

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: November 2008, London
Project: Derecognition of Financial Assets
Subject: The Flowcharts – From the Transferor's Perspective
(Agenda Paper 15D)

INTRODUCTION

1. At the October meetings (IASB and the Joint Board) the staff proposed two approaches to derecognition of financial instruments. The staff also presented two flow charts demonstrating how the suggested approaches may be applied in practice.
2. Both flow charts include a test of 'practical ability to transfer' (Application Criterion 2, see below). Flowchart 1 has an additional step which tests for 'other access to the economic benefits underlying the asset' (Application Criterion 3, see below).
3. Both flowcharts apply Criteria 2 and 3 from the perspective of the transferee. However, Application Criterion 1 (the continuing involvement test), in both approaches, is assessed from the perspective of the transferor.

Application 2 – Practical Ability to Transfer

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

Application 3 – Other Access to Economic Benefits

Does the transferee presently have other access to all or some of the cash flows of the asset for its own benefit?

PURPOSE

4. This paper addresses issue No 4 as highlighted in Agenda Paper 15A –
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?*
5. 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.
6. This paper discusses how we might change the perspective from the transferee to that of the transferor.
7. The staff will be asking the Board:
 - a. which of the suggested wording the Board would like to adopt and in particular whether the staff recommendation is appropriate and if not
 - b. how the Board might amend the criteria to satisfy its concerns.

THE ISSUE

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?

8. The purpose of the *‘practical ability to transfer’* test (Application Criterion 2) and *‘other access’* test (Application Criterion 3) is to establish who controls the asset transferred. The objective is to establish whether a transferor has given control of the asset to another party.
9. As analysed in the October papers, the staff believes that for an entity to have an asset, the entity must have access to the future economic benefits embodied in that asset and generally must be able to deny or regulate others access to those benefits.
10. Due to the nature of transfer transactions, if the transferor is deemed to be in control of the economic benefits underlying the asset, the transferee will therefore not be in control (and vice versa).
11. For operational reasons, both FAS 140 and IAS 39 evaluate transfer transactions (for derecognition) from the transferee’s perspective. The staff believes that it is operationally more straight-forward to assess transfer transactions from the perspective of the transferee. The staff also believes that, while the wording can be changed to assess the transfer from the transferor’s perspective, to a large extent one inevitably ends up considering what the transferee can or cannot do. That is, it is largely a play on words.
12. However, the staff acknowledges that it is more conceptually appealing to assess derecognition of an asset originally held by a transferor from the perspective of the transferor.
13. **The staff does not believe that changing the assessment from the perspective of the transferee to that of the transferor is particularly helpful and may**

have adverse unintended consequences. Nevertheless, to address the request of some Board members, the staff provides in this paper, alternative approaches to how the focus of the assessment could be switched to the transferor’s perspective.

14. The staff notes that the FASB has proposed an amendment to FAS 140 that would assess the transferee’s ability to exchange or pledge the asset from the perspective of the transferor. An extract of the proposed amendment is reproduced below:

“A transfer of an individual financial asset in its entirety, a group of financial assets in their entirety, or a participating interest in an individual financial asset shall be accounted for as a sale if and only if all of the following conditions are met:

.....

*c. **The transferor**, its consolidated affiliates included in the financial statements being presented, or its agents **do not maintain effective control over the transferred financial assets**. Judgment is required to assess whether a particular agreement provides the transferor with effective control of the transferred financial asset. **For example, effective control over the transferred financial assets by the transferor exists through** (1) an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity (paragraphs 47–49), (2) the ability to unilaterally cause the holder to return specific financial assets, other than through a **cleanup call** (paragraphs 50–54), (3) **a restriction on the transferee’s right to pledge or exchange the transferred financial asset it receives unless such constraint is designed primarily to provide the transferee with a benefit (paragraphs 54A–54D)**, or (4) an agreement that permits the transferee to require the transferor to repurchase the transferred financial assets at a price that is so favorable to the transferee that it is probable that the transferee will require the transferor to repurchase the transferred financial assets (paragraph 54E).” Paragraph 9 [emphasis added]*

CRITERION 2 – ‘PRACTICAL ABILITY TO TRANSFER’ TEST

Criterion 2 – Practical Ability to Transfer

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

15. The staff has developed four alternatives that addresses Criterion 2 from the perspective of the transferor. The alternatives are as follows:
- a. Has the transferor retained control over the transferred asset by restricting the transferee’s practical ability to transfer that asset [to a third party] for the transferee’s benefit?
 - b. Has the transferor surrendered control over the transferred asset to such an extent that the transferee has the practical ability to transfer the asset [to a third party] for the transferee’s benefit?
 - c. Has the transferor restricted the transferee’s practical ability to transfer the asset to a third party for the transferee’s benefit?
 - d. Has the transferor restricted the transferee’s practical ability to access the economic benefits of the transferred asset through subsequent transfer of that asset to a third party for the transferee’s benefit?

Alternative A

16. We could draft the wording of Criterion 2 in the manner used by the FASB in the proposed amendment to FAS 140 (in changing the assessment of its ability to exchange or pledge test from the transferee’s perspective to that of the transferor) and amend Criterion 2 to read as follows:

a. Has the transferor retained control over the transferred asset by restricting the transferee’s practical ability to transfer that asset [to a third party] for the transferee’s benefit?

17. This places emphasis on the conceptual underpinning of the proposed derecognition criteria (i.e. control) and how the transferor has or has not retained control.
18. The staff would like the Board to note that the test above is not the same as the SFAS 140 ED ability to pledge or exchange test and that the reference to the benefit in the above step means precluding others from the economic benefits of the asset as opposed to the restriction benefiting the transferee. Moreover, the proposed model focuses on practical ability to transfer and not the ability to

- pledge or exchange. The two may be perceived as similar but they differ in emphasis and may give different outcomes in some cases.
19. One of the reasons for the difference in outcomes is that the FASB ability to pledge or sell is considered together with the legal isolation test whereas the practical ability test focuses only on the economic implications. Also, where the transferor has an obligation and entitlement to reacquire the asset transferred (whether the asset is readily obtainable or not), the transaction would fail the derecognition criteria in FAS 140.
 20. We believe that, although, this wording has transferor in it and purports to make the assessment from the transferor's perspective, one would still have to look at what the transferee can or cannot do to make a conclusion. We do not believe this is a substantial change to Criterion 2 and amounts to just play on words.
 21. Moreover, the Conceptual Framework project is attempting to replace 'control' with other expressions and hence the staff does not believe incorporating the term 'control' is consistent with the Boards' current thinking.
 22. One major weakness of Alternative A is that it focuses on restrictions that the transferor has placed on the transferee. The practical ability test as explained in Paper 15B takes into account factors other than express restrictions placed on the transfer by the transferor.
 23. Alternative A may be contentious in practice as a transferor may argue that the inability of the transferee to practically transfer the asset to third parties is not due to any restrictions the transferor has placed on the transfer.

Alternative B

b. Has the transferor surrendered control over the transferred asset to such an extent that the transferee has the practical ability to transfer the asset [to a third party] for the transferee's benefit?

24. Alternative B has many of the shortcomings identified under Alternative A but 'surrender of control' appears to be more in keeping with the issue of

derecognition than ‘retention of control’ hence Alternative B might be preferred to Alternative A.

Alternative C

c. Has the transferor restricted the transferee’s practical ability to transfer the asset to a third party for the transferee’s benefit?

25. Although the staff believes that referring to ‘control’ in the test focuses attention on what the test is supposed to evaluate (i.e. control), we feel it is probably redundant and the phrases ‘**retained control over the transferred asset**’ and ‘**surrendered control over the transferred asset to such an extent that**’ in Alternative A and B, respectively, could be removed without significantly changing the meaning of the wording. Alternative C achieves that and results in a more elegant and concise wording.
26. However, this wording also suffers from the shortcomings identified under Alternative A.

Alternative D

d. Has the transferor restricted the transferee’s practical ability to access the economic benefits of the transferred asset through subsequent transfer of that asset to a third party for the transferee’s benefit?

27. The phrase practical ability to transfer does not emphasise enough that Criterion 2 is assessing which entity can obtain and preclude others from the economic benefits embodied in the asset. Alternative D provides a link between the practical ability test and the proposed derecognition principle –
- ‘An entity should derecognise a financial asset or component thereof when it no longer qualifies as an asset of the entity (i.e. when the economic benefits no longer exist or the 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)’.*
28. , The Boards have tentatively adopted in the Conceptual Framework project, in replacement of ‘control’, ‘access’ as the means by which a particular entity is

linked to the economic benefits generated by an asset. The staff believes that ‘access’ to economic benefits is a superior approach to assessing whose asset is it than using the concept of ‘control’.

29. Also, Alternative D emphasises that the practical ability to transfer should result in inflow of economic benefits for the exclusive benefit of the party that so obtains the economic benefits. Moreover, the wording in Alternative D is consistent with Criterion 3 in flowchart 1 (see below) and hence would make the model (Flow chart 1) easier to understand and apply.

Staff Recommendation

30. The staff believes Alternative D is the best option for the reasons outlined above and recommends that if the Board decides to change the derecognition test from the perspective of the transferee to that of the transferor, the Board should adopt this alternative in replacement of the wording in Criterion 2 (as proposed in October).
31. *Do you agree that, Criterion 2 should be changed to focus on the transferor? and*
32. *If so, should the wording in Criterion 2 be changed in the manner expressed under option Alternative D above? If not, why not and what would you propose doing instead?*
33. *Do you think that any further improvement should be considered? If so, what improvements would you suggest, and why?*

Criterion 3 (in flow chart 1 only)

<p>Criterion 3 – Other Access to Economic Benefits</p>

<p>Does the transferee presently have other access to all of the cash flows of the Asset for its own benefit?</p>
--

34. The Board could replace transferee with transferor in Application Criterion 3 (existing wording) and by making this change Criterion 3 could be amended to read as follows:

Criterion 3 – Other Access to Economic Benefits

Does the transferor presently have access to all of the cash flows of the Asset for its own benefit?

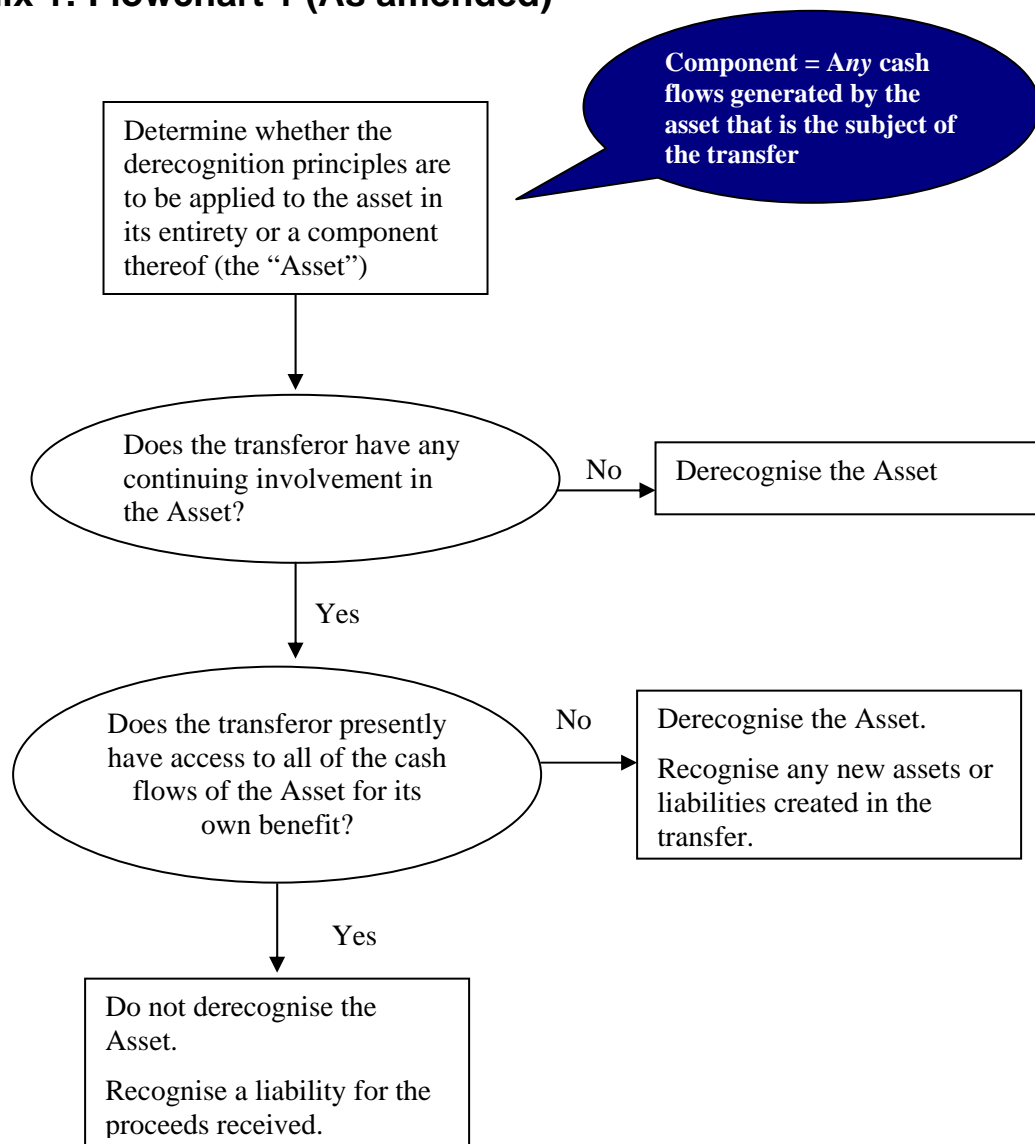
35. The staff does not see this change to be problematic but notes that changing from the transferee's perspective to that of the transferor would change a couple of the outcomes under flow chart 1 (i.e. sale with forward contracts and physically settled total return swaps).
36. As noted in the October papers, under flow chart 1, a sale with a forward contract to buy back the asset transferred or a sale with an attached physically settled total return swap fails the derecognition test.
37. To illustrate, assume a transfer of originated loan with forward purchase at fixed price (assume terms of forward reflect market conditions and prices at the time of transfer)
38. In such scenarios, the transferee would have access to all of the transferred asset's cash flows if it could hold onto the asset to maturity or if it could transfer the loan to the transferor for fair value (i.e., the present value of the loan's cash flows).
39. Since the price of the forward is fixed and assuming the term of the forward does not match the term of the loan, the transferee does not have access to all of the loan's cash flows
40. However, if the test is applied from the perspective of the transferor, such transactions will qualify for derecognition. This is because whereas the conclusion would be that the transferee does not have **present access** to all of the economic benefits of the asset transferred and hence the transferor should continue to recognise the asset, if the transferor is judged not to have **present access** to all of

- the economic benefits of the asset transferred it would mean the transferor does not have control of the asset and hence it should derecognise the asset.
41. The reason for the apparent anomaly is because of the 'Asset' that is being assessed for derecognition. The 'Asset' that ought to be assessed for derecognition should be part of, or the entire, interest-only (IO) strip. This is because, over the life of the transaction, the transferee would have access to all or some of the interim flows on the asset (i.e. the interest payments) but not the principal or nominal part of the loan.
 42. Since the contract for the transfer would specify that the item transferred is the entire loan, the item that many would require that the derecognition model is applied to, would be the entire loan asset. Although the staff considers this as an unsatisfactory result, we have not been able to identify any other way that we could require an economic analysis to identify what was transferred and hence what the derecognition model should be applied to in such cases
 43. The staff believes this is however a better result and more consistent with the underlying derecognition principle i.e. an asset of an entity is a present access to economic benefits that others do not have. The staff notes that the transferor does not have present access to the economic benefits embodied in the asset until the forward contract is exercised.
 44. Another benefit of changing the test from the transferee perspective to that of the transferor is that we could eliminate Criterion 2 in Flowchart 1 and still maintain the simplicity, outcomes and robustness of Approach 1.
 45. Appendix 1 shows how flowchart 1 may be revised should the Board choose to pursue this alternative.
 46. However, if the Board choose to amend only Criterion 2 (as recommended by the staff), the revised flow chart for Approach 2 would be as shown in appendix 2.

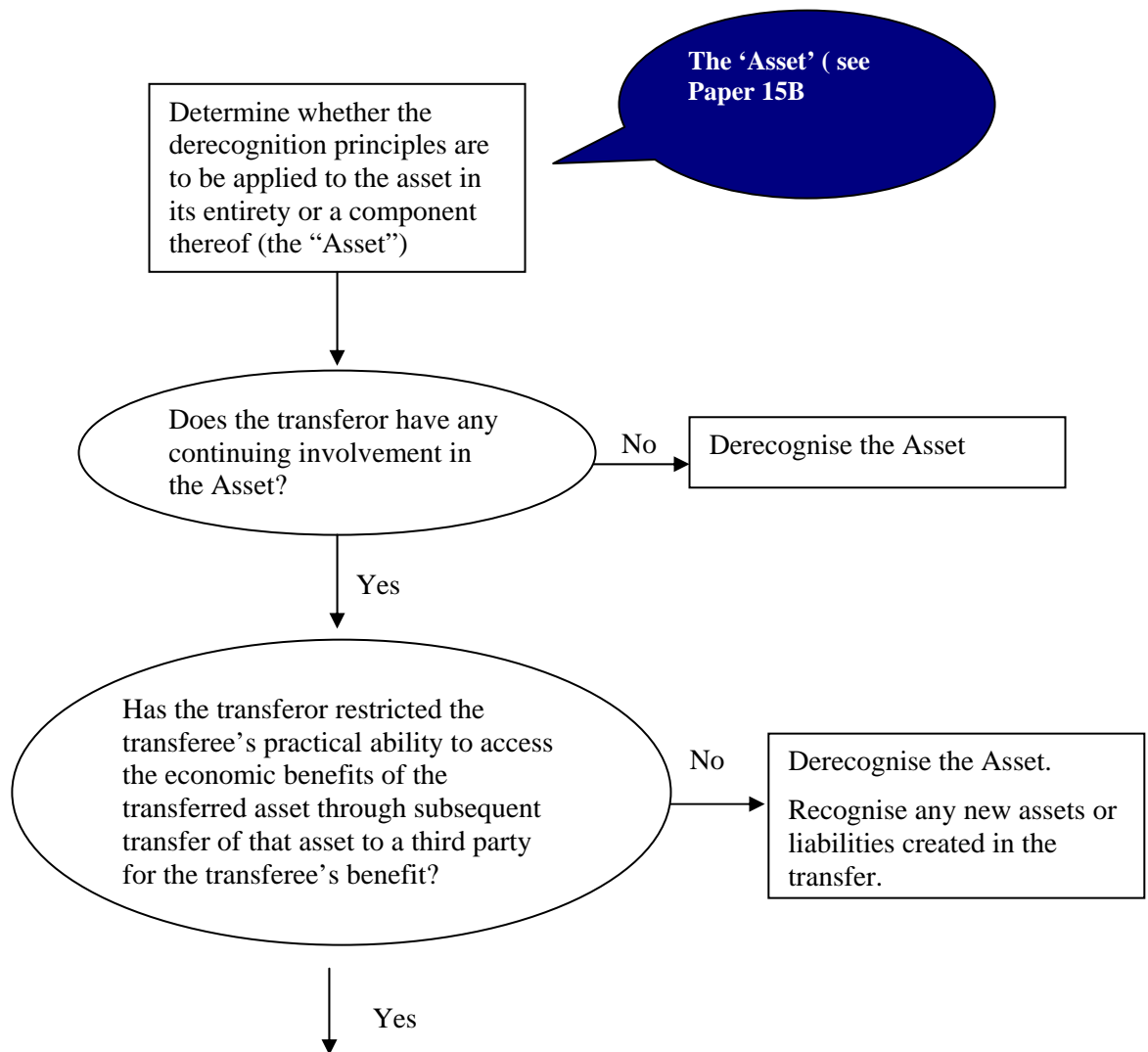
QUESTIONS FOR THE BOARD

47. Do you agree that, Criterion 3 should be changed to focus on the transferor in the manner expressed above? If not, why not and what would you suggest instead?
48. Do you think that any further improvement should be considered? If so, what improvements would you suggest, and why?

Appendix 1: Flowchart 1 (As amended)



Appendix 2: Flowchart 2 (as amended)



Do not derecognise the Asset.
Recognise a liability for the proceeds received.



Determine if linked presentation applies.