations and standards give special labels to these entity types—special purpose entities, variable interest entities and qualifying special purpose entities.

13. In contrast, the model we are developing does not create classes of entities—it assesses the rights and responsibilities that one entity has in the assets and liabilities of another entity. We believe that this approach accommodates better a model that helps to avoid creating silos or boxes that, almost inevitably, are separated by bright lines or leave gaps.

Creation and purpose

14. To help develop these concepts it might be helpful to look at some examples of arrangements commonly found in practice.

15. Securitisations, conduits, structured investment vehicles (SIVs) and similar arrangements are generally created for valid business reasons in order to reduce the cost of borrowing, improve liquidity or shift risk to other parties and allow investors to obtain tax benefits. They are often structured to isolate risks associated with assets (eg credit risk) and provide bankruptcy remoteness such that the assets of the entity are removed from the creator's and investors' statements of financial position (ie non-consolidation). However, these arrangements can also be used to remove assets and liabilities from an entity's statement of financial position, or avoid consolidation when control actually exists. It is the latter circumstances that have received the most attention in recent years and these entities now have the reputation of being created to conceal a company's true financial position.

Common features of these arrangements

16. The characteristics that are common to entities that are used for securitisations and similar arrangements are:

    (a) a narrow purpose;

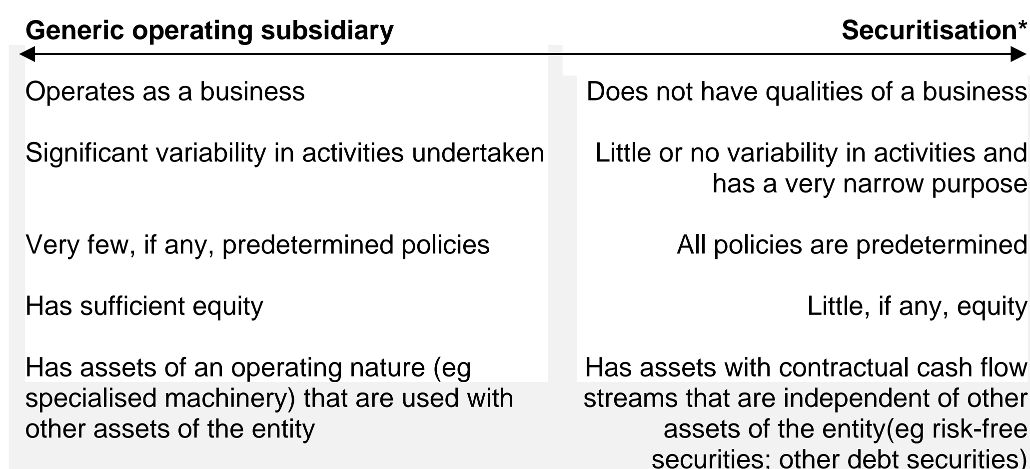
    (b) predetermined strategic policies; and

    (c) little, if any, equity.

17. In earlier staff papers we have argued that it is only possible to establish an entity with predetermined policies and little or no equity if the nature of the

assets and liabilities it houses lend themselves to such an arrangement. We have argued that these arrangements tend to have characteristics more closely associated with an asset than with a business.

18. In considering such arrangements, we think that there is a continuum of indicators—at one end (the left hand side of the diagram below), there are operating subsidiaries that would clearly be controlled by one party through strategic power. At the other end (the right hand side), the activities of a structured arrangement would be entirely predetermined and it would be necessary to consider the rights and responsibilities of each party. In between, judgement must be applied to determine what assets and liabilities should be recognised. There is not a point or a particular set of criteria that indicates when the traditional control model should stop being used. This is explored further in the section on our proposed approach to consolidation in paragraphs 33-53 of this paper and in paper 8B.



*This continuum can also be applied more generally to other types of arrangements, such as conduits, collateralised debt obligations, etc.

Narrow purpose

19. An entity can have a narrow purpose if its assets have cash flows steams that are largely independent. That is to say, if an entity has a narrow purpose, it is likely to be the consequence of its assets.

20. That an entity has a narrow purpose is an indicator that the traditional control model might not be an appropriate basis for identifying which parties have rights over the assets of the entity or responsibility for its liabilities. However, having a narrow purpose is not a necessary or sufficient characteristic for

concluding that the power over the strategic policies of an entity will be unhelpful in assessing rights.

Predetermined strategic policies (referred to by SIC-12 as 'autopilot')

21. Many of these arrangements are able to operate with predetermined policies. The extent of the predetermination can vary and often depends on the variability in the activities of the arrangement, and the types of assets held by the arrangement. The more variability in the types of activities undertaken by the arrangement, the less likely it will be that it can have predetermined policies.

22. The extent of predetermination is explored further in paper 8B.

Little, if any, equity

23. If the entity does not have the ability to fund or finance its operations without assistance from, or reliance on, another party, the equity is not sufficient to absorb the variability of its assets and liabilities (ie profits and losses). In cases in which the investors have a guaranteed return such that they do not participate in the entity's losses, it is likely that the entity is not an operating business.

24. Although having sufficient equity capital gives the appearance that an entity can be assessed using the 'traditional' control model, this is not to say that all thinly-capitalised, highly leveraged entities cannot.

Approach in accounting standards

25. When discussing the type of entity that we have described in the previous section, it is often difficult to analyse these entities using a 'traditional' control perspective (because no party appears to have control). In response to this issue, IFRSs and GAAP emphasise the importance of benefits and risks when evidence of control is not available.

IFRSs

26. SIC-12 looks to the substance of the relationship between an entity and an SPE to determine whether the SPE is controlled by that entity. In essence, when power is not evident, the party that benefits most will be likely to have control.[1] Despite referring to control, SIC-12 is perceived and applied as a risks and rewards model. It notes that the following factors should be considered:

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[1] The criteria in SIC-12 is in contrast to the criteria in FIN 46(R) in that SIC-12 gives more weight to benefits, while FIN 46(R) gives more weight to losses.

(i) The activities of the arrangement are being conducted on behalf of the entity according to its specific business needs so that the entity obtains benefits from the arrangement's operation;

(ii) The entity has the decision-making powers to obtain the majority of the benefits of the activities of the arrangement or, by setting up an 'autopilot' mechanism, the entity has delegated these decision making powers;

(iii) The entity has rights to the majority of the benefits of the arrangement and therefore may be exposed to risks incident to the activities of the arrangement; or

(iv) The entity retains the majority of the residual or ownership risks related to the arrangement or its assets in order to obtain benefits from its activities.

US GAAP

27. In US GAAP, structured arrangements are accounted for in accordance with FIN 46(R) and SFAS 140.

(a) FIN 46(R) gives primacy to identifying who absorbs the variability of the entity. FIN 46(R) assumes that the primary beneficiary of a variable interest entity (such as an SPE, but it also relates to other types of entities) has the majority of risks and benefits, with the emphasis being on exposure to potential losses. The primary beneficiary is the party that holds a significant amount of the variable interests in a variable interest entity. When different types of variable interests exist, the interest that has exposure to loss before other variable interests is considered to be the interest with the greatest level of variability. A variable interest is considered 'significant' when it is greater than the variable interests held by the other individual entities that hold variable interests (ie significant is a majority of all variable interests held in the entity).

(b) SFAS 140 focuses on the extent of the predetermination of the entity. The standard relates to very passive arrangements (referred to as 'qualifying SPEs'), such as those that hold only financial assets and liabilities and which function only to receive and distribute proceeds to investors, and relates only to the transferee of the arrangement. Investors in qualifying SPEs cannot exercise control over the entity since all activities are predetermined and the entity effectively is 'brain dead'.[2] The level of risks and rewards is not considered relevant in this case as qualifying SPEs are not subject to consolidation as long as specific criteria are met. The

[2] A 'brain dead' entity is considered to be one which requires no active management, with only an administrator who manages the day-to-day activities of the entity within predefined parameters.

FASB are currently considering changing the requirements of SFAS 140 to address concerns that entities that should be consolidated are not because they are being structured to fit within the definition of a qualifying SPE in SFAS 140.

Practical issues with SIC-12 and FIN 46(R)

28. The switch from a control model to a risk and/or rewards model does not resolve the issues of when, whether and what to consolidate. Even with guidelines in place, it is not always clear which party ultimately receives the majority of the benefits from the activities of the entity or which party has assumed the majority of the risks. In fact, in practice, 'control' can sometimes pass between investors solely due to changing market conditions, when nothing has changed in the substance of the relationship between the investors and the entity. FIN 46(R) is perceived as complex and rules-driven, particularly its approach to calculating expected losses and expected residual returns of the entity—the party exposed to the majority of those expected losses (or if no one is exposed to the majority of the expected loss, the majority of the expected residual returns) should consolidate the entity.

29. A practical problem with SIC-12 is that it could lead to more than one party being identified as the parent of an entity, contrary to the unilateral control-based consolidation model. There are also interpretation difficulties with SIC-12. Although SIC-12 is based on the principle of control, reference is also made to benefits (ie risks and rewards), making it difficult to determine which factors need to be considered. This therefore leads to a conflict between the control model and the risks and rewards model (ie the party who has control by traditional means does not always receive a majority of the rights associated with holding a controlling voting interest). The models should not conflict. We believe that the focus on 'the entity as a whole', rather than the assets and liabilities of the entity, is at the root of this conflict.

30. Determining whether an entity controls (ie meets the power and benefits criteria) a structured arrangement continues to cause confusion in practice. In April and May 2006, the IFRIC addressed, amongst other issues, whether there are any indicators of control that play a dominant role in determining whether an entity should be consolidated under IAS 27 and SIC-12. At both meetings, the IFRIC decided that there is no single indicator and that all factors relevant to the determination should be considered.

31. In a world of continuous financial engineering, it is not surprising that reporting entities have created instruments that will help them to get around the requirements of US FIN 46(R) and SIC-12. One of the more common instruments is the 'expected loss note'. By issuing expected loss notes to a third party (who is often in the business of doing this), an entity is able to transfer enough of the exposure to risks and rewards to that party to demonstrate that it is not exposed to the majority of expected losses and not entitled to the majority of expected residual returns. The existence of the note provides loss protection to the investors and/or debt holders.

32. We have a more fundamental difficulty with a simple shift in focus away from assessing control and onto assessing risks and rewards. Our difficulty is that the assessment is still undertaken with the purpose of identifying who controls the entity **as a whole**. It could be that no single party has rights over all the assets of an entity (or any rights of importance).

Our proposed approach to consolidation

33. FIN 46(R) and SIC-12's reliance on assessing who receives the risks or rewards of ownership creates two fundamental dilemmas:

    (a) Is it appropriate to account for, on a consolidated basis, the benefits represented by an entity's assets and not simply the direct benefits that the participants control though their investment?

    (b) Is it reasonable that changes in the levels of risks and/or rewards due to outside factors (such as changing market conditions) when the economic rights and obligations have not changed should influence which party should consolidate the entity?

34. To avoid practical misunderstandings and uncertainty, we are therefore proposing a single control model and not a risk and rewards model. Having said that, the identification of risks and rewards might often, however, be helpful in assessing who has control over the assets and liabilities of the entity.

35. We believe that the accounting treatment should be consistent, regardless of the type of entity in which the asset resides. Consider a simple example of an asset under three circumstances:

    (a) Owned outright,

    (b) Placed in a wholly-owned subsidiary, or

(c) Transferred to a securitisation arrangement.

36. The asset **owned outright** [case (a)] would be recognised by the entity. In this case, it is generally easy to determine that the entity has all of the ownership rights of the asset and therefore controls the asset.

37. The **asset placed in a wholly-owned subsidiary** [case (b)] would be recognised if the subsidiary was controlled by the entity owning the subsidiary. Traditional control principles would apply and the asset would be recognised upon consolidation.

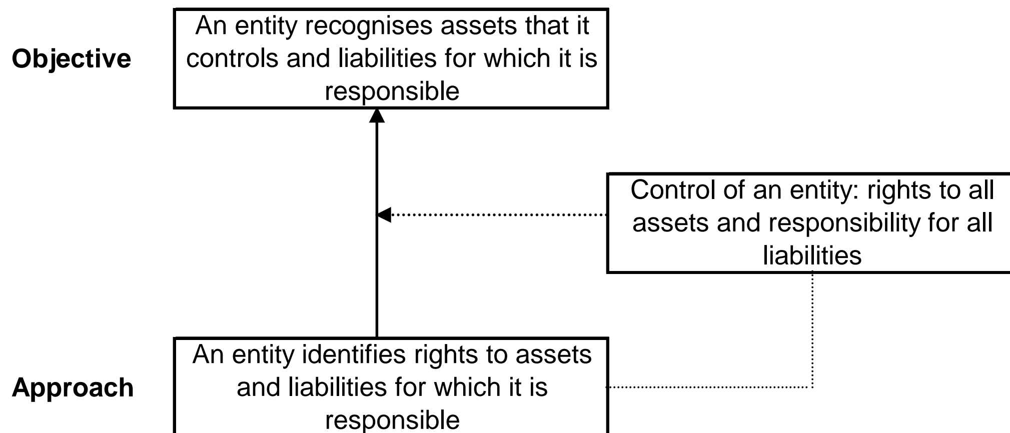
38. The **asset transferred to a securitisation arrangement** [case (c)] would require further analysis. If the transferor has rights to, and receives benefits from, the asset, the asset should be recognised. It is important to ask 'who owns what' and to consider what it is that each party receives and gives up in a transaction. The accounting treatment should not be different merely because the asset resides in a structured arrangement rather than in an operating subsidiary.

39. The decision of whether (and what) to consolidate depends on an entity's ability to benefit from the assets and liabilities of another entity and the exposure to the risks inherent in those benefits. That is to say, the accounting should reflect the economic rights and obligations of the participants. In the case of an investor controlling the entity as a whole, there should be no practical difference between the recognition of assets and liabilities when an entity is consolidated using the traditional control model and the recognition of the individual assets and liabilities when you 'look through' the entity to identify the parties' rights and obligations.

40. The approach is similar to that proposed in ED 9 *Joint Arrangements* published by the Board in September 2007. Our ultimate goal is that an entity recognises the assets that it controls and the obligations for which it is responsible. In the absence of strategic control, the way to identify the assets controlled and obligations for which it is responsible is to identify each party's contractual rights and obligations.

41. In most cases, it will be obvious which party controls an entity and should therefore consolidate it. Entities are often controlled by a shareholder that has access to the majority of the voting rights. However, because there are situations in which control over an entity is not obvious, the solution therefore might be a model in which, first, the existence of control is assessed and, second, if control

of the entity cannot (or should not) be established, each investor will recognise their respective rights and responsibilities related to their interest in the entity. [3] Put simply, consolidation will not always be appropriate.



42. In some arrangements such as SIVs, the arrangement operates more like an operating finance company with structured finance characteristics. It is similar to the treasury function of a bank, with assets, liabilities, liquidity and administration functions that must be managed. There is often continuous reinvestment of assets and management not only of credit risk but also of interest rate, foreign currency and liquidity risk. In this situation, it is likely that the activities of the SIV cannot be substantially predetermined and that one party controls the entity as a whole and should consolidate it.

43. Conversely, in some conduit arrangements it will be likely that no single entity controls the conduit as a whole, but has the rights to specified assets and is responsible for specified liabilities.

44. To reiterate, we are not proposing full consolidation of **all** entities that are within the scope of SIC-12, or that **none** of them be consolidated, but rather accounting for each party's economic investment in these entities. This is because control is sometimes held over the investment in the entity, not the entity itself or its underlying assets. The amounts to be recognised by each investor include:

    (a) the assets over which rights are held,

    (b) the obligations and risks assumed, and

    (c) any income or losses received.

[3] The party that has control will consolidate the entity.

Concerns

45. There may be a number of concerns about the approach that we are proposing:

    (a) Surely, parties would not be exposed to significant risks or entitled to benefits without controlling the activities that create those risks and rewards in some way. Is it possible that entities are set up to be significantly predetermined such that no one controls the entity as a whole?

    (b) Is there a risk that we will be encouraging entities to hide exposures to risks; that we will be encouraging 'off balance sheet' financing?

46. Regarding concern (a), we believe that some entities can be set up to operate without any active decision-making by having policies that are significantly, if not totally, predetermined. For example, an entity that is set up to hold risk-free securities only (such as government bonds) with predetermined contractual cash flows that are matched with payments to be made to investors. Those assets have very limited risks (almost no credit or liquidity risk), and require very little management or servicing. Investors exposed to risks and rewards would not require ongoing control over the entity because their risks have been reduced or entirely predetermined in setting up the entity. It can be argued that investors in these types of arrangements implicitly have accepted the predetermined policies of the entity and are therefore unable to control the entity's assets or the associated future economic benefits. Presumably, they are not interested in doing so.

47. In addition, there are arrangements in which it would appear that investors effectively have joint control of an arrangement. This is discussed in more detail in paragraphs 12-14 of paper 8B.

48. Regarding concern (b), we think that our approach will not result in risks being hidden. Our approach would ensure that where an entity has rights to assets (and is exposed to their risks) and has responsibility for obligations, those assets and liabilities would be shown in its financial statements. Our approach will avoid the possibility of including items in an entity's statement of financial position when the entity has no rights to those assets and no responsibility for the liabilities.

49. In addition, we think that our approach might require consolidation of entities or recognition of assets and liabilities that are not consolidated today. For example, newspaper articles and other sources suggest that many SIVs are kept 'off balance sheet', presumably because they meet the criteria of SFAS 140 to be

qualifying SPEs. Under our approach, we think that many of these are likely to be consolidated.

50. Although it is too soon to discuss disclosure in detail, we anticipate proposing disclosures about risks in the discussion paper. For example,

    (a) it might be useful that any investments in securitisations or other arrangements (that are not consolidated) are described as such in the statement of financial position (as a separate line item).

    (b) when an entity provides credit enhancement of, say, CU20 million, but that obligation is recognised and measured appropriately at CU1 million in its statement of financial position, we would propose that disclosures are given of the credit enhancement provided, how the obligation has been measured and the entity's maximum potential exposure of CU20 million. [4]

51. Paper 8B explores in more detail our proposed approach in accounting for arrangements such as securitisations by looking at the characteristics of such arrangements—predetermination of activities; types of assets held by the arrangements; the level of servicing provided.

Summary

52. This paper focuses on those arrangements for which it is difficult to conclude that one entity controls another entity using the traditional control criteria, perhaps because the policies have been predetermined or the holders of the voting rights are not the absorbers of the variability of the assets and liabilities of the entity. It is meant to assist in developing principles for consistent accounting in situations in which the form of the arrangement makes it difficult to assess the rights and obligations of a party with an interest in an entity.

53. In developing the analysis and scenarios in paper 8B, our objective has been to identify what rights and responsibilities each party to the arrangement has, and to reflect that in the accounting outcome proposed. Once we agree on that outcome, we will develop the principles, to be included in the discussion paper, that are most likely to achieve that outcome on a consistent basis. Much of the thinking behind those principles are already included in these papers, however we will draw out the principles more specifically in future papers.

[4] An entity that provides credit enhancement agrees to provide funding to an arrangement in the event that cash flows are not received from assets (ie the entity takes on credit risk associated with the assets of an arrangement in return for a fee).

54. The model we are developing is consistent with the principles underlying IAS 27, SIC-12 and FIN 46(R). It does not create classes of entities, but rather it assesses the rights and responsibilities that one entity has in the assets and liabilities of another entity.

55. The main difference between the proposed model and the existing models (particularly FIN 46(R)) is that the objective of the proposed model is not limited to identifying which party shall consolidate all of the assets and liabilities of an entity. Because the party absorbing the majority of the variability of an entity might, in fact, be absorbing all of the variability of some of the assets of the entity and none of the variability of other assets of the entity, a requirement for that party to consolidate all of the assets of the entity could result in it reporting assets that it does not control and for which it does not absorb variability. Conversely, the party that absorbs all of the variability of those other assets (and presumably has some power over them) does not report those assets.

56. We believe that our approach will avoid creating silos or boxes that, almost inevitably, are separated by bright lines and that lead to opportunities to 'get around the rules'. Most importantly, it attempts to reflect the economics of these types of transactions.

57. ***Question for the Board:***

We would like feedback from the Board regarding the proposed approach to consolidation and its application as illustrated in paper 8B.

Appendix A

Comparison of consolidation approach with the derecognition requirements in IAS 39 and the derecognition project undertaken by the IASB staff

A1. As noted in the main body of the paper, we have focused on *recognition* of assets and liabilities when considering consolidation. We have taken a 'contractual rights and obligations' approach to the recognition of assets and liabilities, not a risks and rewards approach. Therefore, if an entity has contractual rights to an economic resource, or a share of an economic resource, the entity recognises that right to the economic resource as an asset. Having a right to a resource means that the entity is exposed to the risks of that resource and has the ability to obtain benefits from the resource. Alternatively, if an entity does not have contractual rights to an economic resource, it does not recognise it, regardless of whether it previously owned the resource or whether it retains any risks and rewards associated with the resource. If the entity does not have rights to a resource, any risks and rewards that it has would be associated with other assets to which it has rights, not the asset originally owned.

For example, Entity A sells securities to Entity B, transferring all contractual rights associated with the securities. As part of the transaction, Entity A obtains cash and a subordinated interest in Entity B such that it is exposed to some risks and has rights to benefits arising from the activities of Entity B. In accordance with the approach discussed in this paper, Entity A would recognise the cash and its interest in Entity B, rather than the securities—it no longer has any contractual rights to those securities. Entity A is exposed to the risks and rewards of ownership of its contractual interest in Entity B, not directly to the risks and rewards of the securities.

Derecognition according to IAS 39

A2. Guidance on derecognition of financial instruments within existing IFRSs is found in IAS 39. The derecognition tests for IAS 39 look both to risks and rewards and to control, with more emphasis being placed on risks and rewards (ie control, or the ability of the entity to sell the asset, is the determining factor

only in cases when the entity has neither retained nor transferred substantially all the risks and rewards of ownership, see paragraphs 20(c) and 23 of IAS 39).[5]

A3. For example if an entity ceases to have contractual rights to a financial asset that is sold under an agreement to repurchase it at a fixed price, it is not derecognised in IAS 39 (see paragraph AG 51 (a)) because the entity retains substantially all the risks and rewards of ownership.

A4. Because we have taken a contractual rights and obligations approach to recognition, and IAS 39 takes a risks and rewards approach to derecognition, there are situations in which we would argue that assets should not be recognised whereas IAS 39 would prevent derecognition, and vice versa.

Derecognition according to the derecognition project

A5. Both the consolidation project and derecognition project agree that present contractual rights to economic resources, or present obligations to outflow of economic benefits, should be recognised. In this sense, both projects eliminate *historical rights* and *historical obligations,* or the retention of historical risks and rewards of assets and liabilities previously owned, from the analysis of whether an asset or liability should be recognised.

A6. The derecognition project proposes that in the context of financial assets it is a contractual promise that qualifies as an economic resource if it is capable of producing economic benefits. A contractual promise may produce economic benefits by being held until economic benefits specified by the contractual promise are received, by using the contractual promise as collateral to secure improved lending terms or by selling the contractual promise to another party for cash. In all these cases the derecognition project proposes that it is the contractual promise that represents the economic resource, and not the economic benefits that the contractual promise is capable of producing.

A7. The derecognition project further proposes that in terms of the definition of an asset it is the contractual promise (ie the economic resource) that should be controlled, and not the manner in which the entity expects to convert that contractual promise into inflows of economic benefits or reductions in outflows of economic benefits. For the purpose of determining whether an asset exists it is **not** important to know whether the entity intends to hold the contractual

[5] In IAS 39, the basis for control is whether the transferee can sell the transferred asset without restriction. See paragraph 23 of IAS 39.

rights to the asset, use the contractual rights as collateral or intends to sell the contractual rights for cash. What is important is that the contractual promise, that is capable of producing cash inflows or reducing cash outflows, *is controlled* by the entity.

A8. In terms of the derecognition project, an entity obtains control of a contractual promise when the entity gains the right in the contract to that promise. It is the entity's right in the contract that establishes the entity's power or ability to insist that the promise in the contract is honoured. It is only when the entity ceases to have the right in the contract that it ceases to have the power or ability to insist that the promise in the contract is honoured, and the entity ceases to control the contractual promise- and the financial asset should be derecognised.

A9. Because both projects follow a 'contractual rights and obligations approach', in many situations, our conclusions regarding recognition of assets and liabilities is consistent with the conclusions that would be reached regarding derecognition in the derecognition project.

A10. However, we have identified situations in which we have different interpretations of the application of a 'contractual rights and obligations' approach to the definition of an asset.

A11. The derecognition project, as noted above, would derecognise a financial asset only when an entity's rights in a contract that gave rise to the financial asset cease to exist. Therefore, for example, an entity would derecognise a trade receivable only when the entity no longer has the right to receive cash flows from the debtor, which may require the consent of the debtor in an amendment to the contract. If an entity becomes party to a new contract that does not cause a cessation of the entity's right to the promise in the contract, but promises to immediately pass cash flows received from the receivable to a third party, the derecognition project would conclude that the entity should not derecognise the receivable. Rather, it should recognise a liability in respect of the present contractual obligation to make payments to the third party.

A12. The consolidation project has applied contractual rights to the definition of an asset—'a resource controlled by the entity as a result of part events and from which future economic benefits are expected to flow to the entity' *Framework* paragraph 49—by considering that a contractual right is an asset only if the entity has the ability to use or benefit from the asset.

a. Therefore, in general, if an entity has contractual rights to cash flows generated from a financial asset, we assume that the entity can use the cash for its own purposes, to generate returns from which it benefits, and therefore, those contractual rights represent an asset of the entity.

b. However, there are a few situations in which we have a different view. If an entity has contractual rights to cash flows that it must transfer to a third party, such that it does not effectively have access to future economic benefits, we do not consider those rights to cash flows to be an asset of the entity. That is to say, we are of the view that a contract to transfer cash flows generated from a financial asset can result in an entity's no longer having rights to those cash flows, if the contract to transfer is such that the entity no longer has access to benefits from the cash flows. We do not think that all contracts to transfer or 'pass-through' cash flows from a financial asset should result in the derecognition of the asset; only those that effectively mean that the entity cannot use or benefit from the asset. For example, we would consider that the entity no longer has rights to cash flows in the following situations:

    i. the entity must transfer the cash flows received from a financial asset immediately, effectively only acting as an agent collecting those cash flows and passing them on.

    ii. the entity may not be obliged to transfer the cash flows immediately, however it could not invest or otherwise use the cash for its own purposes (it might be able or required to invest the cash for the benefit of the third party in any intervening period).

   In these situations, we think that the entity is unable to use or benefit from the cash in a way that indicates control. The entity would appear to be simply collecting or holding the cash on behalf of a third party—it is the third party who receives the benefits associated with control. The financial asset, therefore, would not be an asset of the entity, but of the third party.

A13. In the context of transferring assets to a structured arrangement such as a securitisation, the similarities and differences between the consolidation project and the derecognition project are illustrated as follows:

c. If the transferor sold debt or equity securities to another party, such that it ceases to have contractual rights to the cash flows or the ability to use or benefit from the securities, the derecognition project would require the derecognition of the securities by the transferor and the consolidation project would **not** require recognition by the transferor. The treatment required by both projects would, therefore, be consistent and would not be influenced by whether the transferor retained risks and rewards associated with the securities. The transferor may or may not service the asset on behalf of the entity, eg the transferor might collect the cash flows on behalf of the entity that legally owns the securities.

d. If the transferor sold the beneficial interest in a portfolio of mortgage receivables to an entity, such that it retains the right to receive mortgage payments in the contracts but promises to pay amounts received immediately to another party (such that the entity no longer has the ability to use or benefit from the receivables), the consolidation project would **not** require recognition of the receivables by the transferor. However the derecognition project would require continued recognition of the mortgage receivables by the transferor because the entity retains the right to receive mortgage payments, and would recognise the separate obligation to pay as a liability.

A14. To summarise, the derecognition project takes the view that the likelihood of there being a future flow of economic benefits arising from the financial asset is a matter affecting the measurement of its value, presentation and disclosure and is not a matter affecting whether it should be recognised.

A15. In contrast, the consolidation project takes the view that the likelihood of there being a future flow of economic benefits arising from the financial asset affects whether the financial asset is an asset of the transferring entity or the purchasing entity.