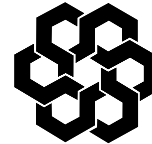

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410   Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org   Website: www.iasb.org

International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

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:	**December 2008, London**
Project:	**Derecognition of Financial Assets and Liabilities**
Subject:	**Interaction between the derecognition approaches for financial assets and liabilities (Agenda Paper 10F)**

INTRODUCTION

1. Paper 10E discussed a derecognition principle for financial liabilities.

2. This paper analyses particular issues arising from the interaction between the derecognition approaches for financial liabilities and financial assets. Those issues are:

   a. secured liabilities with recourse;

   b. secured liabilities without recourse;

   c. collateral arrangements which are not transfers.

3. Please note that, in line with this project, this paper is about recognition and derecognition questions, not measurement.

PURPOSE OF PAPER

4. The purpose of this paper is to ask the Board whether any of the issues relating to the interaction of the derecognition approaches for financial assets and liabilities that are discussed in this paper should be considered in more detail at this stage of the project.

SECURED LIABILITIES WITH RECOURSE

5. Assets and liabilities may be related, contractually or otherwise, by security arrangements. A security arrangement gives a creditor particular legal rights pertaining to one or more specific assets of a debtor entity. By granting or agreeing to those rights, the debtor accepts restrictions on the securing asset(s).

6. Commonly, the restrictions may:

   a. preclude sale of the asset unless the debt is satisfied;

   b. allow the creditor to take possession of the securing asset if the entity does not meet its obligations under the related secured liability; and

   c. give the creditor a preferred claim to the securing asset or the proceeds from sale of it in the event of the entity's insolvency or liquidation.

7. An asset subject to a security arrangement may be sold or used to satisfy the particular liability that is associated with the security arrangement but generally cannot be directly used to satisfy other liabilities.

8. The security arrangement is a concession by the debtor to the creditor. A security arrangement in itself affects the debtor's ability to benefit from the securing asset but not the debtor's obligations under the secured liability. It affects the debtor's ability to derive economic benefit from the asset by limiting to some extent the ways in which an entity can use the asset for generating cash to satisfy claims of other creditors and investors.

Should a security arrangement result in special accounting treatment for the securing asset or secured liability?

9. When an entity grants a security, it raises questions about whether the securing asset still qualifies as the asset of the debtor; that is, can the entity obtain the benefit embodied in the asset and control others' access to it?

10. Alternative answers include:

- ***Alternative A*** - The debtor could offset the two; that is, report the securing asset net of the obligation.
- ***Alternative B*** - The securing asset could be derecognised by the debtor and recognised by the creditor. The secured liability could be derecognised by the debtor, and the receivable derecognised by the creditor.
- ***Alternative C*** – The secured liabilities and securing assets could be accounted for without special treatment, in the same way as unsecured liabilities and unpledged assets.

Alternative A

11. The staff believes that offset is not applicable in this case as there is no right of setoff (as defined in IFRS[1]). Based the existing criteria for set-off, the right of setoff must be present to offset assets and liabilities in the statement of financial position.

12. The right of setoff is a right, which exists between parties, each of whom under an independent contract owes an ascertained amount to the other, to set off his or her respective debt by way of mutual deduction, so that in any action brought for the larger debt the residue only, after such deduction, shall be recovered.

[1] Paragraph 42 of IAS 32 provides that ‘ a financial asset and a financial liability shall be offset and the net amount presented in the statement of financial position when, and only when, an entity (currently has a legal enforeceable right to set off the recognised amounts; and (b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

13. As setoff is only permitted if the entity has a legally enforceable right to setoff and the entity lacks such right in this case, the staff concludes that offset is not appropriate in this case.

Alternative B

14. As discussed in paper 10E, an essential characteristic of a liability is that the entity has a present obligation. As the entity continues to have a present obligation to the lender, the staff does not believe derecognising the liability would be appropriate in this case. Furthermore, despite the security arrangement, the collateral (the asset) still qualifies as the asset of the debtor because the debtor can obtain the benefit embodied in the asset and control others' access to it.

Alternative C

15. The remaining alternative is to account for secured liabilities in the same way as unsecured liabilities, and the related securing assets in the same way as unpledged assets. The security arrangement would be disclosed either by the descriptions used in the statement of financial position or in the notes.

16. This is because the security arrangement affects the securing asset but does not in itself affect the debtor's obligations under the related liability as discussed above. (of course, it may affect the measurement of the asset and liability – but that is not this project). The debtor's obligation to transfer assets to the creditor is not satisfied by the grant of a security, nor is the creditor's claim weakened or restricted by it. The staff believes that restrictions on the debtor's ability to benefit from the securing asset are best dealt with by disclosure.

Question to the Board

17. **Does the Board agree with the staff analysis and conclusions regarding security arrangements? If not, why not and what treatment does the Board believe is appropriate in such scenarios.**

SECURED LIABILITIES WITHOUT RECOURSE

18. A security arrangement may be supplemented by another type of contractual relationship - a nonrecourse provision. That is an agreement that, should the

debtor default on a secured obligation, the creditor can look only to the securing asset (or assets) to recover its claim. Should the debtor fail to pay and the specific asset(s) fail to satisfy the full claim, the creditor has no legal recourse other assets of the debtor.

19. All nonrecourse provisions involve security arrangements, but not all security arrangements involve nonrecourse provisions.

20. Whereas the purpose of all security arrangements is to reduce credit risk (the risk of loss if the debtor does not honor its obligation), a nonrecourse provision reduces the debtor's risk of losing other assets should the securing asset fail to produce sufficient benefits. In essence, a nonrecourse provision can be seen as a concession by the creditor to the debtor, whereas a security arrangement is a concession by the debtor to the creditor.

21. Unlike the security arrangement relationship between particular assets and liabilities, a nonrecourse provision in itself affects the secured liability but not the securing asset. By accepting a nonrecourse provision, the creditor limits its interest to the securing asset and does not reduce the debtor's control over its other assets and the availability of those other assets to satisfy claims of other creditors and investors.

22. The nonrecourse liability is thus not a senior liability of the entity (subordinated creditors and even owners can be paid from other assets, even in bankruptcy, whether or not the nonrecourse debt has been fully satisfied). The securing asset is affected by the security arrangement that accompanies the nonrecourse provision, but the effects of that security arrangement on the securing asset are the same whether or not the creditor has recourse beyond it.

23. The instruments related by a nonrecourse provision can be analysed in two ways.

24. The nonrecourse provision can be characterised as effectively being a put option on the securing asset, written by the creditor and held by the debtor, the strike price for which is the amount of the nonrecourse debt. In that characterisation, the debtor's liability is a compound instrument consisting of one or more

unconditional payables and a conditional obligation (the security arrangement) plus an option (the nonrecourse provision); the debtor also has the related but separate securing asset.

25. Alternatively, the position of the debtor in a nonrecourse loan can be characterised as resembling that of someone who holds only a call option and owes nothing: the debtor has the right to take full, unfettered ownership of the securing asset by paying the amount specified in the loan, which the debtor will likely do if market price movements or other developments make the asset worth more than the secured obligation. But the debtor also has the right to settle its "obligation" by walking away, accepting the loss of collateral, which the debtor will likely do if the securing asset's value seems incurably impaired.

26. Those two characterisations are economically equivalent. The concept of put-call parity holds that the net value of the two positions in this case must be the same or else there will be risk-free opportunities for arbitrage.

27. While the two characterisations of the nonrecourse relationship may be economically comparable because their values must be the same, their accounting representations in the statement of financial position would be quite different.

Should a Nonrecourse Provision Result in Special Accounting Treatment?

28. Alternative answers include:

- ***Alternative A*** - Nonrecourse liabilities could be offset against the securing assets. The debtor could offset the two and report the securing asset net of the liability.
- **Alternative B** - Liabilities secured under nonrecourse agreements and the securing assets could be accounted for in the same way as other secured liabilities and securing assets.
- **Alternative C** - Nonrecourse provisions could be considered effectively to be call options, and thus the liability need not be recognised and related securing asset should be derecognised by the debtor.

Alternative A

29. This alternative views nonrecourse obligations as being liabilities and the related securing instruments as being assets, both to be recognised by the debtor, but requires offsetting some or all of the nonrecourse liabilities against the securing assets. The nonrecourse provision gives the debtor a right similar to setoff. The right to tender the securing asset in full settlement of the liability insulates the debtor from the market and credit risks associated with the securing asset, just as the right of setoff insulates against the risk of loss from default by the other party.

30. The staff believes that offset is not applicable in this case as there is no right of setoff (as defined in IFRS). The analysis set forth in paragraphs 11 – 13 is applicable here.

31. As setoff is only permitted if the entity has a legally enforceable right to setoff and the entity lacks such right in this case, the staff concludes that offset is not appropriate in this case.

Alternative B

32. The second alternative is to account for secured liabilities with nonrecourse provisions in the same way as other secured liabilities, and the related securing assets in the same way as other securing assets, as discussed in the previous section of this paper. The fact that the security arrangement is without recourse would be disclosed either by the descriptions used in the statement of financial position or in the notes.

33. This view is consistent with current practice. This alternative requires one to view the nonrecourse provision as illusory or that the nonrecourse provisions are real but the restrictions on the creditor's ability to press for collection of the secured obligation not to be relevant. This alternative is seen to be most relevant for security arrangements in which the debtor retains physical custody (and with it, most of the attributes of ownership) of the securing asset.

34. The staff believes that, although the debtor may volunteer to pay the difference should the actual future benefits of the securing asset fail to satisfy the obligation

(despite the nonrecourse clause), such situations are of the same class as an agent's choosing to pay his principal's defaulted obligation.

35. That is, they are losses and liabilities recognisable only when that choice is made irrevocably (that is, when they become an obligation to the debtor). Under the nonrecourse agreement, nothing obliges an entity to transfer economic resources beyond the amounts of cash it has invested and its residual claim on those embodied in the asset.

36. The staff notes that a nonrecourse debtor may plan to pay the debt in cash as, but the debtor does not have to do that: it need only let the creditor have the securing asset. The fact that the debtor is not obliged (no present obligation) to pay more, weakens the argument that the debtor has a liability. The staff does not believe recognising a liability for the nonrecourse security arrangement in this case is appropriate.

Alternative C

37. Under this alternative the debtor would derecognise the related secured assets. That is the view characterised earlier as considering the debtor as holding a call option on the securing asset effectively written by the nonrecourse creditor. Under this alternative, the creditor might recognise an asset, the securing asset net of the effective call option written.

38. To hold the view that the entire nonrecourse secured arrangement is equivalent to a call option requires one to take the position that a nonrecourse obligation is not a liability of the debtor. The argument has to be that the security arrangement with the nonrecourse provision substantively transferred the securing assets to the "creditor." (And the creditor is not a creditor, but recognises the asset).

39. Although a nonrecourse debtor may plan to pay the debt in cash (transferring what are unquestionably its assets), the debtor does not have to do that: it need only let the creditor have the securing asset.

40. Thus, it can be said that the debtor in a nonrecourse borrowing no longer owns the securing asset. By undertaking the nonrecourse borrowing, the debtor in effect exchanged the securing asset for a call option. By extension then, since someone owns every asset, the lender in a nonrecourse borrowing must own the securing asset.

41. To the extent that the debtor is receiving cash from the securing asset that need not be handed on directly to the creditor, the arrangement differs from the typical call option, which entitles the option holder to none of the cash inflows generated by the underlying asset and may require a different accounting treatment

42. In some secured loans with nonrecourse provisions, the primary source from which the debtor is expected to obtain cash to pay the principal and interest on the loan is independent of or only indirectly related to the securing asset. The purpose of those security arrangements is to give the debtor a greater incentive to honor its obligation for fear of losing the securing asset. The securing asset is only a potential secondary source of cash to settle the obligation if the primary source proves insufficient, and the nonrecourse feature does no more than limit the debtor's potential loss to the securing asset in that event. This type of arrangement may also call for a different accounting treatment.

43. In other secured loans with nonrecourse provisions, the primary source from which the debtor is expected to obtain cash to pay the principal and interest on the loan is the securing asset. In those security arrangements, the securing asset is the source of cash to settle the obligation, and the nonrecourse feature, by setting the upper bound for the cash the creditor will receive, is central to the entire arrangement. It may be that this alternative treatment should be limited to only this kind of self liquidating secured nonrecourse obligation.

Staff recommendation

44. The staff recommends that the treatment in Alternative C be adopted

    a. for all secured nonrecourse obligations or

b. for the kind of self liquidating secured nonrecourse obligation described in paragraph 43.

45. The Alternative C treatment will avoid potential inconsistencies in the application of the existing guidance on derecognition of financial liabilities and conflicts between the derecognition models for financial assets and financial liabilities. These potential problems are illustrated with some cases in appendix 3.

Question to the Board

46. Does the Board agree with staff recommendation (a), in paragraph 44? If not, why not?

47. If not, does the Board agree with staff recommendation (b), in paragraph 44? If not, why not? If not, what accounting treatment or which of the Alternatives outlined in this section should be used for nonrecourse obligations?

COLLATERAL WHICH ARE NOT TRANSFERS?

(Creditor has custody of and is permitted to sell or lend the securing asset)

48. Some security arrangements transfer physical custody of securing financial assets to the creditor and permit the creditor to lend or sell those assets during the term of the related secured liability (for example, instruments deposited as collateral with broker-dealers to secure "margin" loans or potential obligations under option contracts).

49. One approach would be to treat such arrangements (even though legal title has not changed hands) as having effectively transferred the securing assets to the "creditor," leaving the "debtor" with sales proceeds and a forward contract to purchase the securing asset at a future date.

50. The rationale is that under such a security arrangement, the secured creditor (not the debtor) is the entity that has, during the term of the arrangement, the right to

exchange the securing asset, exact a price for others' use of it, use it to settle liabilities, hold it, or conceivably even distribute it to the creditor's owners. The creditor is obliged only to somehow obtain and deliver the securing asset, or one like it, when the debtor settles its liability.

51. The alternative view is to treat such transactions as not transfers or transactions that need to be assessed for derecognition. The problem with this alternative is that under the control based derecognition model for financial assets, only one party can have control over an asset. On purchase of the ‘transferred asset’ by a third party (from the transferee), the purchaser will have control over the asset and as only one party can have control, it is difficult to conclude that the original ‘transferor’ has control over the asset and hence should continue to recognise the asset in question.

Staff recommendation

52. The staff recommends treating security arrangements where physical custody of securing financial assets is given to the ‘lender’ and the ‘lender’ is permited to lend or sell those assets during the term of the related secured liability as transfers or transactions that need to be assessed for derecognition. The only exception would be transfers such as brokerage arrangements where the transferee acts in an agency capacity to the transferor.

Questions for the Board

53. Does the Board agree with the staff recommendation? If not, why not?

54. If not, what does the Board recommend to be the appropriate accounting in such cases?

APPENDIX

Case 1

Entity A lends $100 to Entity B on a recourse basis. Entity B then purchases receivables (with a fair value of $100) with the funds advanced.

Entity B later transfers part of the right to the cash flows of the receivables (95%, pro rata cash flows) to Entity A in satisfaction of its obligations under the loan agreement. Entity B will collect and pass through the cash flows to Entity A. Entity B does not provide any guarantees or support in relation to the receivables. Hence Entity A will look solely to the receivables for repayment.

Accounting:

Under existing liability derecognition requirements, the conclusion will be that Entity B's liability has been extinguished as Entity B has transferred a financial asset in satisfaction of its obligation.

Also under the proposed derecognition guidance for financial assets (flow chart 1 and 2), the conclusion will be that the asset has been transferred and that Entity B should derecognise the asset.

Case 2

Entity A enters lends $100 to Entity B on a recourse basis. Entity B then purchases receivables (with a fair value of $100) with the funds advanced. Entity A and B later amend the original lending agreement such that Entity A will look to the receivables (95% of the cash flows) purchased by Entity B for both interest and capital repayment.

Accounting:

The conclusion under existing liability derecognition requirements would be that the original loan agreement has been replaced by a non recourse loan agreement and that Entity B has a loan of $100.

However, under the proposed derecognition approaches for financial assets (flow charts 1 and 2), the conclusion will be that Entity B has transferred the asset to Entity A (as transfers of proportionate and specific cash flows qualifies as a component for derecognition). Moreover, the position of both Entity A and B are economically identical to that in Case 1.

Case 3

Entity A 'lends' $100 to Entity B on non-recourse basis. Entity A agrees to look to the receivables (with a fair value of $100) purchased with the funds advanced for both interest and capital repayment (up to 95% of the cash flows, pro rata)

Accounting:

The conclusion under existing liability derecognition requirements would be that Entity B has a loan of $100.

However, under the proposed derecognition approaches for financial assets (flow charts 1 and 2), Entity B has transferred part of the asset to Entity A (as this case is not dissimilar to a pass through arrangement). Moreover, the position of both Entity A and B, under this scenario, are economically identical to that in Case 1.

CURRENT GUIDANCE – ACCOUNTING TREATMENT

	B liability	Receivables
Case 1 – A lends $100 (recourse). B settles liability with 95% pass-through	Derecognised	Recognised by A
Case 2 – A lends $100 (recourse). Loan agreement changed to non-recourse, whereby A only looks to receivables (95% of cash flows).	Original liability derecognised. New liability (non-recourse) recognised by B.	Recognised by B.
Case 3 – A lends $100 (non-recourse). A only looks to 95% of receivables.	B recognises liability.	Recognised by B

PROPOSED TREATMENT

	B liability	Receivables
Case 1 – A lends $100 (recourse). B settles liability with 95% pass-through	Derecognised	Recognised by A
Case 2 – A lends $100 (recourse). Loan agreement changed to non-recourse, whereby A only looks to receivables (95% of cash flows).	Original liability derecognised.	Recognised by A.
Case 3 – A lends $100 (non-recourse). A only looks to 95% of receivables.	Derecognised	Recognised by A