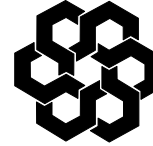




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*These notes are based on the staff papers prepared for the IASB and FASB. Paragraph numbers correspond to paragraph numbers used in the joint IASB-FASB papers. However, because these notes are less detailed, some paragraph numbers are not used.*

## INFORMATION FOR OBSERVERS

**IASB/FASB Meeting:** 20 October 2008, Norwalk  
**Project:** Derecognition of Financial Assets  
**Subject:** Proposed Derecognition Model (Agenda Paper 4A)  
*(please note – this paper was originally presented as Agenda paper 7A at the IASB October 2008 Board meeting. All references refer to that number)*

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## INTRODUCTION

1. This paper sets out –
  - a. the proposed derecognition model for financial assets and
  - b. a summary of the basis for the proposed approach
2. Measurement, gain or loss recognition, presentation and disclosures are all important parts of a derecognition accounting model. The staff will bring

- subsequent papers to the boards addressing these issues, depending on the derecognition approach adopted by the boards. This paper therefore does not discuss these issues in any detail.
3. The derecognition issues discussed in this paper address only financial assets. The staff will address financial liabilities at later a stage in the project.
  4. As explained in Paper 7, the staff believes the boards should consider the following factors in deciding upon a derecognition approach:
    - a. Market environment – calls from regulators and others for an improvement to, and convergence of, current requirements
    - b. Complexity – today’s requirements are difficult to understand and apply
    - c. Convergence – this project is an opportunity to improve and converge IFRS and US GAPP requirements
    - d. User’s requests – users’ request to continue to recognise those items in which the transferor has a continuing involvement
    - e. Divergent views – as to whether transfers in which the transferor has a continuing involvement should be treated as a ‘sale’ or a ‘financing’

## **PURPOSE**

5. The purpose of this paper is to set out the staff’s proposal for a replacement derecognition model for financial assets. The staff will be asking the Board:
  - a. whether the proposed approach merits further work, and if so
  - b. the issues that need to be addressed.

## **THE ISSUE**

### **Under what conditions should an entity derecognise a financial asset?**

6. Derecognising a financial asset is not contentious when the contractual right that gave rise to a financial asset has expired or has been satisfied or cancelled. After these events, the financial instrument has ceased to exist and there is no derecognition issue.

7. Derecognition of financial assets is contentious when the financial asset still exists but the entity has entered into a contract that purports to transfer the asset to another entity and the transferor continues to be involved with the financial asset so transferred.
8. In some transfers, the transferor continues to bear some or all downside risks or retain some or all upside potential of the transferred assets as a result of call or put options, conditional payables or receivables, outright repurchase obligations, or other contractual means.

### **Key Characteristics of Financial Assets**

9. While derecognition of non-financial assets throw up some challenges, accounting issues related to transfers of financial assets are particularly affected by the characteristics of those assets.
10. Most financial assets represent contractual rights to receive cash or another financial asset. (Non-financial assets have an indirect, non-contractual relationship to future cash flows.)
11. Financial assets readily lend themselves to subdivision into components. The components created may later be recombined to restore the original asset or may be combined with other financial instruments to create still different assets. This suggests that a part or component of a financial asset could be derecognised.
12. Furthermore, with financial assets, it is easy to separate legal title from access to future economic benefits. In some situations, legal title and legal ownership of the securities may rest with a nominee, even though the entity has beneficial ownership through its contractual relationship with the nominee. As a result, the nominee has the contractual rights embodied in the financial instrument, but the beneficial owners receive the benefits and have the right to direct how those economic benefits are employed.

13. The staff believes that there is a real difference between financial instruments and non-financial items and that this difference gives rise to different accounting considerations. Due to the significant differences between financial instruments and non-financial items, what is appropriate for financial instruments may not be appropriate for non-financial items.
14. The staff's proposals on derecognition have been developed for application to financial assets. They have not been developed with non-financial assets in mind. However, the staff's proposals may shed some light on the derecognition frameworks for non-financial assets.

## **PROPOSED DERECOGNITION MODEL**

### **The Objectives of the Proposed Model**

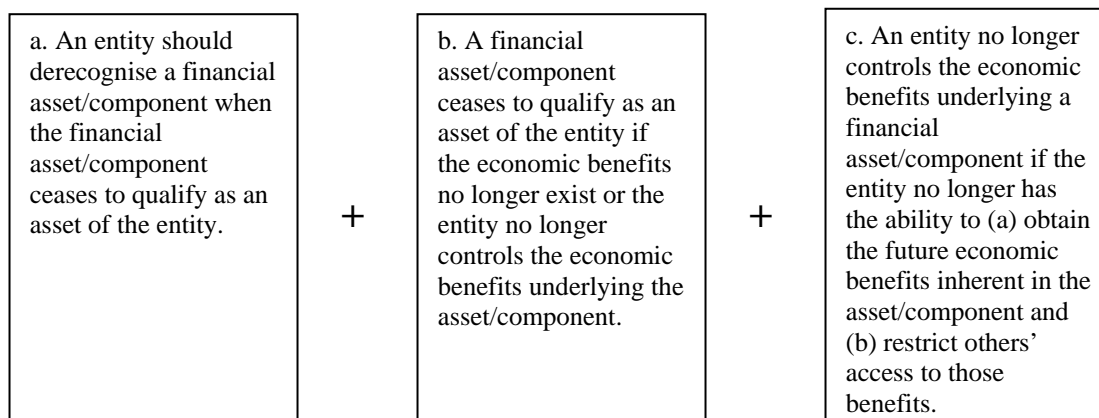
15. The objective of the proposed approach is to provide a derecognition model that:
  - is consistent with both the IASB and FASB conceptual frameworks;
  - is capable of reasonable implementation;
  - is unambiguous and internally consistent; and
  - is sufficiently flexible to analyse and account for both standard and non-standard transactions

### **Fundamental Principles Underlying the Proposed Derecognition Model**

16. The following are the principles underlying the proposed derecognition model:
  - Only items that are assets or liabilities should be recognised and measured as such in financial statements.
  - Financial instruments are made up of bundles of contractual rights and/or contractual obligations (components) that are financial assets and financial liabilities in their own right.

## The Proposed Derecognition Model

17. Based on the above analysis and the background to project (see paragraph 4), the staff proposes the following derecognition principle for financial assets (or components thereof):



### ***Derecognition Model (a+b+c):***

An entity should derecognise a financial asset or component thereof when it no longer qualifies as an asset of the entity (ie 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).

### **Application 1 – No Continuing Involvement**

**The transferor should derecognise a transferred asset (or a component thereof) in its entirety if it has no continuing involvement in the asset (or a component).**

### **Application 2 – Practical Ability to Transfer**

A transferor of a financial asset (or a component thereof) should derecognise the financial asset (or a component thereof) if the transferee:

- (a) has the practical ability to transfer that asset (or component) in its entirety to a third party for its own benefit, and
- (b) is able to exercise that practical ability unilaterally and without needing to impose additional restrictions on the transfer.

## **SUMMARY OF BASIS**

### **Component Derecognition**

18. Financial instruments are made up of bundles of contractual rights and/or contractual obligations, that may be financial assets and financial liabilities in their own right. These bundles of contractual rights and obligations are referred to in this paper as components.
19. Many transfer transactions unbundle those rights and obligations and rebundle them in different ways. Such repackaging is undertaken usually for a commercial reason. Hence if financial statements are to give a faithful representation of transactions and events, the derecognition approach adopted needs to reflect this unbundling and rebundling.
20. The proposed approach therefore treats financial instruments as divisible units (or components) and asks, in respect of each component, whether the circumstances are such that a particular component should be derecognised or whether it should continue to be recognised.
21. This approach is consistent with the way participants in financial markets look at financial assets and manage risk.
22. The staff has not decided on a criteria for determining what constitutes a component.
23. In its purest form (and the most conceptually correct approach) a component of an asset may be defined as the ‘rights and obligations (i.e., assets and liabilities) embedded in that asset.’ This would mean that the right to receive any of the cash flows underlying an asset would in itself qualify as an asset that should be allowed for derecognition if the derecognition criteria is met. This is the approach adopted in Alternative 1 (in paper 7B).
24. Some of the proponents of the above view would amend the foregoing definition to exclude any terms not present in the original financial asset (ie it should not

- have been added in connection with the transfer e.g., a guarantee or subordination)
25. Others argue that in addition to the conditions in paragraph 24, for an item to qualify as a component for derecognition purposes, the item ought to be separately identifiable or specific and pro rata cash flows (consistent with the suggested approach in Alternative 2 of Paper 7B).
  26. If necessary, the staff will address the definition of components in subsequent meetings. The staff might look to the existing definitions of 'part' of an asset under IAS 39 and of 'participation interest' under the exposed FAS 140R (see appendix 1) as a starting point.

### **Symmetry of Accounting**

27. 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).
28. The staff therefore thinks that the transferee's accounting should be the mirror image of the transferor's accounting. In other words, if the transferor is required to derecognise a particular financial asset or component thereof, the transferee should be required to recognise it, and if the transferor is required to continue recognising a particular financial asset or component, the transferee should not recognise it.
29. Logically, the issue of derecognition (ie who controls the economic benefits of an asset) should be assessed from the transferor's perspective. For simple transfer transactions control can easily be assessed from the perspective of the transferor. But for the more complex transactions it is easier to assess control from the transferee's perspective.
30. 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

simpler and easier for users and preparers to assess transfer transactions from the perspective of the transferee.

31. Moreover, as a financial asset is assessed for derecognition after a transfer has taken place, it is therefore necessary and appropriate to assess control (derecognition criteria) at that point from the perspective of the transferee.
32. Assessing control from the transferee's perspective makes the transferor's accounting a function of the rights of the transferee. However the staff notes that the right of the transferee to do as it pleases with an asset may constitute the ultimate evidence that the transferee has given up control. For these reasons and for ease of application, the staff has chosen to apply the proposed derecognition model from the perspective of the transferee.

<p><b>a. An entity should derecognise a financial asset/component when the financial asset ceases to qualify as an asset of the entity.</b></p>
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33. A fundamental purpose of financial reporting is to recognise and measure assets and liabilities of an entity on a reporting date.
34. The primary use of the statement of financial position (in financial reporting) is in assessing the amounts, timing and certainty of future cash flows. Hence the total resources that underlie these future cash flows (and on which income will be earned in the future) should be shown in the statement of financial position together with the means by which they are financed.
35. The Boards' definition of assets and liabilities, in their conceptual frameworks, limits the population of assets and liabilities to the underlying economic resources and obligations of an entity.
36. The definitions of the elements of financial statements are a significant first step in determining the content of financial statements. They screen out items that lack one or more characteristics of assets or other elements of financial statements. Consequently, the definitions of the elements impose limits or restraints on what can be included in assets and liabilities.



37. Thus, when an item fails to qualify as an asset of an entity (as defined under the frameworks), questions should not arise about whether the entity should continue to recognise the asset, how the asset should be measured on the books of the entity or how the entity should display the asset in its financial statements.
38. The IASB Framework defines “assets” in the following terms:  
*‘An asset is a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity’*
39. The definition of an asset from FASB Concept Statements 6 is similar:  
*‘Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.’*
40. Concepts Statements 6 also states:  
*‘The kinds of items that qualify as assets under the definition in paragraph 25 are also commonly called economic resources. They are the scarce means that are useful for carrying out economic activities, such as consumption, production, and exchange.’*
41. The Boards have agreed the following working definition of an asset as part of the Conceptual Framework Project:  
*‘An asset of an entity is a present economic resource to which the entity, through an enforceable right or other means, has access or can limit the access of others’*
42. An asset has two essential characteristics and an item does not qualify as an asset of an entity if it lacks one or more of these essential characteristics:
- (a) it represents “future economic benefits” that “are expected to flow to the entity”
  - (b) the right to the expected future benefits is “controlled by the entity”

**b. A financial asset/component ceases to qualify as an asset of the entity if the economic benefits no longer exist or the entity no longer controls the economic benefits underlying the asset/component.**

43. Future economic benefit and control of that benefit are the essence of an asset.
44. The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. That potential may be a productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production (paragraph 53, IASB Framework).
45. The future economic benefit embodied in a financial asset is the contractual right to future cash flows. For example, receivables are expected to generate cash, which is their only function.
46. To assess whether a particular item constitutes an asset of a particular entity at a particular time requires at least a consideration of:
  - a. whether the item obtained by the entity embodied future economic benefits in the first place;
  - b. whether all or any of the future economic benefits to the entity remain at the time of assessment; and
  - c. if the future economic benefits exist, whether the entity controls them.
47. Thus if the economic benefits underlying the financial asset ceases to exist or is extinguished, the entity should remove the asset from its financial statement.
48. Also, if control over the future economic benefits has been relinquished, the asset or a component thereof has been sold and should be derecognised and vice versa.

**c. An entity no longer controls the economic benefits underlying a financial asset/component if the entity no longer has the ability to (a) obtain the future economic benefits inherent in the asset/component and (b) restrict others' access to those benefits.**

49. The definition of an asset focuses on 'control of economic benefits' and hence the concept of control is fundamental to the determination of whether an entity has an asset (or a component thereof).
50. The staff believes that the issue of 'control' is at the heart of the derecognition issue and that the appropriate derecognition approach is, in effect, to ask whether the transferor has relinquished or surrendered control of the economic benefits underlying the asset 'transferred'.
51. 'Control' in terms of an asset is the means by which the entity ensures that the economic benefits accrue to it and not to others.
52. Hence to have an asset, an 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.
53. As the future economic benefit embodied in a financial asset is the right to future cash inflows, 'control' in context of financial assets means, in general terms, the ability to obtain (access) the future cash inflows and the ability to restrict the others access to those future cash inflows.
54. Under the current definitions of an asset, only present abilities to obtain future economic benefits are assets under the definition but not items that may in the future become an entity's assets but have not yet become its assets.
55. Hence an entity has no asset for a particular future economic benefit if the entity would have access to and control of the benefit in the future. Also, an entity is considered to still have an asset if the entity's access to and control of the economic benefit would be removed, but the event that would remove its access or control of the economic benefits is in the future.

### **Application 1 – No Continuing Involvement**

**The transferor should derecognise a transferred asset (or a component thereof) in its entirety if it has no continuing involvement in the asset (or component).**

56. A transferor will have no continuing involvement in a financial asset if it neither retains any of the contractual rights that represented that asset nor obtains any new contractual rights or contractual obligations relating to the asset, i.e., if it has no interest in the future performance of that asset and no responsibility to make payments in the future in respect of the asset under any circumstance.
57. Based on the above, servicing retained by a transferor will constitute a continuing involvement in the asset transferred. The staff believes an exception ought to be made for servicing contracts that qualifies as fiduciary (or agency) relationships.
58. The servicer stands in a fiduciary or agency position if the servicer's role is that of a service provider which is contractually obligated to perform its duties (at market rates for such services) in the best interest of the transferee (in this case the entity that owns the asset).
59. The existence of a continuing involvement in the transferred asset could mean that the transferee's ability to obtain and restrict others access to the future economic benefits is constrained and control of the economic benefits has not passed.
60. However, in transfers that leave the transferor with no continuing involvement in the transferred asset, it is clear that control over the economic benefits underlying the asset has been relinquished.
61. The staff therefore concludes that the first criterion in assessing whether the transferor has relinquished control of the economic benefits is to assess whether the transferor has any continuing involvement with the transferred asset. If the transferor has no continuing involvement of any kind in the transferred asset, it no longer controls the economic benefits underlying the asset.

62. Hence Application 1 of the staff proposal requires a transferred asset to be derecognised by the transferor if the transferor no longer has a continuing involvement in that asset. This will be the case for many straightforward transactions where one entity transfers all its rights and obligations relating to a financial asset to another entity and acquires no new rights and obligations relating to that asset.
63. The staff has not decided on a definition for continuing involvement but we intend basing any improved definition on the existing definitions under FAS 140 and IAS 39 (please see appendix 2).

**Application 1 - Practical Ability to Transfer**

A transferor of a financial asset should derecognise the financial asset (or a component thereof) if the transferee:

- (a) has the ability to transfer that asset (or component) in its entirety to a third party for its own benefit and
- (b) is able to exercise that practical ability unilaterally and without needing to impose additional restrictions on the transfer.

64. The future economic benefits embodied in an asset may flow to an entity in a number of ways.
65. The staff however believes that the following are the main and most common means by which an entity can obtain the economic benefits of a financial asset:
- a. the asset may be exchanged for other assets or
  - b. the asset may be used to settle a liability or
  - c. the asset may be distributed to the owners of the entity (together 'transfer')
66. If the transferee is free and able to transfer a financial asset in any of the above ways, 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.

67. This interpretation is consistent with the notion that the entity that has an asset is the one that can within limits set by the nature of the benefit or the entity's right to it, use as it pleases.
68. The staff believes that an entity is only able to give control of an asset to a third party if the entity itself has that control.
69. For instance, if the transferee is free and able to transfer (ie practically able to transfer) the asset to a third party, any such transferee would obviously have control over the economic benefits underlying the asset and the asset would qualify as an asset of that third party.
70. As the item would qualify as the asset of the third party, we can conclude that the third party controls the economic benefits. This implies that the original transferee must have had control over those economic benefits.
71. Assessing whether the transferee has the practical ability to transfer the asset would require judgement. Whether the transferee does or not can only be assessed after considering all the relevant facts and circumstances. The following paragraphs discuss the transferee's practical ability to unilaterally transfer an asset without needing to impose additional restrictions on the transfer.
72. The 'practical ability to transfer' test is currently in IAS 39 but is placed towards the bottom of the decision tree (embedded in the control test). This proposal would make this the primary derecognition test, consistent with a control-based model. A similar concept is in FAS 140 (ie 'does the transferee have the ability to transfer or pledge the transferred asset'). However passing this test alone would not qualify a transferred asset for derecognition under FAS 140 as all the requirements under paragraph 9 of FAS 140 would have to be met before an item can derecognised.

### **Unilateral Ability to Transfer Without Attaching Restrictions**

73. The proposed model would require that the assessment by the transferor as to whether a contract constrains a transferee be made once only, at the date of transfer. That requirement reflects the Staff's view that, regardless of the merits

- that any alternative approach might have, it would be impractical to require the transferor to re-evaluate such contracts and, if necessary, change the accounting treatment of the transfer, on an ongoing basis throughout the life of the contract.
74. The key issue is what the transferee is able to do in practice rather than contractual rights or contractual prohibitions the transferee has regarding the asset.
  75. 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. For example, a contractual prohibition on transfers to third parties may have no practical effect (and may therefore not prevent the transferee from having the practical ability to transfer the asset to a third party) if replacement assets are readily available, because the transferee may be able to transfer the asset and still satisfy the prohibition by obtaining a replacement asset.
  76. For similar reasons, a limitation imposed by the transferor on the specific parties to whom the transferee can transfer the asset may have no practical effect if replacement assets are readily available.
  77. For this purpose, replacement assets are deemed to be readily available only if the asset is actively traded on an accessible market.
  78. 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, that consent can be withheld without reason, and that restriction is effective in practice.
  79. 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 asset unilaterally.
  80. 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. The retention by the transferor of a right to match a bona fide offer

- received by the transferee from a third party will also not prevent the transferee from having the practical ability to transfer the asset to a third party.
81. Similarly, the Staff believes that, if a transferee has to attach additional restrictions on a transfer of a transferred asset to a third party in order to protect itself from losses that it would otherwise incur on the transfer, it is economically impeded from, and therefore not practically free and able to, transfer to a third party the whole of the asset that was previously recognised by the transferor.
82. Also, 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. 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.

#### **Application of the practical ability to transfer test to Call and Put Options**

83. If a transferee writes 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. If the transferee transfers the asset and the transferor exercises the call option, the transferee may be unable to get back the asset in order to deliver it to the transferor. The existence of the call option therefore means that the transferee is not free to transfer the asset without restrictions.
84. However, if the assets involved are not capable of being easily replaced, but because of market convention, other established practice or an express or implied term of the transaction, it is 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, a call option of the type described in the preceding paragraph will not prevent the transferee from transferring the asset.



85. In the case of a transfer of a non readily obtainable financial asset whereby the transferee retains a put option over the transferred asset, or over a component of the asset, the transferee is likely to be economically impeded from transferring the asset (or component) unencumbered by an option or right to reacquire, since the transferee would not then be able to exercise its retained put option.
86. Although a transferee is, in theory, always free to choose not to exercise a put option, in reality a put option that is virtually certain to be exercised 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.
87. As explained in paragraph 73, the proposed model requires that the assessment by the transferor as to whether an option constrains a transferee be made once only, at the date of transfer. That requirement reflects the Staff's view that, it would be impractical to require the transferor to re-evaluate the option and, if necessary, change the accounting treatment of the transfer, on an ongoing basis throughout the life of the option.
88. However, the proposed model would treat the expiry or unexercise of an option previously considered to be constraining as a recognition/derecognition event.

### **Practice Implications of the Practical Ability to Transfer Test**

89. The major implication of Application criteria 2 is that if the transferee is free and able to transfer the transferred asset, whatever the nature of the transferor's continuing involvement in the asset, the transferor must have passed control of the economic benefits to the transferee.
90. As most sale and repurchase agreements involving financial assets (repo transactions) concern the transfer of one easily replaceable security in exchange for another easily replaceable security, an implication of Application criteria 2 is that most repo transactions will, under the proposed model, be treated as involving the sale of the transferred assets.
91. That means that each party to the transaction will derecognise the security it had been recognising prior to the transaction and each will recognise the security

received in return. In most jurisdictions around the world this will represent a fundamental change in accounting treatment because, to date, sale and repurchase agreements have generally been treated as secured borrowings, and stock lending transactions have generally not affected the assets and liabilities recognised in the statement of financial position.

92. The Staff recognises that this is a change that will have a major impact on the reported financial position of many entities. The Staff is also aware that FASB concluded, in FASB Statement 140, that the nature of the transactions was ambiguous and that a change in practice could not be justified. Nevertheless, for the reasons set out above the Staff believes its proposal to be appropriate.

### **Merits of the Proposed Approach**

93. Application of the proposed derecognition principle in some instances may generate results that differ considerably from present practice. The proposed model could either increase or decrease reported assets and liabilities.
94. However, the proposed approach is consistent with the conceptual framework and provides greater consistency in the way entities report similar events and would thereby enhance comparability of financial statements.
95. The staff believes that one significant advantage of the proposed approach is that the expectations of future cash in-flows that are controlled by the transferor, and the risks that arise from those expectations, will be correctly stated on the statement of financial position and in the note disclosures analysing the statement of financial position amounts.
96. Against the backdrop for the project (outlined in paragraph 4), the proposed approach have the following additional merits:
- it provides a clear and consistent framework that ensures clarity of treatment whilst retaining sufficient flexibility to analyse non-standard transactions in a coherent and consistent manner.

- approach is principles-based and more robust to change and thus more likely in the long term to yield accounts that reflect economic reality.
- it reflects the economic consequences of contractual provisions underlying financial assets and liabilities.
- the principles are applied by both transferors and transferees, resulting in mirror image accounting

### **Perceived Drawbacks of the Proposed Approach**

97. Many believe that removing an asset from the statement of financial position of an entity where the asset no longer qualifies as an asset of the entity (as defined under the Framework), does not provide a true picture of the risks or exposures of the entity.
98. The staff disagrees with this assertion. The staff notes that conservatism is not a separate qualitative characteristic in the qualities that make accounting information useful.
99. Accounting is not an end in itself. The justification for accounting can be found only in how well accounting information serves those who use it.
100. The staff's view is that the appropriate way to treat uncertainty (conservatism) is to disclose its nature and extent honestly, so that those who receive the information may form their own opinions of the probable outcome of the events reported. The staff believes that it is not the accountant's job to protect investors, creditors, and others from uncertainty, but only to inform them about it.
101. The allocation of risks between different economic agents is a central part of financial intermediation, and financial statements should adequately reflect the allocation and magnitude of the exposure to risks.
102. If financial statements are to faithfully represent an entity's financial position and changes in financial position, none of the significant financial functions of the entity or its relationships can be lost or distorted.

103. The staff believes that the proposed approach coupled with adequate disclosures would provide a more representationally faithful and reliable model and would provide relevant information to investors and creditors.

## **INTERACTION WITH OTHER PROJECTS**

### **Interaction with the Conceptual Framework Project**

104. Although the staff acknowledge that this project interacts and could be impacted by other on going projects, the staff does not believe that completion of this project have to await completion of other projects.
105. While there is an overlap between this project and the Boards' project on the conceptual framework, the staff does not think that it is necessary (or prudent) to delay the derecognition project until the completion of the conceptual framework project. The staff notes that the proposed derecognition principle is consistent with both the existing and draft conceptual frameworks and the definitions of the elements of financial statements in those frameworks.

### **Interaction with the Consolidation Project**

106. Likewise with the project on consolidation. Some transfers involving financial assets can give rise both to derecognition issues and consolidation issues. For example, it may be that an entity transfers a financial asset to an entity that may be part of the transferor's group for financial reporting purposes. In such circumstances, it is necessary first to decide whether the transferor should derecognise the transferred asset and then to decide whether the transferee forms part of the transferor's group.
107. Some believe that the same criteria should be used to address both these issues and that the two issues should therefore be looked at together. Others believe that, although they are not the same issue (and, as a result, different criteria may be involved), a derecognition framework that addresses the derecognition of financial assets in an individual entity's financial statements without also addressing consolidation issues is incomplete.

108. The interaction between the consolidation and derecognition question has to be considered, but the staff believes they are two separate questions.
109. The staff is monitoring the progress and the approach the Boards are taking on consolidation of reporting entities to ascertain any potential conflicts or inconsistencies.
110. The staff notes that the core principle of the proposed derecognition model – the ability to obtain and restrict others to the economic benefits underlying a financial asset is consistent with the approach proposed in the draft IASB consolidation standard (ie focus on power and benefit in ascertaining control).
111. The draft consolidation model is based on control of a reporting entity. Control in that context, is defined as the power to govern the operating and financial policies of an entity so as to obtain the benefits (ie focuses on power and benefit as the key indicators of control).
112. The staff’s proposed model is also control based. ‘Control’ in context of financial assets is analysed in this paper as the ability to obtain (‘power’) the future cash inflows and the ability to restrict the others access to those future cash inflows (‘benefit’).
113. Hence the approach adopted for this project is consistent with the approach the board is proposing for the consolidation project.
114. In particular the staff would like to draw the Boards attention to the treatment of potential voting rights, which is similar to the treatment of transfers of a readily-obtainable financial asset together with a purchased call option (under Alternative 1 in Paper 7B).

## **QUESTIONS FOR THE BOARD**

115. The staff proposes that a financial asset previously recognised by the transferor to be derecognised:

- a) If the transferor has no continuing involvement with the asset transferred; or
- b) If the transferee has the practical ability, which it can exercise unilaterally and without imposing additional restrictions, to transfer an asset or a component thereof to a third party for its own benefits.

[Further possible additional derecognition steps that might follow on from the ones discussed in this paper are discussed in paper 7B. Therefore, in this paper, we are only asking for the boards' views on the core derecognition steps set out in this paper].

116. Question to the boards: Do you agree with the proposed approach? If not, how would you change the proposed approach, and why?

## **APPENDIX 1 – Definition of part of an asset and participation interest**

### **Paragraph 16, IAS 39**

‘Before evaluating whether, and to what extent, derecognition is appropriate under paragraphs 17-23, an entity determines whether those paragraphs should be applied to a part of a financial asset (or a part of a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety, as follows.

(a) Paragraphs 17-23 are applied to a part of a financial asset (or a part of a group of similar financial assets) if, and only if, the part being considered for derecognition meets one of the following three conditions.

(i) The part comprises only specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an interest rate strip whereby the counterparty obtains the right to the interest cash flows, but not the principal cash flows from a debt instrument, paragraphs 17-23 are applied to the interest cash flows.

(ii) The part comprises only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of all cash flows of a debt instrument, paragraphs 17-23 are applied to 90 per cent of those cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the cash flows provided that the transferring entity has a fully proportionate share.

(iii) The part comprises only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of interest cash flows from a financial asset, paragraphs 17-23 are applied to 90 per cent of those interest cash flows. If there is more than one counterparty, each counterparty is not required to have a proportionate share of the specifically identified cash flows provided that the transferring entity has a fully proportionate share.

(b) In all other cases, paragraphs 17-23 are applied to the financial asset in its entirety (or to the group of similar financial assets in their entirety). For example, when an entity transfers (i) the rights to the first or the last 90 per cent of cash collections from a financial asset (or a group of financial assets), or (ii) the rights to 90 per cent of the cash flows from a group of receivables, but provides a guarantee to compensate the buyer for any credit losses up to 8 per cent of the principal amount of the receivables, paragraphs 17-23 are applied to the financial asset (or a group of similar financial assets) in its entirety.

In paragraphs 17-26, the term ‘financial asset’ refers to either a part of a financial asset (or a part of a group of similar financial assets) as identified in (a) above or, otherwise, a financial asset (or a group of similar financial assets) in its entirety.’

### **FAS 140R – Paragraph 8B**

‘The requirements of paragraph 9 apply to transfers of an individual financial asset in its entirety, transfers of groups of financial assets in their entirety, and transfers of a **participating interest** in an individual financial asset (which are referred to collectively in this Statement as *transferred financial assets*). A participating interest has the following characteristics:

- a. It represents a proportionate ownership interest in an entire individual financial asset other than an equity instrument, a **derivative financial instrument**, or a hybrid financial instrument with an embedded derivative that is not clearly and closely related as described in Statement 133.
- b. All cash flows received from the asset are divided among the participating interests (including any interest retained by the transferor, its **consolidated affiliates** included in the financial statements being presented, or its **agents**) in proportion to the share of ownership represented by each. Cash flows allocated to a servicer as compensation for servicing activities, if any, shall not be included in that determination. The transferor’s ownership shares must remain pro rata over the life of the original financial asset. Participating interests may be further apportioned by the transferor as long as the resulting portions meet the definition of a participating interest.
- c. The rights of each participating interest holder (including the transferor if it retains a participating interest) have the same priority, and that priority does not change in the event of bankruptcy or other receivership of the transferor, the original debtor, or any participating interest holder. Participating interest holders have no recourse, other than standard representations and warranties, to the transferor (or its consolidated affiliates included in the financial statements being presented or agents) or to each other, and no participating interest holder is subordinated to another. That is, no participating interest holder is entitled to receive cash before any other participating interest holder in its role as a participating interest holder.
- d. No party has the right to pledge or exchange the entire financial asset. If a transfer of a portion of an individual financial asset meets the definition of a participating interest, the transferor shall apply the guidance in paragraph 9. If a transfer of a portion of an individual financial asset does not meet the definition of a participating interest, the transferor and transferee shall account for the transfer in accordance with the guidance in paragraph 12.’



## **APPENDIX 2 – Definition of Continuing Involvement**

### **Paragraph 30, IAS 39**

#### **Continuing Involvement in Transferred Assets (see paragraph 20(c)(ii))**

‘If an entity neither transfers nor retains substantially all the risks and rewards of ownership of a transferred asset, and retains control of the transferred asset, the entity continues to recognise the transferred asset to the extent of its continuing involvement. The extent of the entity’s continuing involvement in the transferred asset is the extent to which it is exposed to changes in the value of the transferred asset. For example:

(a) when the entity’s continuing involvement takes the form of guaranteeing the transferred asset, the extent of the entity’s continuing involvement is the lower of (i) the amount of the asset and (ii) the maximum amount of the consideration received that the entity could be required to repay (‘the guarantee amount’).

(b) when the entity’s continuing involvement takes the form of a written or purchased option (or both) on the transferred asset, the extent of the entity’s continuing involvement is the amount of the transferred asset that the entity may repurchase. However, in case of a written put option on an asset that is measured at fair value, the extent of the entity’s continuing involvement is limited to the lower of the fair value of the transferred asset and the option exercise price (see paragraph AG48).

(c) when the entity’s continuing involvement takes the form of a cash-settled option or similar provision on the transferred asset, the extent of the entity’s continuing involvement is measured in the same way as that which results from non-cash settled options as set out in (b) above.’

### **FAS 140R**

#### **Continuing involvement**

Any involvement with the transferred financial assets that permits the transferor to receive cash flows or other benefits that arise from the transferred financial assets or that obligates the transferor to provide additional cash flows or other assets to any party related to the transfer. Examples of continuing involvement include, but are not limited to, servicing arrangements, recourse or guarantee arrangements, agreements to purchase or redeem transferred financial assets, derivative instruments related to the transferred financial assets, implicit commitments to provide financial support, pledges of collateral, or the transferor’s beneficial interests.