



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**

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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: November 2008, London
Project: Derecognition of Financial Assets
Subject: The Meaning of "Practical Ability to Transfer"
(Agenda Paper 15C)

PURPOSE

1. This paper addresses issue No 3 as highlighted in Agenda Paper 15A –
3 *What does it mean for the transferee to have the 'practical' ability to transfer the asset it purchased from the transferor?*
2. Some Board members questioned whether the practical ability test required a continuous assessment. Another issue that a Board member raised related to the criteria the staff provided around 'practical' ability in the October papers.
3. 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.

4. 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.
5. The staff will be asking the Board:
 - a. Whether the staff explanation of the concept is clear
 - b. Whether the concept could be implemented in practice
 - c. Whether the Board would like the staff to address any of the issues raised further and if so, how?

THE ISSUE

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

Application Criterion 2 – Practical Ability to Transfer

Does the transferee have the practical ability to transfer the Asset for its own benefit?

6. The purpose of Application Criterion 2 assessment is to establish where control lies. The objective is to establish whether a transferor has given control of the asset to another party. This test is based on the notion that if the transferee is ‘free and able’ to transfer the asset to a third party for its own benefit then control of the economic benefits has passed.
7. As discussed at the October Meetings, if the transferee is free and able to transfer a financial asset, we can conclude that the transferee can obtain the economic benefits. And to the extent that the transferee can restrict others access to those

benefits we can also conclude that the transferee controls the economic benefits underlying the asset.

8. The proposed approaches, set out in the October papers, express the notion of the transferee being “free and able” to transfer an asset by focusing on whether the transferee has the *practical ability* to transfer the financial asset in its entirety to a third party and is able to exercise that ability *unilaterally* and *without needing to impose additional restrictions* on the transfer for its own benefit.
9. The following paragraphs discuss this key concept.

“PRACTICAL ABILITY TO TRANSFER”

10. The test of ‘practical ability to transfer’ seeks to identify whether, in substance, the transferor has restricted the transferees ability to transfer and obtain the underlying economic benefits.
11. The key issue is what the transferee is able to do in practice (not what it will do). The focus is not what contractual rights the transferee has or what contractual prohibitions exist. The test is about ‘practical ability’ rather than rights. Otherwise economically insignificant clauses in a transfer agreement (permitting or prohibiting transfer) could have a significant effect on the accounting.
12. Therefore assessing whether the transferee has the practical ability to transfer the asset requires judgement. Whether the transferee has the practical ability to transfer can only be assessed after considering all the relevant facts and circumstances. The staff believes the following are some (but not all) of the factors that ought to be taken into account in making this assessment:
 - The terms of the transfer (contractual) arrangement
 - Other contracts or arrangements entered into in relation to the transfer
 - The nature of the asset
 - The market for the asset
 - The transferee’s ability to obtain the full economic benefits

- Economic constraints

Contractual Terms

13. Although not sufficient in itself, a contractual prohibition on disposing of an asset may in some circumstances be the clearest evidence that the transferor has denied the transferee the ability of realising, through transfer, the economic benefits of the asset.
14. However, contractual restrictions on the transferee's right to transfer a financial asset to a third party will not necessarily prevent the transferee from having the practical ability to make such a transfer (see below).

Associated Contracts

15. In assessing a particular transfer, it is necessary to consider any related arrangements, including any side agreements or sets of simultaneous agreements entered into contemporaneously with, or in contemplation of, the transfer of the financial asset.
16. For example, if the transferee has written a call option whereby the transferor can insist on the return of a transferred asset that is unique (and therefore irreplaceable), the transferee will risk defaulting on its obligation to the transferor if it transfers the asset to a third party. In such a situation the transferee will be judged to lack the practical ability to transfer the financial asset to a third party.

Nature of the Asset (fungibility and availability)

17. In considering the practical effect of any restrictions relating to the transferee's ability to transfer the asset to a third party, the ease with which replacement assets can be obtained is an important factor. In essence, the issue is whether the transferee might find itself in default of any commitments or obligations to the transferor if it transfers the asset to a third party.

18. A contractual prohibition on disposing of an asset (or the absence of an explicit contractual right to dispose of it) may have no effect on the transferee's practical ability (and may therefore not prevent the transferee from having the practical ability to transfer the asset to a third party) if it is easy to obtain replacement assets, because the transferee may be able to transfer the asset and still satisfy the prohibition by obtaining a replacement asset.
19. For the practical ability to transfer analysis, replacement assets are deemed to be readily available only if the asset is actively traded on an accessible market (at the date of transfer).

The Market for the asset

20. A restriction or limitation, that is effective, on the number or identity of the parties to whom the transferee can transfer the asset also will have no practical effect if sufficient other potential buyers exist to create a market for the transfer of the asset.
21. Although the assets involved in a transfer may not be capable of being easily replaced, because of market convention, other established practice or an express or implied term of the transaction, it may be possible to be reasonably certain that an asset that is not identical to the asset transferred will be considered by the transferor to be an acceptable replacement for the transferred asset. If that is the case, the other arrangements entered into by the parties to the transfer (as part of the transfer) will not prevent the transferee from transferring the asset. This is consistent with the current requirements under FAS 140.

Transferee's Ability to Obtain the Full Economic Benefits

22. As the practical ability to transfer test assesses the transferee's ability to obtain the full economic benefits of the asset transferred, any retained rights by the transferor that does not prevent the transferee from doing so will have no effect on the test of practical ability.

23. The retention by the transferor of a right to match a bona fide offer received by the transferee from a third party will not prevent the transferee from having the practical ability to transfer the asset to a third party. In such cases, when the repurchase occurs pursuant to the contract, the transferee's position is no better or worse than if it were to sell the financial asset in the market on that day.
24. The same analysis applies to transfers where the transferor retains a first right of refusal on the asset or a repurchase right at the prevailing market value of the asset.

Economic constraints to transfer

25. If a transferee stands to incur losses on the transfer to a third party, it would economically be impeded from, and therefore judged not to be practically free and able to, transfer the asset to a third party.
26. For example, a put option held by the transferee will constrain the transferee's ability to dispose of the asset unless replacement assets are readily available. The transferee is likely to be economically impeded from transferring the asset unencumbered by an option or right to reacquire, since the transferee would not then be able to exercise its retained put option.
27. Although a transferee is, in theory, always free to choose not to exercise a put option, in reality a put option will convey benefits to the transferee that it is unlikely to be prepared to give up lightly, so its existence is likely to constrain the transferee.
28. A case in point will be a transfer with a deep in the money put option. In this case, at the transfer date, one can conclude that there is no practical possibility that it will be out of the money at the exercise date (and hence would be exercised). The transferor is unlikely to forfeit the benefit of the option by transferring the 'asset' in isolation (i.e. without attaching the option or a similar option).

29. Some believe that this is not appropriate because the transferee would generally be able to sell the asset and put option together to another party and, in that circumstance, the put option would not represent an additional restriction imposed on the transfer.
30. The staff does not believe that in the above case the transferee have the practical ability to transfer the 'asset' being assessed for derecognition without imposing a restriction (i.e. a call or a put option) on the transfer. The impact of attaching the option to the transfer is that the transferee would be obliged to transfer the 'asset' subject to a similar option and would not be able to transfer the 'asset' in isolation (see paper 15B for a discussion about the 'asset').
31. Hence the ability of the transferee to transfer the 'asset' and the put option together does not prove that the transferee has the practical ability to transfer the 'asset' being assessed for derecognition in isolation but rather confirms the transferee's lack of practical ability to transfer the 'asset' in isolation.
32. The staff also believes that there will be many circumstances in which the put option is not transferable in that way (a put option held by a factor to give effect to the recourse arrangements underlying a transfer of receivables with recourse is an example of a non-transferable put i.e. a bilateral agreement).
33. In majority of cases where the put option is transferable, the 'asset' being assessed for derecognition would be a readily obtainable asset and hence the transferee would be deemed to have the practical ability to transfer (as he would be able to acquire a replacement asset to fulfil its obligation or rights under the option contract).
34. Other factors apart from price will also need to be taken into account in the assessment. For example, an asset underlying a call option may be one that, because of the nature of the option holder's activities or the way in which it operates, it would wish to reacquire even if the reacquisition cost appears higher than its market value to other potential buyers at that time.

“UNILATERAL ABILITY TO TRANSFER”

35. Application Criterion 2 requires the transferee to be able to exercise its practical ability to transfer the asset to a third party unilaterally. That is, the transferee should have the ability to dispose of the asset independently of the actions of others. This concept is based on the reasoning that an apparent ability to dispose of something is not a practical ability if another party can prevent the apparent ability from being used.
36. The transferee will not be able to exercise its ability unilaterally if, for example, the terms of the transfer require the transferee to obtain the consent of the transferor to the transfer of the asset, which consent can be withheld without reason, and that restriction is effective in practice.
37. On the other hand, if the transferor’s consent is needed but it cannot reasonably be withheld, the transferee may still have the ability to transfer the components unilaterally.

“WITHOUT ADDITIONAL RESTRICTIONS”

38. The transferee needs also to be able to exercise its ability to transfer the asset to a third party without having to impose additional restrictions on that transfer. Restrictions that have no impact on the transferee’s s practical ability to transfer should not be taken into account.
39. The concept of additional restrictions refer to any contract that the transferee would have to enter into with a third party on a subsequent transfer of the asset being assessed for derecognition. Such a contract would be required if as part of the original transfer between the transferor and the transferee, the parties entered into an additional contract and that additional contract effectively prevents the transferee from transferring the asset being assessed for derecognition except a similar additional contract is entered into by transferee and that third party.

40. Such an arrangement need not be in a separate contract from the contract for the sale and purchase of the asset being assessed for derecognition. Both the 'sale and purchase agreement' and the additional contractual arrangement may be part of one contract. An additional restriction cannot be any feature inherent in the asset being assessed for derecognition i.e. that feature should not have been part of the asset before the transfer.
41. This point is well illustrated taking the case of a convertible bond. Although there may be a call option embedded in the convertible bond, that option is part of the asset being assessed for derecognition and hence would not be considered an additional contract entered into as part of the transfer.
42. On the other hand, a call option (separate from the embedded option) attached to a convertible bond that is not readily obtainable (is an additional contract and) may mean that the transferee would have to add a similar option to a subsequent transfer to avoid default under the call option contract between the transferor and the transferee. That is, the transferee have to add restrictions (or additional restrictions) to the subsequent transfer of the asset being assessed for derecognition and hence would be deemed not to have the practical ability to transfer the asset being assessed for derecognition in isolation.
43. The following are examples of circumstances where the transferee would be judged not be free and able to transfer to a third party the asset transferred as it risks being in default of its obligations to the transferor if it undertakes a transfer without attaching restrictions to protect its position:
- (a) if the transferee has written a call option enabling the transferor to insist on the return of a transferred asset that is unique (and therefore irreplaceable), the transferee will risk defaulting on its obligation to the transferor if it transfers the asset to a third party without attaching a call option or forward purchase contract.
 - (b) a put option held by the transferee will also constrain the transferee's ability to dispose of the asset unless replacement assets are readily available. In this case the transferee is likely to be economically impeded from transferring the asset unencumbered by an option or right to

reacquire, since the transferee would not then be able to exercise its retained put option.

- (c) If the transferor has imposed obligations on the transferee concerning the servicing of the asset, which the transferee would have to impose on any entity to which it transferred the asset, the transferee would need to attach a similar provision to any transfer that it makes to a third party.

INITIAL ASSESSMENT AND REASSESSMENTS

- 44. Initial assessment, under the proposed model, will be based on the notion that if the transferee is not in a position immediately after the transfer to complete a second transfer to a third party, it will not have the practical ability to transfer the asset to third party. It will not be in a position to complete the transfer if, for example, it has to exercise a call option to obtain additional rights to be able to transfer the asset or if it has to obtain additional rights before it can insist on the third party paying an amount equal to the fair value of the entire asset.
- 45. The proposed model would require that the assessment by the transferor as to whether an option, for instance, constrains a transferee be made once only, at the date of transfer. The staff does not believe that an alternative of continuously assessing whether the option is bound to be exercised and as such whether it constrains the transferee from transferring the asset would be practical.
- 46. A continuous assessment approach would mean transferred assets would be moving on and off the transferor and the transferee's statements of financial position from reporting date to reporting date. This will hardly provide useful information to users of financial statements and will be extremely cumbersome in practice. The staff notes that changes in the value of an option is not currently treated as either a recognition or derecognition event.
- 47. In assessing whether a call option or a put option constrains the transferee, subsequent events that change the probability of the option being exercised generally would not result in any change to the assets and liabilities recognised and derecognised.

48. The only exception will be where the option previously considered to be constraining the transferee's ability to transfer the asset expires unexercised and, as a result, the transferee is no longer constrained.
49. In this case, the transferred asset would be derecognised in its entirety on that date. As such the proposal treats the expiry or unexercised of an option previously considered to be constraining as a recognition/derecognition event.
50. The staff notes that once an asset is derecognised under the proposed model as a result of the transferee having the practical ability to transfer, the asset so derecognised would not have to be re-recognised if the market for the asset changes such that the transferee is deemed no longer to have the practical ability to transfer the asset.
51. On the other hand, the staff notes that a transaction which is treated as not qualifying for derecognition because the transferee is deemed not to have the practical ability to transfer the asset to a third party, would qualify for derecognition if conditions change so as to give the transferee such an ability.

QUESTIONS FOR THE BOARD

52. Does the Board agree that the staff explanation of the practical ability to transfer concept is clear? If not, why not?
53. Does the Board believe that the concept could be implemented in practice? If not, why not?
54. Are there any issues that the Board would like the staff to address further? If so, what are the issues and how should the staff address them?