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:	**December 2008, London**
Project:	**Derecognition of Financial Assets and Liabilities**
Subject:	**Change to Transferor's Perspective: Impact on Forward Examples in Flowchart 1 (Agenda Paper 10D)**

Background

1. At the November IASB meeting the staff noted that if the derecognition tests in Flowchart 1 were applied from the perspective of the transferor, the outcomes of two transactions would change. Those transactions were:

   a. a transfer of a non-readily obtainable financial asset with a physically-settled fixed-price forward purchase and

   b. a transfer of a non-readily obtainable financial asset with a physically-settled total return swap.

2. Some board members asked the staff to illustrate further those transactions and related outcomes.

3. This paper:

a. provides a brief refresher of the derecognition principle and application of that principle in the original Flowchart 1 (discussed at the October meetings) and the amended Flowchart 1 (Flowchart 1R, as discussed in November);

b. applies Flowchart 1 and Flowchart 1R to the two transactions set out in paragraph 1; and

c. provides a staff recommendation.

4. Flowchart 1 and Flowchart 1R are set out in the appendix.

The derecognition principle and application in the flowcharts

5. Flowchart 1 has two derecognition tests. The staff developed those tests to make the derecognition principle operational. That principle (originally presented in October – see IASB Agenda Paper 7 and Joint Agenda Paper 4A) is:

> An entity should derecognise a financial asset or component thereof when it no longer qualifies as an asset of the entity (ie when the economic benefits no longer exist or the economic benefits exist but the entity ceases to have the ability
>
> (a) to obtain the future economic benefits inherent in the asset/component, and
>
> (b) to restrict others' access to those benefits).

6. The two derecognition tests in Flowchart 1 split the (a) part of the derecognition principle into two application pieces. That is, a transferee can obtain the cash flows of a transferred asset:

a. if it can transfer the asset to a third party; or

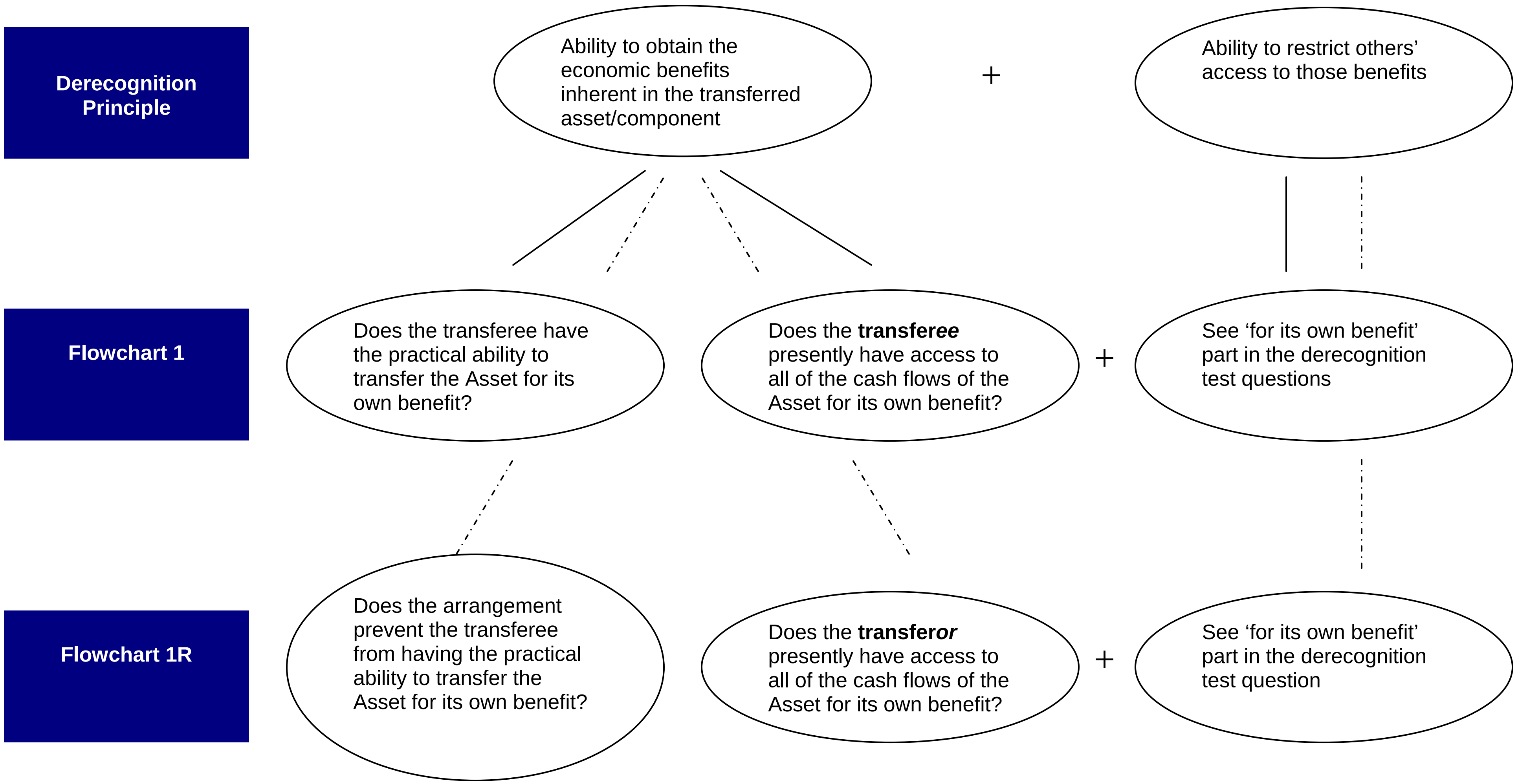
b. if it can obtain the underlying cash flows by other means (eg, if it is entitled by contract or otherwise to receive all of those cash flows).

If the transferee can keep the cash flows so obtained for itself (the (b) part of the derecognition principle), then the transferred asset is derecognised.

7. At the November IASB meeting the staff noted that applying the Flowchart 1 derecognition tests from the transferor's perspective would change the outcomes for the forward and total return swap examples. This amended flowchart is Flowchart 1R.[1]

8. The link between the staff's derecognition principle and the two derecognition tests in Flowchart 1 and in Flowchart 1R can be graphically illustrated as follows (see following page):

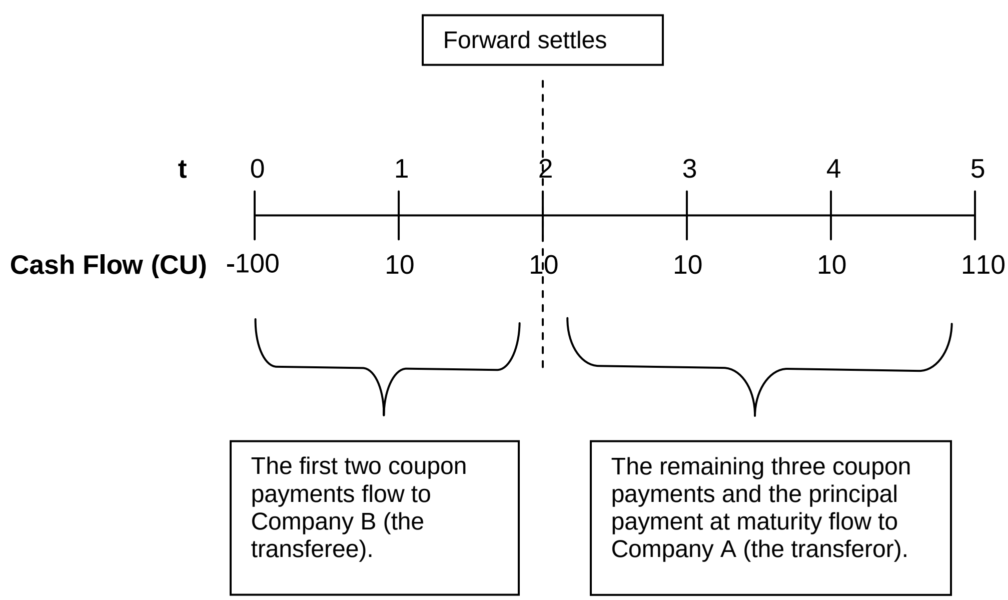
[1]The amended Flowchart 1 that the staff presented at the IASB meeting in November combined the two derecognition tests into one test. For ease of comparison to the original Flowchart 1, the staff decided to include both tests in the amended Flowchart 1 in this paper (albeit it changed the 'practical ability to transfer' test to refer to the arrangement and the 'other access' test to the transferor's perspective).


Derecognition Principle
Ability to obtain the economic benefits inherent in the transferred asset/component
+
Ability to restrict others' access to those benefits
Flowchart 1
Does the transferee have the practical ability to transfer the Asset for its own benefit?
Does the **transfer*ee*** presently have access to all of the cash flows of the Asset for its own benefit?
+
See 'for its own benefit' part in the derecognition test questions
Flowchart 1R
Does the arrangement prevent the transferee from having the practical ability to transfer the Asset for its own benefit?
Does the **transfer*or*** presently have access to all of the cash flows of the Asset for its own benefit?
+
See 'for its own benefit' part in the derecognition test question

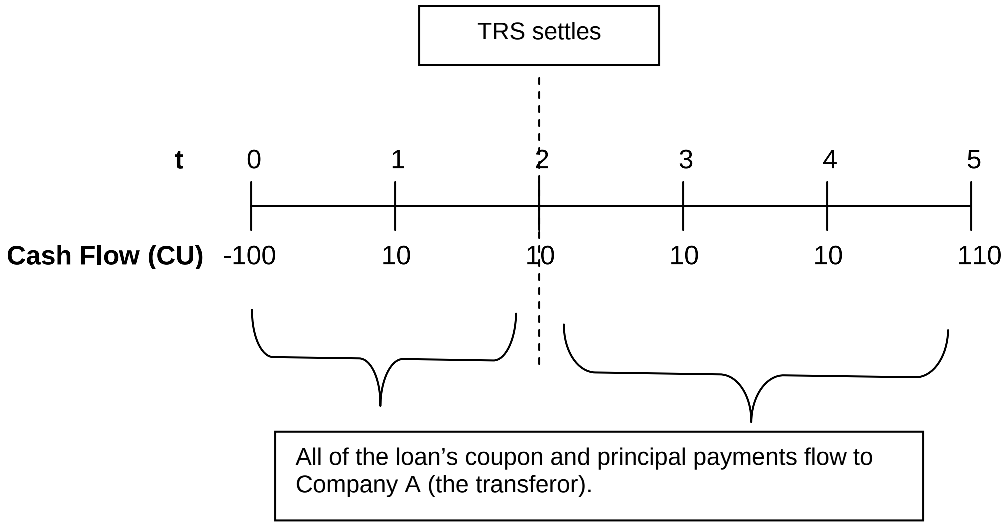
Examples

9. Flowchart 1R changes an outcome compared to Flowchart 1. Take the following transactions:

   a. **Example 1**: Transfer of a non-readily obtainable interest-bearing financial asset (say, an originated loan) together with a physically-settled forward purchase at a fixed price. Assume that the coupon payments before settlement of the forward flow to and remain with the transferee. Further assume the following timeline of the loan's cash flows and how they flow to the transferor and transferee:



   b. **Example 2**: Transfer of a non-readily obtainable interest-bearing financial asset (say, an originated loan) together with a physically-settled total return swap (TRS). This is essentially the same economics as Example 1 except that the coupon payments before settlement of the TRS are passed back to the transferor. Assume the following timeline of the loan's cash flows and how they flow to the transferor and transferee:



10. The analysis of Example 1 and Example 2 for Flowchart 1 and Flowchart 1R is shown on the next few pages.

11. A few comments upfront:

   a. As indicated in the table for Example 1 (see below), the staff previously believed that the transferee did not have access to all of the loan's cash flows. However, on the basis of its current thinking, the staff would regard the transferee as *presently* having access to all of the loan's cash flows (that is until the forward settles). As a result, the outcomes for Example 1 under Flowchart 1 and Flowchart 1R are now the same. That is, the staff were wrong.

   b. However, for Example 2 the outcome would be different if the alternative view of 'the Asset' is adopted. More on that point later.

Example 1

Steps	Flowchart 1	Flowchart 1R
Both flowcharts: What is 'the Asset' to which the derecognition tests are to be applied?	The loan (as specified in the transfer agreement). This view of 'the Asset' is also consistent with what was economically transferred. Economically, the transferee has received all of the coupon payments and principal payments of the loan (ie the coupon payments at t1 and t2 flow to the transferee and until the forward settles the transferee is also entitled to the coupon payments at t3-t5 and the principal payment at t5).	
Both flowcharts: Does the transferor have any continuing involvement in the Asset?	**Yes.** The fixed-price forward meets the definition of 'continuing involvement' in the loan because it represents 'the acquisition of [a] new contractual right and contractual obligation relating to the loan' (ie, through the forward, Company A has an 'interest in the future performance of the loan and also a responsibility to make payments in the future in respect to the loan').	
*Both flowcharts: Does the transferee have the practical ability to transfer the Asset for its own benefit?**	**No**. The transferee does not have the practical ability to transfer the loan for its own benefit because if it were to do so it would have to default under the forward. Alternatively, the transferee might be able to transfer the loan but only if it were to attach a similar forward to the loan.	
*Flowchart 1 only: Does the **transferee** presently have other access to all of the cash flows of the Asset for its own benefit?* *Flowchart 1R only: Does the **transferor** presently have other access to all of the cash flows of the Asset for its own benefit?*	<u>Transferee's Perspective:</u> At the October and November meetings, the staff answered this step 'no.' This was because it believed that Company B (the transferee) did not have access to **all** of the loan's cash flows because 1. it could not hold onto the loan to maturity (ie the term of the forward did not match the term of the loan) or 2. it could not transfer the loan to the transferor under the forward at fair value (ie, the present value of the loan's remaining cash flows – the coupon payments at t3, t4 and t5 and the principal payments at t5). The staff's current thinking is that the answer to this step is '**yes**.' This is because Company B is entitled to all of the loan's cash flows until the forward settles (which is when the transferor gets access to the loan's remaining cash flows – the coupon payments at t3, t4 and t5 and the principal payment at t5). Stated differently, at time of transfer, Company B **presently** has access to **all** of the loan's coupon and principal payments	<u>Transferor's Perspective:</u> **No**. Company A (the transferor) does not have access to the first two coupon payment which flow to Company B. In addition, Company A does not presently have access to the coupon payments at t3-t5 and the principal payment at t5 (it will have access to those cash flows once the forward settles).
*Different accounting outcome? **NO***	Control of the Asset (the loan) has passed to Company B (the transferee). As a result, • Company A (the transferor) derecognises the loan and recognises the forward as a derivative. • Company B recognises the loan and forward (as a derivative).	

*Ignore wording change to refer to the arrangement for Flowchart 1R

Example 2 (economic view of 'the Asset')

<table>
<tr><th>Steps</th><th>Flowchart 1</th><th>Flowchart 1R</th></tr>
<tr><td>Both flowcharts: What is 'the Asset' to which the derecognition tests are to be applied?</td><td colspan="2">Coupon payments at t3-t5 and principal payment at t5 (Principal Only (P/O) Strip + Part of Interest Only (I/O) Strip). Unlike Example 1, the interim coupon payments (at t1 and t2) flow to the transferor. As a result, economically only the coupon payments at t3-t5 and principal payments at t5 were transferred to the transferee.</td></tr>
<tr><td>Both flowcharts: Does the transferor have any continuing involvement in the Asset?</td><td colspan="2">Yes. The TRS meets the definition of 'continuing involvement' in the P/O Strip + Part of I/O Strip because it represents 'the acquisition of [a] new contractual right and contractual obligation relating to those strips (ie, through the TRS, Company A has an 'interest in the future performance of the I/O Strip + Part of I/O Strip and also a responsibility to make payments in the future in respect to those strips).</td></tr>
<tr><td>Both flowcharts: Does the transferee have the practical ability to transfer the Asset for its own benefit?*</td><td colspan="2">No. Company B (the transferee) does not have the practical ability to transfer the P/O Strip + Part of I/O Strip for its own benefit because to do so it would have to transfer the loan contract. In light of the physically-settled TRS, Company B is effectively precluded from transferring the loan unless it attaches a similar TRS to the loan.</td></tr>
<tr><td>Flowchart 1 only: Does the transferee presently have other access to all of the cash flows of the Asset for its own benefit?

Flowchart 1R only: Does the transferor presently have other access to all of the cash flows of the Asset for its own benefit?</td><td><u>Transferee's Perspective:</u>
Yes. Company B (the transferee) presently has access to all the cash flows of the P/O Strip + Part of I/O Strip (this is until the TRS settles and the P/O Strip + Part of I/O Strip go to Company A).</td><td><u>Transferor's Perspective:</u>
No. Although Company A (the transferor) has access to the first two coupon payments, it does not presently have access to the coupon payments at t3-t5 and the principal payment at t5 (it will have access to those cash flows once the TRS settles).</td></tr>
<tr><td>Different accounting outcome? NO</td><td colspan="2">Control of the Asset (P/O Strip + Part of I/O Strip) has passed to Company B (the transferee). As a result,
• Company A (the transferor) derecognises a portion of the loan (equivalent to the fair value of the P/O Strip + Part of I/O Strip) and recognises the TRS as a derivative.*
• Company B recognises a portion of the loan (equivalent to the fair value of the P/O Strip + Part of I/O Strip) and recognises the TRS as a derivative.*

*Assuming Company A receives the fair value of the loan when it transfers the loan to Company B, the staff has not decided yet on whether the resulting net credit might be treated as part of the forward (ie the forward is off market) or as a separate financing liability.</td></tr>
</table>

*Ignore wording change to refer to the arrangement for Flowchart 1R

Example 2 (alternative view (contractual view) of ‘the Asset’)

Steps	Flowchart 1	Flowchart 1R
Both flowcharts: What is ‘the Asset’ to which the derecognition tests are to be applied?	The loan (as specified in the transfer agreement)	
Both flowcharts: Does the transferor have any continuing involvement in the Asset?	**Yes**. The fixed-price TRS meets the definition of ‘continuing involvement’ in the loan because it represents ‘the acquisition of [a] new contractual right and contractual obligation relating to the loan’ (ie, through the TRS, Company A has an ‘interest in the future performance of the loan and also a responsibility to make payments in the future in respect to the loan’).	
*Both flowcharts: Does the transferee have the practical ability to transfer the Asset for its own benefit?**	**No**. The transferee does not have the practical ability to transfer the loan for its own benefit because if it were to do so it would have to default under the physically-settled TRS. Alternatively, the transferee might be able to transfer the loan but only if it were to attach a similar TRS to the loan.	
*Flowchart 1 only: Does the **transferee** presently have other access to all of the cash flows of the Asset for its own benefit?* *Flowchart 1R only: Does the **transferor** presently have other access to all of the cash flows of the Asset for its own benefit?*	Transferee’s Perspective: **No**. Company B (the transferee) does not presently have access to **all** the loan’s cash flows because the first two coupon payments flow to Company A (the transferor).	Transferor’s Perspective: **No**. Although Company A (the transferor) has access to the first two coupon payments, it does not presently have access to the coupon payments at t3-t5 and the principal payment at t5 (it will have access to those cash flows once the TRS settles).
*Different accounting outcome? **YES***	Control of the Asset (the loan) has **not** passed to Company B (the transferee). As a result, • Company A (the transferor) continues to recognise the loan and recognises a liability for the proceeds received. • Company B recognises a receivable for the cash paid.	Control of the Asset (the loan) has passed to Company B (the transferee). As a result, • Company A (the transferor) derecognises the loan and recognises the TRS as a derivative.* • Company B recognises the loan and TRS (as a derivative).* *Assuming Company A receives the fair value of the loan net of the fair value of the manufactured coupons when it transfers the loan to Company B , the staff has not decided yet on whether the resulting net debit should be treated as a. a transfer of a component of the loan asset back to the transferor b. part of the TRS (effectively making the TRS off market) or c. a separate asset for the transferor and separate liability for the transferee.

*Ignore wording change to refer to the arrangement for Flowchart 1R

12. As the analysis of Example 2 shows, the accounting outcome would be different under Flowchart 1R by itself but also in relation to Flowchart 1 depending on whether 'the Asset' is specified to be

a. what was documented in the transfer contract as the asset transferred (ie the loan) – the contractual view of 'the Asset', or

b. what was economically transferred (only the coupon payments at t3-t5 and the principal payment at t5, not the coupon payments at t1 and t2 because they flow to the transferor) – the economic view of 'the Asset'.

13. What is interesting and worthy of highlighting is that if 'the Asset' is the coupon payments at t3-t5 and the principal payment at t5, the outcome under Flowchart 1R is consistent with a components approach to derecognition. That is, the transferor derecognises the component of the loan transferred (again, coupons at t3-t5 and principal at t5) and continues to recognise the component of the loan retained (coupons at t1 and t2).

14. On the other hand, if 'the Asset' is loan, the outcome under Flowchart 1R might or might not be consistent with that a components approach to derecognition. If 'the Asset' is the loan, Flowchart 1R would result in the transferor (a) derecognizing the loan in its entirety, (b) recognising the TRS as a derivative and (c) recognizing the right to receive the manufactured coupons at t1 and t2 as an asset. If the right to the manufactured coupons is viewed as a component of the loan that the transferee has transferred back to the transferor, the outcome would be same as the one if 'the Asset' is the coupon payments at t3-t5 and the principal payment at t5 (ie the outcome would be consistent with a components approach).

15. On the other hand, if the right to the manufactured coupons is judged to be a separate asset from the loan so transferred (and also from the TRS), then the outcome is that of applying an 'all or nothing' approach.

Staff alternatives

16. The staff proposes some alternative ways to move forward with this issue (for all alternatives, see respective flowcharts in the appendix to this paper):

    a. **Alternative 1**: Don't change the original Flowchart 1.

    b. **Alternative 2:** Adopt Flowchart 1R.

    c. **Alternative 3**: Adopt Flowchart $1R^2$. In this flowchart the staff has

        i. eliminated the first step in the original Flowchart 1 – 'the Asset' in the 'continuing involvement' and 'practical ability to transfer' tests would then be the financial asset that the transferor recognised before the transfer, and

        ii. inserted 'some' in the 'other access to the Asset's cash flows' test – the test would then read 'Does the transferee presently have other access, for its own benefit, to all *or some* of the cash flows of the financial asset that the transferor recognised before the transfer?'

    Flowchart $1R^2$ is the flowchart that the staff presented to the IASB in small group sessions in September 2008 and that indirectly 'defines' components (ie components is not pre-determined as a first step but is assessed at the 'other access' test).

    d. **Alternative 4:** Adopt Flowchart $1R^3$. This flowchart is the same the Flowchart $1R^2$ (Alternative 3) except that the staff has changed

        i. the 'practical ability to transfer' test to refer to the arrangement and

        ii. the perspective of the 'other access to the Asset's cash flows' test to that of the transferor - the test would then read 'Does the transfer***or*** presently have other access, for its own benefit, to all *or some* of the cash flows of the financial asset that it recognised before the transfer?'

17. As the previous examples illustrated, the accounting outcomes are the same under Flowchart 1 (Alternative 1) or Flowchart 1R (Alternative 2) assuming that 'the

Asset' is determined as the loan in Example 1 and as part of the I/O strip and P/O strip in Example 2. However, the outcome would be different for Example 2 if 'the Asset' were specified as the loan.

18. The staff notes that the accounting outcomes under Alternative 3 and Alternative 4 would be consistent with the ones under Alternative 1 and Alternative 2 (assuming that under the latter alternatives 'the Asset' is specified as the loan in Example 1 and as part of the I/O strip and P/O strip in Example 2). This is because Alternative 3 and Alternative 4 would conclude that the transfer has resulted in the transferee having access to all of the cash flows of the financial asset that the transferor previously recognised on its statement of financial position (ie the loan) in Example 1 and to some of the cash flows in Example 2. Accordingly, Alternative 3 and Alternative 4 effectively determine 'the Asset' through the 'other access to all or some of the cash flows' test.

19. The staff is indifferent amongst the four alternatives except that to the extent the Board views 'the Asset' in Example 2 to be the loan contract it would prefer the Board not adopt Approach 1. The reason for the staff's preference is that the application of Approach 1 to that fact pattern would result in the loan not being derecognised at all even though most of the loan's cash flows (those being the coupon payments at t3-t5 and the principal payment at t5) have been passed onto the transferee.

20. The foregoing being said, the staff points out that if the Board were to adopt either Alternative 2 or Alternative 4, the perspective of the revised Flowchart 1 would be that of the transferor and thus different from the perspective of Flowchart 2 – the Board decided at the November meeting not to change the perspective of the tests in Flowchart 2.

21. Furthermore, the staff points out that if the Board were to adopt Alternative 3 or Alternative 4, the structure would (obviously) be different from that of Flowchart 1 or Flowchart 2 in that Flowchart 1 and Flowchart 2 require that 'the Asset' is determined as a first step.

22. The following table provides the advantages and disadvantages of each alternative (flowchart):

<table>
<tr><th></th><th>Pro’s</th><th>Con’s</th></tr>
<tr><td>Alternative 1: Flowchart 1</td><td colspan="2"><u>Con’s</u>
• The derecognition tests might not be intuitive because they are from the perspective of the transferee (derecognition deals with assets that an entity previously recognised and are tested for whether they qualify for derecognition now that the entity transferred them to someone else).

• If contractual view of ‘the Asset’ is adopted, Flowchart 1 might result in no derecognition at all even though significant components of an asset have been transferred (see analysis of Example 2 under contractual view).

• If economic view of ‘the Asset’ is adopted, there might not be a need to go through the derecognition tests (determining the cash flows that economically were transferred is akin to determining which component of the asset the transferor has effectively given up control of and thus should be derecognised).</td></tr>
<tr><td>Alternative 2: Flowchart 1R</td><td colspan="2"><u>Pro’s</u>
The derecognition tests might be more intuitive because they are from the perspective of the transferor.

<u>Con’s</u>
• Because the derecognition tests are from the transferor’s perspective, Flowchart 1R would be different from Flowchart 2 in that regard (the Board decided at the November meeting to retain the transferee’s perspective for Flowchart 2).

• If contractual view of ‘the Asset’ is adopted, Flowchart 1R might result in an outcome that is more consistent with an ‘all-or-nothing’ approach (see analysis of Example 2 under the contractual view – if the right to the first two manufactured coupons is judged to be a separate asset and not a component of the loan retained by the transferor, the outcome will not be the same as that under a components approach).

• If economic view of ‘the Asset’ is adopted, there might not be a need to go through the derecognition tests (determining the cash flows that economically were transferred is akin to determining which component of the asset the transferor has effectively given up control of and thus should be derecognised)</td></tr>
<tr><td>Alternative 3: Flowchart 1R[2]</td><td colspan="2"><u>Pro’s</u>
No need to specify ‘the Asset’ upfront (‘the Asset’ to which the derecognition tests are applied is the financial asset that the transferor recognised before the transfer)</td></tr>
</table>

	Con's • The derecognition tests might not be intuitive because they are from the perspective of the transferee (derecognition deals with assets that an entity previously recognised and are tested for whether they qualify for derecognition now that the entity transferred them to someone else). • Although the flowchart does not require one to specify 'the Asset' upfront, doing so (under the economic view of 'the Asset') might be a more efficient way of determining which component of an asset should be derecognised. • Arguably it should be easier and more efficient to draft an exposure draft for two derecognition models when the structure of the two models are similar. The structure of Flowchart 2 is more consistent with the structure of the flowcharts underlying Alternative 1 and Alternative 2 (which first determine 'the Asset' and are then followed by the 'continuing involvement' step and 'practical ability to transfer' test). Thus adopting Alternative 3 could result in inefficiencies in drafting the exposure draft.
Alternative 4: Flowchart 1R[3]	**Pro's** • The derecognition tests might be more intuitive because they are from the perspective of the transferor. • No need to specify 'the Asset' upfront ('the Asset' to which the derecognition tests are applied is the financial asset that the transferor recognised before the transfer) **Con's** • Because the derecognition tests are from the transferor's perspective, Flowchart 1R would be different from Flowchart 2 in that regard (the Board decided at the November meeting to retain the transferee's perspective for Flowchart 2). • Although the flowchart does not require one to specify 'the Asset' upfront, doing so (under the economic view of 'the Asset') might be a more efficient way of determining which component of an asset should be derecognised. • Arguably it should be easier and more efficient to draft an exposure draft for two derecognition models when the structure of the two models are similar. The structure of Flowchart 2 is more consistent with the structure of the flowcharts underlying Alternative 1 and Alternative 2 (which first determine 'the Asset' and are then followed by the 'continuing involvement' step and 'practical ability to transfer' test). Thus adopting Alternative 4 could result in inefficiencies in drafting the exposure draft.

Staff Recommendation

23. The staff does not have a strong preference for one of the four alternatives in paragraph 15 (except that to the extent the Board decide for Example 2 on the contractual view of 'the Asset', the staff would recommend the Board not select Alternative 1 (Flowchart 1) for the reason outlined in paragraph 18).

24. **On balance, the staff recommends that the Board adopt Alternative 4 (Flowchart 1R[3])**.

This is because the flowchart (by applying the derecognition tests to the financial asset previously recognised by the transferor) is a more helpful (one might also say a more elegant) way of determining which of the cash flows of the asset have effectively been transferred – rather than requiring that assessment in one single first step as Alternative 1 or Alternative 2 would (this assumes that the Board adopt the economic view of 'the Asset').

25. Recommending Alternative 4 illustrates the staff's preference for a components approach to derecognition.

To the extent the Board selects Alternative 1 or Alternative 2 (which require that 'the Asset' be determined first), the staff recommends that the Board adopt the economic view of 'the Asset'.

In Example 2, the Asset would then be the coupon payments at t3-t5 and principal payment at t5 (as opposed to the entire loan).

Questions for the Board

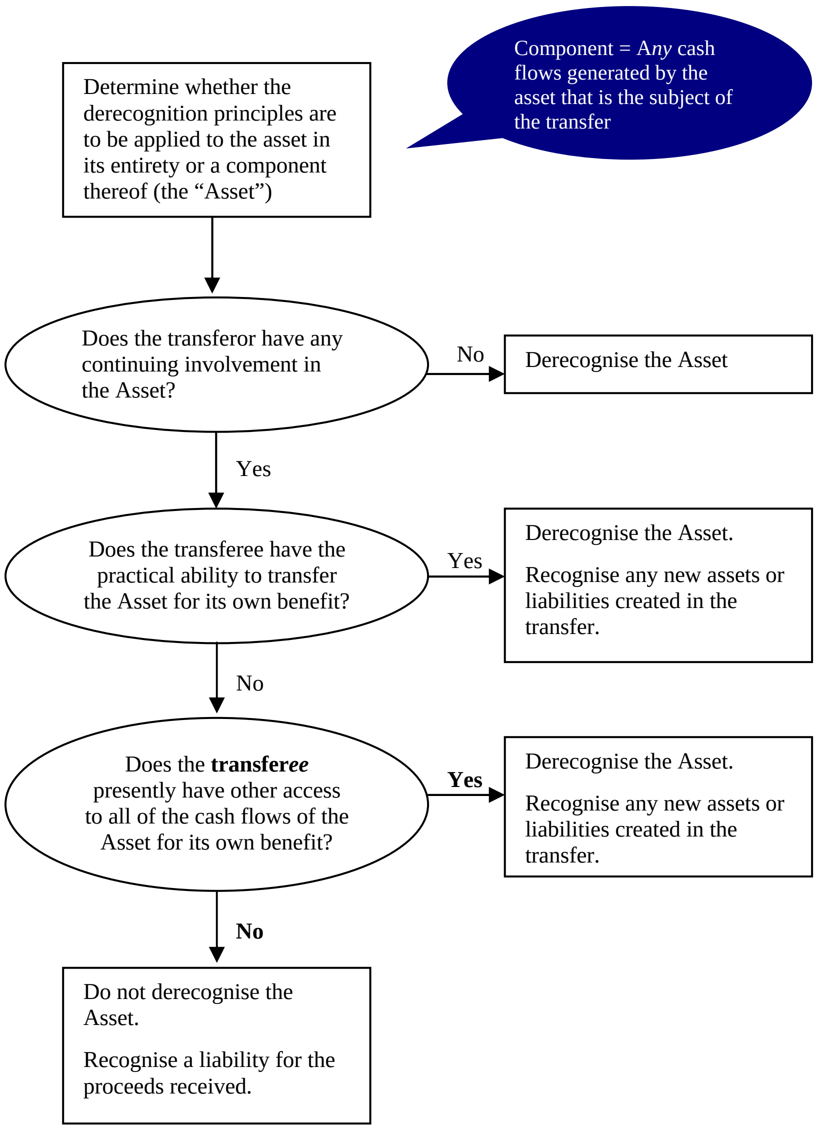
26. Do you agree with the staff's recommendation in paragraph 24? If not, why not and which alternative would you prefer?

27. To the extent you decide to adopt either Alternative 1 or Alternative 2, do you agree with the staff's recommendation in paragraph 25? If not, why not?

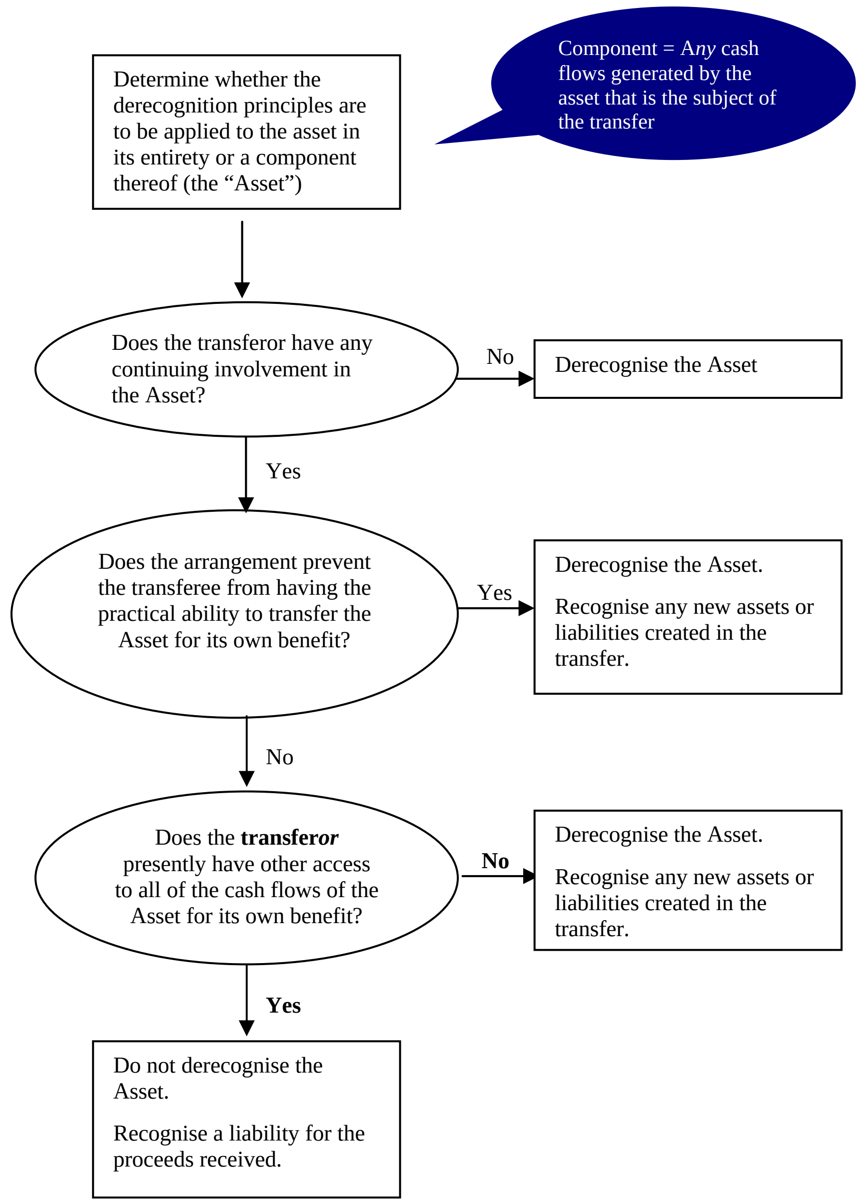
28. In the case you answered 'no' to question in paragraph 27, would you prefer the contractual view of 'the Asset'?

Appendix

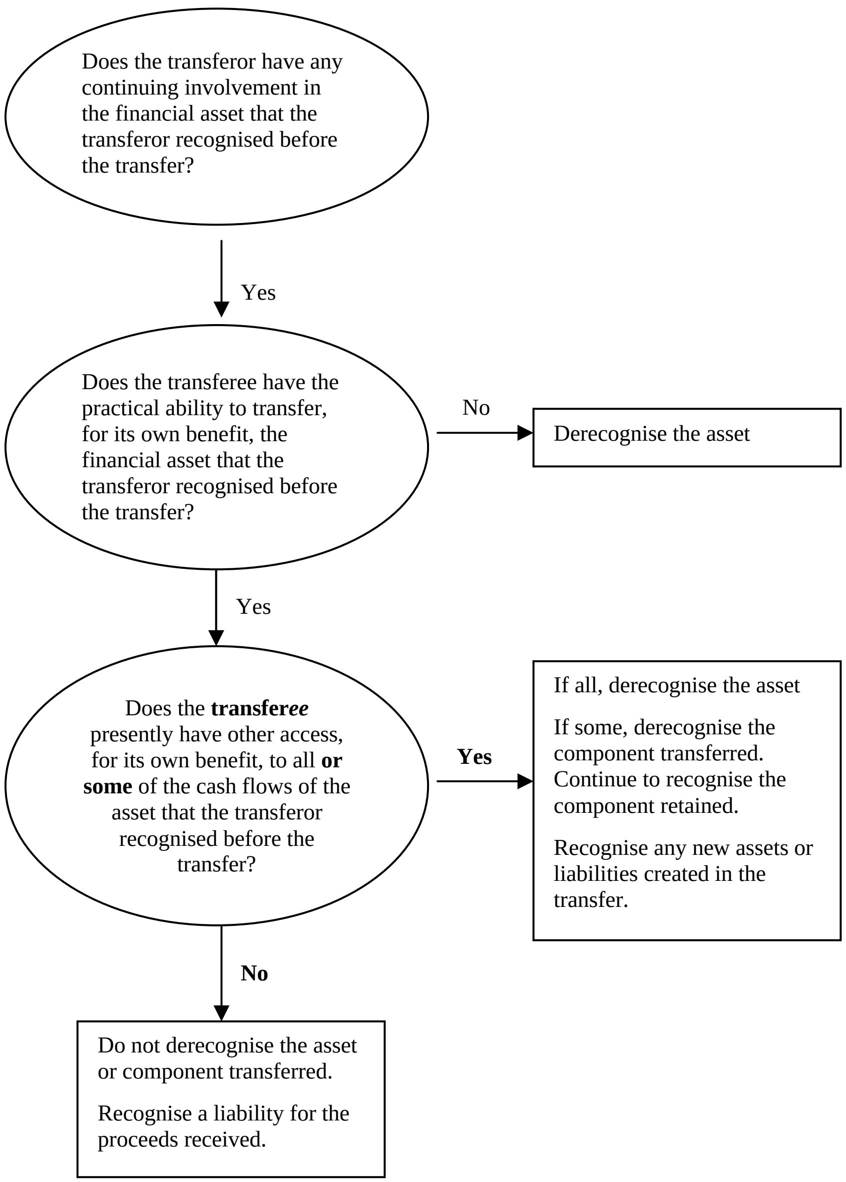
ALTERNATIVE 1: FLOWCHART 1



ALTERNATIVE 2: FLOWCHART 1R



ALTERNATIVE 3: FLOWCHART 1R[2]



ALTERNATIVE 4: FLOWCHART 1R[3]