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**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: 15 September 2008, London
Project: Derecognition of Financial Assets
Subject: a) Application of Flowcharts to Transactions
b) Comparison to IAS 39 and FAS 140 ED
(Agenda Paper 7C)

Introduction

1. This paper:
 - a) illustrates how Flowchart 1 and Flowchart 2 in Agenda Paper 7B are applied to some transactions (see summary below); and
 - b) compares the accounting results in a) to those that would be obtained under IAS 39 and the proposed amendment to FAS 140.

2. The transactions to which Flowchart 1 and Flowchart 2 are applied are the following:

Transfer of a Readily Obtainable Financial Assets

- 1: Transfer of publicly-traded government bond with forward purchase, purchased call, written put, or total return swap

Transfer of a Non-Readily Obtainable Financial Assets

- 2: Transfer of originated loan with forward purchase at fixed price or *physically-settled* total return swap
- 3: Transfer of originated loan with purchased call at fixed price
- 4: Transfer of originated loan with written put at fixed price
- 5: Transfer of originated loan with *net-settled* total return swap
- 6: Transfer of a portfolio of originated loans with servicing retained
- 7: Transfer of *first* 80% interest in a portfolio of originated loans

3. The application of the two flowcharts to the selected transactions are based on the following:

- a) For Flowchart 1, ‘components’ are defined as ‘*any* cash flows generated by the asset that is the subject of the transfer’. For Flowchart 2, ‘components’ are defined similar to how a ‘part of a financial asset’ is defined in IAS 39 (see replication of definition in the appendix to Agenda Paper 7A).
- b) Both for Flowchart 1 and Flowchart 2, ‘continuing involvement’ is defined as retaining any of the contractual rights that represented that asset or obtaining any new contractual rights or contractual obligations relating to the asset (see paragraph 56 of paper 7A).
- c) For Flowchart 2, ‘linked presentation’ applies if the transferee can look only to the cash flows of the ‘transferred’ financial assets for repayment, but not to any of the transferor’s other assets (ie, the liability that is created as a result of accounting for the transfer as a failed sale is akin to a nonrecourse loan to the transferor).

Application of Flowchart 1 and Flowchart 2 to Transactions

Transfer of Readily Obtainable Financial Assets

Transaction 1: Transfer of publicly-traded government bond with forward purchase, purchased call, written put, or total return swap

Step	Flowchart 1	Flowchart 2
<i>Asset/Component?</i>	Entire loan	Same as for Flowchart 1
<i>Continuing Involvement?</i>	Yes (forward, call, put, swap)	Same as for Flowchart 1
<i>Practical Ability to Transfer Asset/Component?</i>	Yes. The transferee has the practical ability to transfer the bond for its own benefit given that it can sell the bond to someone else unilaterally and without having to impose any additional restrictions. Because the bond is publicly traded, the transferee likely will not have to combine the bond with the derivative (forward, call, put or total return swap) in order to sell it. Also, the transferee can easily obtain a replacement bond when it has to (wants to) perform under the forward or call (put).	Same as for Flowchart 1
<i>Other Access to Asset's/Component's Cash Flows for Own Benefit?</i>	N/A. Application of this test is not necessary in light of the transferee having the practical ability to transfer the bond for its own benefit (see first test above)	N/A. This test does not exist in Flowchart 2.
<i>Linked Presentation?</i>	N/A. This test does not exist in Flowchart 1.	N/A. Application of this test is not necessary in light of the transferee having the practical ability to transfer the bond for its own benefit (see first test above)
<i>Accounting Result?</i>	Transferor: <ul style="list-style-type: none"> • Derecognise the bond • Recognise the forward, call, put, or swap as a derivative Transferee: <ul style="list-style-type: none"> • Recognise the bond • Recognise the forward, call, put, or swap as a derivative 	Same as for Flowchart 1

Transfer of Non-Readily Obtainable Financial Assets

Transaction 2: Transfer of originated loan with forward purchase at fixed price or *physically-settled* total return swap (assume terms of forward/swap reflect market conditions and prices at the time of transfer)

Step	Flowchart 1	Flowchart 2
<i>Asset/Component?</i>	Entire loan	Same as for Flowchart 1
<i>Continuing Involvement?</i>	Yes (forward/swap)	Same as for Flowchart 1
<i>Practical Ability to Transfer Asset/Component?</i>	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/swap. Alternatively, the transferee might be able to transfer the loan but only if it were to attach the forward/swap to the loan.	Same as for Flowchart 1
<i>Other Access to Asset's/Component's Cash Flows for Own Benefit?</i>	No. The transferee would have access to all of the loan's cash flows if it could hold onto the loan to maturity (this would necessitate that the term of the forward/swap matches the term of the loan) or if it could transfer the loan to the transferor for fair value (ie, the present value of the loan's cash flows). Since the price of the forward is fixed and assuming the term of the forward/swap does not match the term of the loan, the transferee does not have access to all of the loan's cash flows.	N/A. This test does not exist in Flowchart 2.
<i>Linked Presentation?</i>	N/A. This test does not exist in Flowchart 1.	No. The liability that is created as a result of the failed sale is recourse to the transferor (ie, transferee can go after the transferor's general assets if the loan's cash flows are not sufficient to pay off the liability).
<i>Accounting Result?</i>	Transferor: <ul style="list-style-type: none"> Continue to recognise the loan in its entirety 	Same as for Flowchart 1

	<ul style="list-style-type: none">• Recognise a liability for the proceeds received <p>Transferee:</p> <ul style="list-style-type: none">• Recognise a receivable for the cash paid	
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Transfer of Non-Readily Obtainable Financial Assets

Transaction 3: Transfer of originated loan with purchased call at fixed price (assume the call is neither deeply in the money nor deeply out of the money)

Step	Flowchart 1	Flowchart 2
<i>Asset/Component?</i>	Entire loan	Same as for Flowchart 1
<i>Continuing Involvement?</i>	Yes (call)	Same as for Flowchart 1
<i>Practical Ability to Transfer Asset/Component?</i>	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 if the transferor exercised the call. Alternatively, the transferee might be able to transfer the loan but only if it were to attach the call to the loan.	Same as for Flowchart 1
<i>Other Access to Asset's/Component's Cash Flows for Own Benefit?</i>	<p>Yes. The transferee currently has access to all of the loan's cash flows given that it can hold onto the loan to maturity and receive, and keep for itself, all the loan's cash flows. The transferor has a right to get access to the loan's cash flows, but until it exercises the right and pays the strike price of the option, it would not have present access to the loan's cash flows.</p> <p>Note: Whether and when the transferor exercises the call will depend on variables impacting the FV of the loan (market interest rates, credit of the debtor), which are outside of the transferor's control. The staff would also like to point out that if one were to treat this transaction as a failed sale and require the transferor to recognise a liability for the proceeds received, that liability would not meet the definition of a liability in the Framework. That is, the transferor does not have "a present obligation ... arising from past events, the settlement of which is expected to</p>	N/A. This test does not exist in Flowchart 2.

	<p>result in an outflow from the [transferor] of resources embodying economic benefits.”</p> <p>The only obligations that the transferor has are to (a) pass on to the transferee any cash flows that it receives from the debtor underlying the loan (assuming the debtor continues to make loan payments to the transferor after the transfer) and (b) pay the strike price upon exercise of the call. Both obligations are <i>future</i> obligations. The obligation to pass on cash flows to the transferee arises upon receipt of cash from the debtor. The obligation to pay the call’s strike price arises upon exercise of the call. As said, whether the transferor will exercise the call will depend on factors outside its discretion.</p>	
<p><i>Linked Presentation?</i></p>	<p>N/A. This test does not exist in Flowchart 1.</p>	<p>Yes. The liability that is created as a result of the failed sale is nonrecourse to the transferor ie, the transferee does not have any power to enforce settlement of the liability with the transferor. However the transferor would only exercise the call if its estimation of the future benefits from the asset is equal to or greater than the exercise price. Stated alternatively, if the cash flows of the ‘transferred’ loan prove to be insufficient to pay off the liability to the transferee, the transferor would not exercise and the transferee cannot require that the transferor use its general assets (those other than the loan) to pay off the liability).</p>

<p><i>Accounting Result?</i></p>	<p>Transferor:</p> <ul style="list-style-type: none"> • Derecognise the loan Recognise the call as a derivative <p>Transferee:</p> <ul style="list-style-type: none"> • Derecognise the loan • Recognise the call as a derivative 	<p>Transferor:</p> <ul style="list-style-type: none"> • Continue to recognise the loan in its entirety • Recognise a liability for the proceeds received • Present the liability as a contra-asset to the loan on the statement of financial position <p>Transferee:</p> <ul style="list-style-type: none"> • Recognise a receivable for the cash paid
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Transfer of Non-Readily Obtainable Financial Assets

Transaction 4: Transfer of originated loan with written put at fixed price (assume the put is neither deeply in nor deeply out of the money)

Step	Flowchart 1	Flowchart 2
<i>Asset/Component?</i>	Entire loan	Same as for Flowchart 1
<i>Continuing Involvement?</i>	Yes (put)	Same as for Flowchart 1
<i>Practical Ability to Transfer Asset/Component?</i>	No. The transferee does not have the practical ability to transfer the loan for its own benefit because presumably it would only transfer the loan if it attached the put to it or if it attached a provision to the loan requiring the buyer to return the loan to the transferee if the transferee exercised the put.	Same as for Flowchart 1
<i>Other Access to Asset's/Component's Cash Flows for Own Benefit?</i>	<p>Yes. The transferee currently has access to all of the loan's cash flows given that it can hold onto the loan to maturity and receive, and keep for itself, all the loan's cash flows. Until the transferee exercises the put, the transferor would not presently have access to the loan's cash flows.</p> <p>Note: If one were to treat this transaction as a failed sale and require the transferor to continue to recognise the loan as its asset, that asset would not meet the definition of an asset in the Framework. That is, the transferor does not "[control] a resource...as a result of past events and from which future economic benefits are expected to flow to the entity." The transferor will obtain control over the loan only if the transferee exercises the put. Whether and when the transferee will exercise the put will depend on variables that are outside of both the transferee's and transferor's control (market interest rates, credit of the debtor).</p>	N/A. This test does not exist in Flowchart 2.

<i>Linked Presentation?</i>	N/A. This test does not exist in Flowchart 1.	No. The liability that is created as a result of the failed sale is recourse to the transferor (ie, the transferee can go after the transferor's general assets if the loan's cash flows are not sufficient to pay off the liability).
<i>Accounting Result?</i>	<p>Transferor:</p> <ul style="list-style-type: none"> • Derecognise the loan Recognise the put as a derivative <p>Transferee:</p> <ul style="list-style-type: none"> • Derecognise the loan • Recognise the put as a derivative 	<p>Transferor:</p> <ul style="list-style-type: none"> • Continue to recognise the loan in its entirety • Recognise a liability for the proceeds received <p>Transferee:</p> <ul style="list-style-type: none"> • Recognise a receivable for the cash paid

Transfer of Non-Readily Obtainable Financial Assets

Transaction 5: Transfer of originated loan with *net-settled* total return swap (assume terms of swap reflect market conditions and prices at the time of transfer)

Step	Flowchart 1	Flowchart 2
<i>Asset/Component?</i>	Entire loan	Same as for Flowchart 1
<i>Continuing Involvement?</i>	Yes (total return swap)	Same as for Flowchart 1
<i>Practical Ability to Transfer Asset/Component?</i>	Yes. The transferee has the practical ability to transfer the loan for its own benefit given that it can sell the loan to someone else unilaterally and without having to impose any additional restrictions. Because the swap is net settled, the transferee does not have an obligation to deliver the loan to the transferor upon settlement.	Same as for Flowchart 1
<i>Other Access to Asset's/Component's Cash Flows for Own Benefit?</i>	N/A. Application of this test is not necessary in light of the transferee having the practical ability to transfer the loan for its own benefit (see first test above)	N/A. This test does not exist in Flowchart 2.
<i>Linked Presentation?</i>	N/A. This test does not exist in Flowchart 1.	N/A. Application of this test is not necessary in light of the transferee having the practical ability to transfer the loan for its own benefit (see first test above)
<i>Accounting Result?</i>	<p>Transferor:</p> <ul style="list-style-type: none"> • Derecognise the loan • Recognise the swap as a derivative <p>Transferee:</p> <ul style="list-style-type: none"> • Recognise the loan • Recognise the swap as a derivative 	Same as for Flowchart 1

Transfer of Non-Readily Obtainable Financial Assets

Transaction 6: Transfer of a portfolio of originated loans with servicing retained

Step	Flowchart 1	Flowchart 2
<i>Asset/Component?</i>	Entire loan portfolio	Same as for Flowchart 1
<i>Continuing Involvement?</i>	No. Servicing does not represent continuing involvement in the transferred loan portfolio.	Same as for Flowchart 1
<i>Practical Ability to Transfer Asset/Component?</i>	N/A. Application of this test is not necessary in light of the transferor not having continuing involvement in the transferred loan portfolio (see first test above).	Same as for Flowchart 1
<i>Other Access to Asset's/Component's Cash Flows for Own Benefit?</i>	N/A. Application of this test is not necessary in light of the transferor not having any continued involvement in the transferred loan portfolio (see first test above).	N/A. This test does not exist in Flowchart 2.
<i>Linked Presentation?</i>	N/A. This test does not exist in Flowchart 1.	N/A. Application of this test is not necessary in light of the transferor not having continued involvement in the transferred loan portfolio (see first test above).
<i>Accounting Result?</i>	Transferor: <ul style="list-style-type: none"> • Derecognise the loan portfolio Transferee: <ul style="list-style-type: none"> • Recognise the loan portfolio 	Same as for Flowchart 1

Transfer of Non-Readily Obtainable Financial Assets

Transaction 7: Transfer of *first* 80% interest in a portfolio of originated loans

Step	Flowchart 1	Flowchart 2
<i>Asset/Component?</i>	First 80% of loan portfolio (component)	Entire loan portfolio
<i>Continuing Involvement?</i>	Yes ((a) 20% retained interest + (b) subordination of that interest)	Yes ((a) 20% retained interest + (b) subordination of that interest)
<i>Practical Ability to Transfer Asset/Component?</i>	Yes. Assuming the transferee is not contractually precluded from selling its ‘first 80%’ interest (the component) and assuming a market exists on which it could dispose of that interest, the transferee has the practical ability to transfer the ‘first 80%’ interest for its own benefit.	No. Because the transferor retains a 20% interest in the loan portfolio, the transferee cannot transfer the entire loan portfolio for its own benefit.
<i>Other Access to Asset’s/Component’s Cash Flows for Own Benefit?</i>	N/A. Application of this test is not necessary in light of the transferee having the practical ability to transfer the ‘first 80%’ interest for its own benefit (see first test above)	N/A. This test does not exist in Flowchart 2.
<i>Linked Presentation?</i>	N/A. This test does not exist in Flowchart 1.	Yes. The liability that is created as a result of the failed sale is nonrecourse to the transferor (ie, the transferee cannot go after the transferor’s general assets if the loan’s cash flows are not sufficient to pay off the liability).
<i>Accounting Result?</i>	<p>Transferor:</p> <ul style="list-style-type: none"> • Derecognise 80% of the loan portfolio • Continue to recognise the remaining 20% of the portfolio (measurement would reflect subordination) <p>Transferee:</p> <ul style="list-style-type: none"> • Recognise 80% of the loan portfolio (measurement would reflect credit enhancement) 	<p>Transferor:</p> <ul style="list-style-type: none"> • Continue to recognise the entire loan portfolio • Recognise a liability for the proceeds received • Present the liability as a contra-asset to the loan portfolio on the statement of financial position <p>Transferee:</p> <ul style="list-style-type: none"> • Recognise a receivable for the cash paid