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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**November 2008, London**
Project:	**Derecognition of Financial Assets and Liabilities**
Subject:	**Summary of Open Issues (Agenda Paper 15A)**

Background

1. At the IASB and IASB/FASB meetings in October, the staff presented to the boards the following proposed derecognition principle for financial assets:

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

2. The staff proposed two possible approaches to making that principle operational:

   a. ***Approach 1*** – A transferor of a financial asset or a component thereof (herein thereafter referred to as 'the Asset') should derecognise the Asset if:

      i. the transferor has no continuing involvement in the Asset,

      ii. the transferee:

1. has the practical ability to transfer the Asset to a third party for its own benefit, and

2. is able to exercise that practical ability unilaterally and without needing to impose additional restrictions on the transfer, or

iii. the transferee presently has other access to the economic benefits underlying the Asset for its own benefit.

b. ***Approach 2*** – excludes criterion (iii) above, restricts what items could qualify as part or a component of an asset, and requires linked presentation if specified conditions are met.

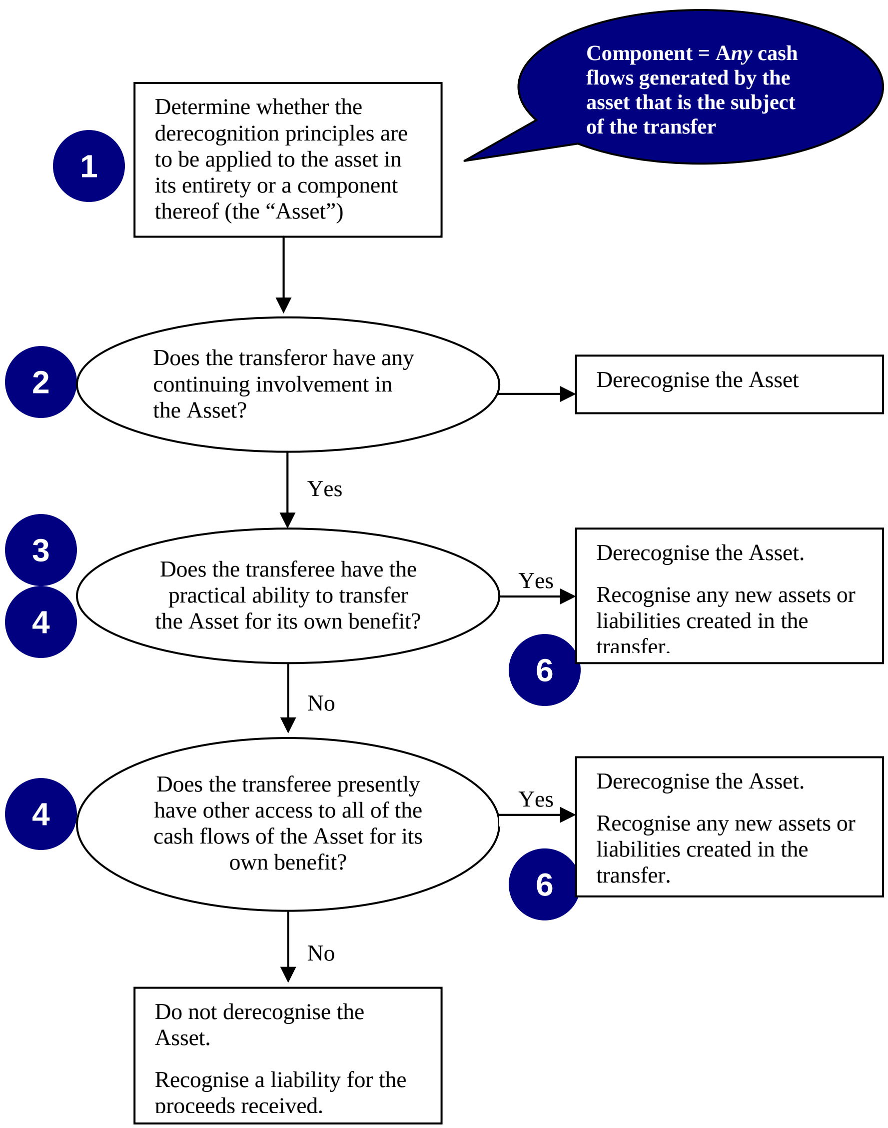
3. Flowcharts illustrating the two approaches are shown on page 3. The two flowcharts are the same as the ones that the staff presented at the October meetings.

4. A majority of the boards expressed a preliminary preference for Approach 2, but raised some issues for the staff to address in developing both approaches further.

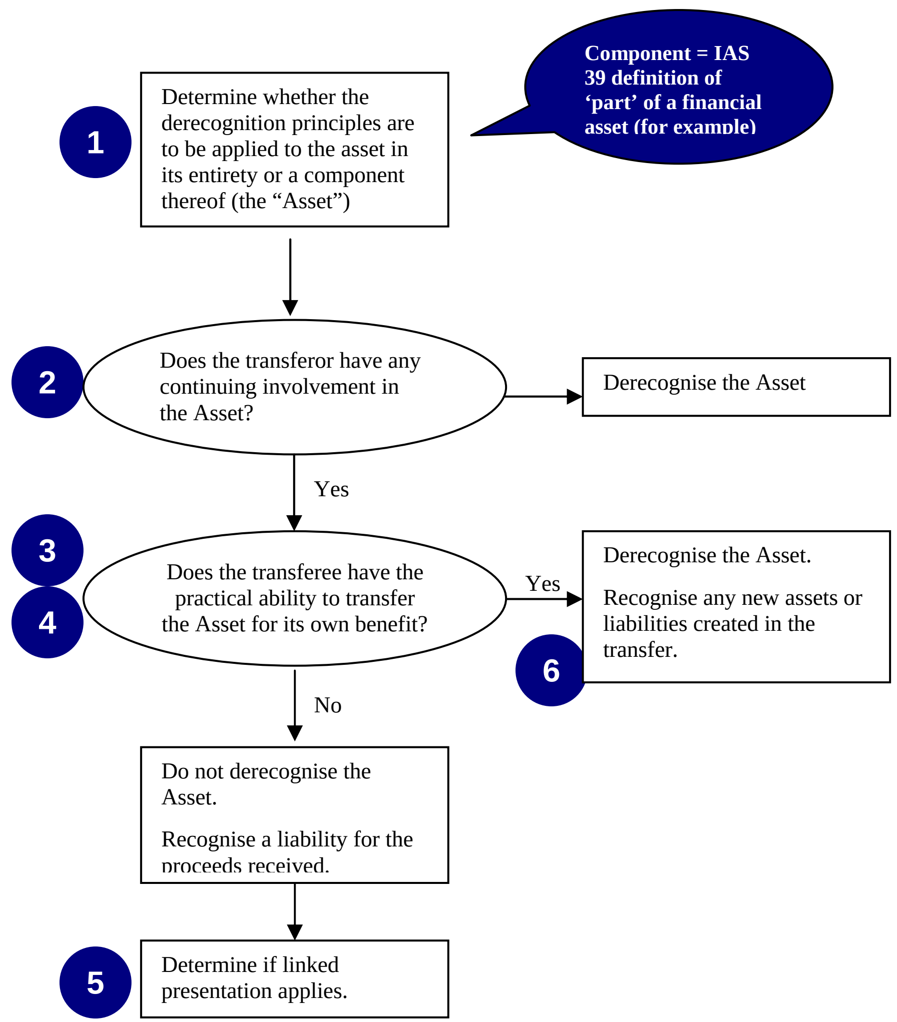
5. This paper provides a summary of those issues and when the staff plans to discuss them with the boards. The issues are structured to follow the steps/tests in the two flowcharts (except for Issue 10, which deals with derecognition of financial liabilities while the two flowcharts deal with derecognition of financial assets).

6. The staff believes that the open issues must be addressed before an exposure draft on derecognition can be issued.

7 8 FLOWCHART 1



7 8 FLOWCHART 2



Open Issues

7. The open issues are:

1 ***What is 'the Asset' that the two flowcharts assess for derecognition?***

This question is geared towards clarifying when it is appropriate to apply the derecognition tests in Flowchart 1 and Flowchart 2 to a transferred portion of a financial asset. For example, if an entity transfers a right to the first 80% of the cash flows of a loan portfolio that it has recognised on its statement of financial position prior to the transfer, does that 'right to cash flows' qualify as a component? What if the entity instead transfers the entire loan portfolio to a special-purpose entity (SPE) and takes back a 'last 20%' beneficial interest (ie, a subordinated interest) from the SPE?

2 ***What is the definition of 'continuing involvement'?***

Both flowcharts ask the question about whether the transferor has any continuing involvement in the Asset (ie, the entire financial asset that the transferor recognised on its statement of financial position prior to the transfer or a component thereof, as so determined in the first step).

This question serves to filter out those transfers for which it is easy to determine that the transferor should derecognise the transferred Assets and for which it is thus not necessary to apply the subsequent derecognition tests. This is because the transferor has no further 'relationship' with those Assets (ie, no exposure to the upside and downside of the Assets in whatever form).

In the October papers, we did not conclude on a definition of 'continuing involvement'. For example, what types of servicing qualify as continuing involvement and which types do not? Do fair value puts, calls, or forwards constitute continuing involvement?

3 ***What does it mean for the transferee to have the 'practical' ability to transfer the asset it purchased from the transferor?***

Some board members questioned whether this test required a continuous assessment of 'practical' ability. For example, assume that in conjunction with a transfer of a financial asset, an entity obtains a right to repurchase the asset at fixed price over the asset's term. Further assume that the asset is not readily obtainable in the marketplace at the time of transfer. Because the transferee would not be able to perform under the call if exercised, it likely will not transfer the asset to someone else. As a result, the transferee does not have the practical ability to transfer the asset for its own benefit, causing the transfer not to qualify for derecognition under Flowchart 2 (under Flowchart 1, the transfer would qualify for derecognition under the following 'other access to the underlying cash flows' test).

What would happen if subsequent to the transfer, a market for the asset developed such that the transferee now could sell the asset knowing that it could repurchase a similar asset if it had to perform under the transferor's call? Should the transferor then derecognise the asset?

What about if at the time of transfer, the call was at the money, but subsequently moves significantly out of the money such that it would seem unlikely the transferor would exercise it? Should the transferor then derecognise the asset?

Another issue that a board member raised related to the criteria the staff provided around 'practical' ability in the October papers. In those papers, the staff indicated that a transferee would have the practical ability to transfer a financial asset if it could exercise that ability unilaterally and without needing to impose *additional* restrictions on the transfer. The board member questioned whether for a transfer of a financial asset (say, a loan) with a call option, the Asset to which the 'practical ability to transfer' test is applied might be the 'loan subject to the transferor's call'. In this case, the transferee would not have to impose *additional* restrictions to transfer the 'loan subject to the transferor's call' to someone else and presumably satisfy the 'practical ability to transfer' test.

4 ***Can/should we change the 'practical ability to transfer' test (both flowcharts) and 'other access' test (Flowchart 1 only) to assess them from the perspective of the transferor?***

Some board members asked whether we could change the perspective of the derecognition tests from that of the transferee to that of the transferor.

This is because assessing whether a transferor should derecognise a financial asset it has recorded on its statement of financial position by looking to what the transferee can do with the asset is not intuitive. Furthermore, making that assessment might be difficult in multiple-step securitisations.

5 ***Should linked presentation be part of Flowchart 2? If so, what are the principles for linked presentation?***

Flowchart 2 provides that in a failed sale, the transferor might be required, if specified conditions are met, to link for presentation purposes the resulting liability with the financial asset that remains on the transferor's statement of financial position.

Some of the board members that favoured Flowchart 2 questioned whether that flowchart should include linked presentation. They are of the view that linked presentation allowed a transferor to present transfers that did not qualify for derecognition as if they did, therefore putting in doubt the basis for having derecognition criteria.

In the October papers, the staff indicated that it had not yet determined the scope, principle, criteria and measurement of linked presentation, as well as how items that qualify for linked presentation might be presented on the statement of financial position and in the statement of comprehensive income. Accordingly, for purposes of deciding whether linked presentation should be included in Flowchart 2, the staff will have to develop (and provide the Board with) principles for such presentation technique.

6 ***How is the carrying amount of the financial asset allocated between the components sold vs. those retained? What is the measurement basis for any such retained component(s)?***

The staff has not considered whether the current measurement guidance in IAS 39 is appropriate for each of the two flowcharts. For transfers of portion(s) of financial asset(s) that qualify for derecognition, the staff will have to address how the previous carrying amount should be allocated between the portion(s) transferred and those continued to be held. How should the portion(s) continue to be held be measured subsequently?

7 ***For each flowchart, what will be the disclosure requirements?***

Some board members emphasised to the staff the importance of disclosures. They think disclosures are especially important for Flowchart 1, considering that it will result in significantly more financial assets or portions thereof being derecognised than under Flowchart 2 or under IAS 39 or the proposed amendment to FAS 140.

8 ***How does derecognition interact with consolidation?***

As the staff has previously stated, it believes that the issue of when to derecognise a financial asset is separate from the issue of when to consolidate an entity. Nevertheless, the staff believes that for purposes of deciding on a derecognition model, it will be beneficial for the boards to have an understanding of those transfers for which the transferor derecognizes the related financial assets under the two derecognition flowcharts but for which it then consolidates the transferee entity under the proposed consolidation model.

The staff notes that the consolidation ED is likely to be published before the staff can complete this work.

9 ***When should financial liabilities be derecognized?***

The staff believes that derecognition of financial assets is a more contentious issue and one on which people find it difficult to agree on a common derecognition principle/criteria than derecognition of financial liabilities. However, because the derecognition project covers the derecognition of *both* financial assets and financial liabilities, the staff will have to consider whether the current derecognition principles for financial liabilities in IAS 39 continue to be

appropriate or whether they require an amendment.

	Open Issues	Timing	Paper Reference
1 3 4	• What is 'the Asset'? • What does it mean for the transferee to have the 'practical' ability to transfer the asset it purchased from the transferor? Does this test require a continuous assessment of 'practical' ability? • Can/should we change the 'practical ability to transfer' test (both flowcharts) and 'other access' test (Flowchart 1 only) to assess them from the perspective of the transferor?	November	Paper 15B Paper 15C Paper 15D
2 8 9	• What is the definition of 'continuing involvement'? • How does derecognition interact with consolidation? • When should financial liabilities be derecognized? • Sweep issues from November meeting	December	N/A
5 6 7	• What are the principles for linked presentation? • How is the carrying amount of the financial asset allocated between the components sold vs. those retained? What is the measurement basis for any such retained component(s)? • For each flowchart, what will be the disclosure requirements? • Sweep issues from December meeting	January	N/A
	• Sweep issues from January meeting	February	N/A

8. The staff plans to put forth papers on these issues over the next few months as indicated in the following table:

9. The staff has shared this paper with the FASB staff. It also plans to share the papers in the foregoing table with the FASB staff and obtain their input on any issues which they have already dealt with in the past.

Questions for the Board

10. Does the table in paragraph 8 capture all of the issues that need to be addressed before issuing an exposure draft on derecognition of financial assets and liabilities? If not, what other issues do you want the staff to address?

11. Do you agree with the proposed timing? If not, why not?