Financial Accounting Standards Board

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INFORMATION FOR OBSERVERS

IASB/FASB Meeting:	**20 October 2008, Norwalk**
Project:	**Derecognition of Financial Assets**
Subject:	**Lack of Practical Ability to Transfer – Now What? (Agenda Paper 4B)** ***(please note – this paper was originally presented as Agenda paper 7B at the IASB October 2008 Board meeting. All references refer to that number)***

Introduction

1 This paper addresses those circumstances in which the transferee does not have the practical ability to transfer all or a defined part (component) of a financial asset for its own benefit. This is often the case when a transferee purchases a non-readily obtainable financial asset in which the transferor continues to be exposed to some or all of the risks and/or rewards.

2 This paper sets out two possible approaches to deal with those circumstances:

a) Approach 1: Other Present Access to the Asset's Cash Flows for Own Benefit

b) Approach 2: Lack of Practical Ability to Transfer = No Control = No Derecognition, but Some Form of Linked Presentation.

3 Both of these approaches would follow after the test of practical ability to transfer, as discussed in Paper 7A.

4 This paper:

a) describes the two approaches;

b) compares and contrasts the two approaches;

c) sets out a staff recommendation; and

d) asks the boards how they would like to proceed.

5 The factors the Board might consider in assessing the two approaches described in this paper are set against the issues described in Paper 7A, namely:

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 GAAP requirements

d) *User's requests* – users' requests not to derecognise 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'

Approach 1: Other Present Access to the Asset's Cash Flows for Own Benefit

6 The principle (in Paper 7A) underlying the proposed derecognition approach is that an entity should derecognise a financial asset or component thereof when it

ceases to control the underlying cash flows (ie, when it no longer has the present ability to (a) obtain those cash flows and/or (b) restrict others' access to them).

7 Paper 7A proposes that the main way by which an entity can obtain the cash flows of a financial asset or component thereof is via *transfer* of that asset or component to someone else in exchange for other asset(s), in settlement of liability or as a distribution to the entity's owners.

8 Therefore paper 7A proposes a derecognition test for the transferor that is based on whether the transferee has the practical ability to transfer the asset.

Other *Present* ***Access to the Cash Flows*** *for its Own Benefit*

9 Another way of obtaining the cash flows of a financial asset or component thereof is via entitlement by contract or otherwise to receive all of the cash flows of that asset or component. For example, a bank selling a pool of loans it originated might restrict the buyer (transferee) from selling those loans because it wants to protect its relationship with the debtors/customers underlying the loans. In this case, even though the buyer (transferee) is precluded from selling the loans, it is contractually entitled to receive any and all cash flows that the loans generate.

Other Present Access to the Cash Flows ***for its Own Benefit***

10 The staff believes that being entitled to receive all of the cash flows of a financial asset or component thereof (the "(a) part" in paragraph 6) is not sufficient for assessing control over those cash flows. This is because the entity might be required by contract or otherwise to pass on the cash flows it receives to someone else (thus failing the "(b) part" in paragraph 6).

11 In the example in paragraph 9 the bank that sold a pool of originated loans will continue to receive the interest and principal cash flows from the underlying debtors. However, it will not receive the cash flows *for its own benefit* because it must forward them to the buyer (transferee) of the loans. Therefore, the bank's role in collecting the cash flows and distributing them to the buyer (transferee) is

that of an agent. As a result, the buyer (transferee), not the bank, has control over the cash flows of the loan portfolio.

*Other **Present** Access to the Cash Flows for its Own Benefit*

12 A transferor has not passed control over the cash flows of a financial asset to a transferee if the transferee does not *currently* have access to those cash flows. Why? Implicit in the definition of assets in the IASB's and FASB's conceptual frameworks is that control is current.[1] This means that the ability to get access to a financial asset's cash flows (ie that ability is conditioned on something else) is not equivalent to having control over that asset.

13 Take a transfer of a loan, with an associated contract whereby the transferor has the right to repurchase the loan at a fixed price. Based on the analysis in the previous paragraph, the transferor has passed control to the buyer (transferee) because the buyer (transferee) will receive all cash flows that the loan generates unless the buyer exercises its right and pays the fixed price. Accordingly, the right the transferor has is a right to *get* access – not a right entitling the entity to *presently have* access – to the loan's cash flows.

14 The staff points out that the ability to *obtain* control is different from *current* control is consistent with the draft IASB exposure draft, *Consolidated Financial Statements*. In other words, a call option over an asset does not give the holder control of that asset.

In summary…

15 Approach 1 would follow the 'practical ability to transfer' test that is described in paper 7A.

16 If an entity does not have the practical ability to transfer all or part of a financial asset, Approach 1 would allow derecognition if the transferee presently controls

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[1]See paragraphs 49 and 58 in IASB's *Framework for the Preparation and Presentation of Financial Statements* and paragraph 25 of FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*.

(by receiving and keeping for its own benefit) the cash flows of that asset or part of the asset – and therefore the transferor does not control the asset. Similar to the principle of practical ability to transfer discussed in Paper 7A, Approach 1 also looks to the power over the benefits that *the transferee* has to determine whether *the transferor* has control.

17 If the Board decides on Approach 1, the staff would propose to make this principle operational by the asking the following question in relation to the financial asset that the transferor previously recognised on its statement of financial position:

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

18 If the answer is ‘yes’, the transferor would derecognise all or some of the transferred asset and recognise any new assets or liabilities created in the transfer. If the answer is ‘no’, the transferor would not derecognise the transferred financial asset, but rather set up a liability equal to the proceeds received. The transferee’s accounting would be the mirror image of the transferor’s.

19 The application of Approach 1 is illustrated in some examples in Agenda Paper 7C. The inclusion of Approach 1 in the proposed derecognition model is also illustrated in Flowchart 1 (included in the appendix to this paper). Note that Approach 1 is in relation to ‘the Asset’ (ie, the entire asset or a component thereof as so determined in the first step of the flowchart).

Approach 2: Lack of Practical Ability to Transfer = No Control = No Derecognition, but Some Form of Linked Presentation

Lack of Practical Ability to Transfer = No Control = ***No Derecognition****, but some form of Linked Presentation*

20 Approach 2 reflects the difficulty in assessing control if a transfer has not resulted in the transferee obtaining the practical ability to transfer the purchased financial asset to someone else for its own benefit. This is often the case if the transferor

continues to be involved in the performance of a non-readily obtainable financial asset following a transfer in some form or manner. For example, the transferor might have transferred some or all of the upside potential, but retained some or all of the downside risk (or vice versa), or the entity might have transferred some of the risks *and* rewards, but not all.

21 Approach 2 draws a line and concludes that, if the transferee does not have the practical ability to transfer the purchased asset, control has not passed from the transferor to the transferee.

22 Approach 2 is a compromise: it is based on control for those arrangements for which it can is relatively easier to determine where control lies, but it disallows derecognition if the transferor's continuing rights and obligations with respect to the transferred assets are so significant that it is unclear whether control over the assets has passed to the transferee.

23 It is important to note that Approach 2 results in the transferor continuing to recognise the asset in its entirety, irrespective of any part of the transferred asset in which the transferor no longer has any continuing involvement. This is different than, for example, the IAS 39 continuing involvement model.

Lack of Practical Ability to Transfer = No Control = No Derecognition, ***but Some Form of Linked Presentation***

24 Approach 2 would require (in some situations) a liability that is created in a transfer of a financial asset that does not qualify for derecognition to be presented as a contra-asset to that asset on the transferor's statement of financial position (similar to how an allowance for bad accounts receivables can be presented). This presentation is referred to as 'linked presentation'.

25 As rationale for this presentation, the staff quotes the draft staff report on derecognition of financial assets and liabilities, , which states that :

> linked presentation provides valuable information by more visibly identifying those liabilities that will be settled based on a connection to economic benefits generated by specific assets. Furthermore by providing information about the recognised financial asset, the recognised financial liability and the difference

between asset and liability, users of financial statements are placed in the position to decide for themselves whether as a result of the amounts, timing, and uncertainty of the entity's future cash inflows and outflows it is better to use the information provided by the gross assets and gross liabilities, or the net position.

26 The staff points out that linked presentation is not the same as derecognition. Linked presentation would apply only if it is determined that a transfer does not qualify as a sale *and* then only if particular conditions are met. Linked presentation does not cause the transferor to derecognise the 'transferred' financial assets; it simply requires the transferor to present the created liability against those assets on the transferor's statement of financial position.

27 At this stage, the staff does not have a recommendation as to the circumstances it is necessary to apply linked presentation. However, the simplest circumstance that linked presentation would be required is if the liability arising from a failed sale is akin to a nonrecourse loan. That is, the transferee can look only to the cash flows of the 'transferred' financial asset for repayment, not to any of the transferor's other assets.

28 Approach 2 would follow the 'practical ability to transfer' test that is described in paper 7A.

29 If the Board decides on Approach 2, the staff would propose the following for a transfer of all or part financial asset that fails the 'practical ability to transfer' test (as with the other approach, the transferee's accounting is the mirror image of the transferor's):

a) **Do not derecognise the asset or component thereof. Recognise a liability for the proceeds received.**

b) **Determine if linked presentation is required.**

30 The application of Approach 2 is illustrated in some examples in Agenda Paper 7C. The inclusion of Approach 2 in the derecognition model is also illustrated in Flowchart 2 (included in the appendix to this paper).

Comparing the Approaches

31 The table on the following pages compares and contrasts each approach in the context of the derecognition models in Flowchart 1 and Flowchart 2:

Approach	Advantages	Disadvantages
Approach 1	• Consistent with the control-based principle underlying the staff's derecognition approach (ie, being able to obtain the economic benefits and restrict others access to those the underlying cash flows signifies control) • Given its focus on control over an asset's economic benefits (ie, cash flows benefits to the entity), it is consistent with the definition of assets and liabilities in the IASB and FASB Frameworks than Approach 2 • In almost all cases, economically similar transactions will be accounted for similarly (ie, assets are less 'sticky' than the other approach) • Given its clear focus on control, simpler and easier to apply than the current derecognition in model in IAS 39, which is a mixed model based on risks and rewards/continuing involvement and control • Principles-based	• More derecognition than today, or than under the other approach if the transferred assets are 'unique' (not readily obtainable) and the transferor continues to be exposed to the risks and rewards of those assets. Not consistent with views expressed by some users and regulators, especially in the current market environment[2] • Closer to convergence with the proposed amendment to FAS 140 than the current model in IAS 39 (given the focus towards control), but not as close as Approach 2 (given the FAS 140 ED defines what qualifies as 'components' restrictively, similar to Approach 2)
Approach 2	• Simpler and easier to apply than the current derecognition model in IAS 39 *and* than Approach 1	• Relative to Approach 1, less derecognition of assets and liabilities by the transferor but recognition of assets and

[2]For example, the Investors Technical Advisory Committee suggested that a transferor should be precluded from derecognising a transferred financial asset if it has *any* continuing involvement in it. See reference to that Committee's recommendation in paragraph 28 of Appendix A to the proposed amendment to FASB Statement No. 140, *Accounting for Transfers of Financial Assets*, which the FASB exposed for comment on September 15, 2008.

	• Similar to the model in the proposed amendment to FAS 140 • Relative to Approach 1, more consistent with calls by users and regulators for a restrictive derecognition model if the transferor has any continuing involvement (especially in the current market environment) • Some constituents see this approach as focusing on the substance of transactions rather than on how they are documented in the underlying contracts (eg, some feel that a sale of a non-readily obtainable financial asset with a written put at a fixed price is not a *real* sale (even though it is documented as such) but a 'parking transaction because the credit risk of the debtor underlying the financial asset remains with the transferor).	liabilities that are not consistent with the definition of assets and liabilities in the IASB Framework (eg, a transfer of a financial assets that the transferor can call at a fixed price will not qualify as a sale under Approach 2 (but will under Approach 1). The resulting liability arguably does not meet the definition of a liability in the Framework (see Transaction 3 in Paper 7C). • Relative to Approach 1, 'history matters', ie, fewer transactions that are economically similar will be accounted for similarly (see treatment of transfers with purchased calls and written puts in Paper 7C) • Will not allow for partial derecognition even though the transferor's continued involvement in the transferred assets is limited (eg, a transfer of a first 80% interest in a loan portfolio will not qualify for derecognition of any part of the loan portfolio even though the first 80% of the cash flows generated by the portfolio will go to the transferee – see Transaction 7 in Paper 7C for more details)

32 With these issues in mind, the staff analysed each approach against the factors the staff believe the Boards should consider (as identified in Paper 7), as follows:

	Winner?	Why?
Market environment	Approach 2	Approach 2 is much more restrictive than Approach 1 in that fewer financial assets and portions thereof would qualify for derecognition.
User's requests	Approach 2	Approach 2 is consistent with the views expressed by many users who have called for no derecognition if the transferor has any continuing involvement in the transferred assets.

		However, both approaches do not contain the risk and rewards filter that is in IAS 39 – this will result in derecognition of some items that would not be derecognised in IAS 39 today (for example, fixed-price repos of liquid securities. Furthermore, both approaches assume that control over the cash flows of a financial asset has passed if the transferee has the practical ability to transfer that asset for its own benefit. As a result (and as said above), repos of liquid securities will qualify for derecognition. This is different from how control is assessed in FAS 140. FAS 140 focuses on control over the specific asset (not the cash flows of that asset) that is the subject of a transfer. If the transferor though a forward is obligated to repurchase the same or substantially the same asset it transferred to the transferee, FAS 140 would say that control has not passed.
Complexity	Approach 2	Approach 2 is less complex than existing requirements. Also Approach 2 is simpler than Approach 1
Convergence	n/a	Approach 2 is similar to the FAS 140 ED in many ways.
Divergent views	Approach 2	Approach 2 focuses on (a) control of the asset by the transferee (the 'practical ability to transfer' test) and (b) drawing a line if it is unclear who has control. Approach 2 reflects the divergent views relating to the accounting treatment of transfers that involve non-readily obtainable financial assets in which the transferor continues to be exposed to some or all of the risks and/or rewards after the transfer.

Staff Recommendations

33 Although the staff believes that Approach 1 is the conceptually correct approach, the staff recommends that the Board select Approach 2 to develop further for the following reasons:.

a) Approach 2 reflects request's by users and others in the current market environment for a model that places a high hurdle on derecognising financial assets when a transferor has some form of continuing involvement after the transfer.

b) Approach 2 acknowledges the diversity in views on this topic and creates a clear-cut line to distinguish between transfers that are accounted for as ‘sales’ and ‘financings’.

c) Approach 2 is simpler to understand and apply than Approach 1 as well as existing requirements.

Questions for the Board

34 The staff recommends that the boards select Approach 2 to develop further. In the absence of the transferee having the practical ability to transfer the asset (or component), Approach 2 would result in no derecognition of the asset (or component). However, linked presentation may be required.

Questions to the boards

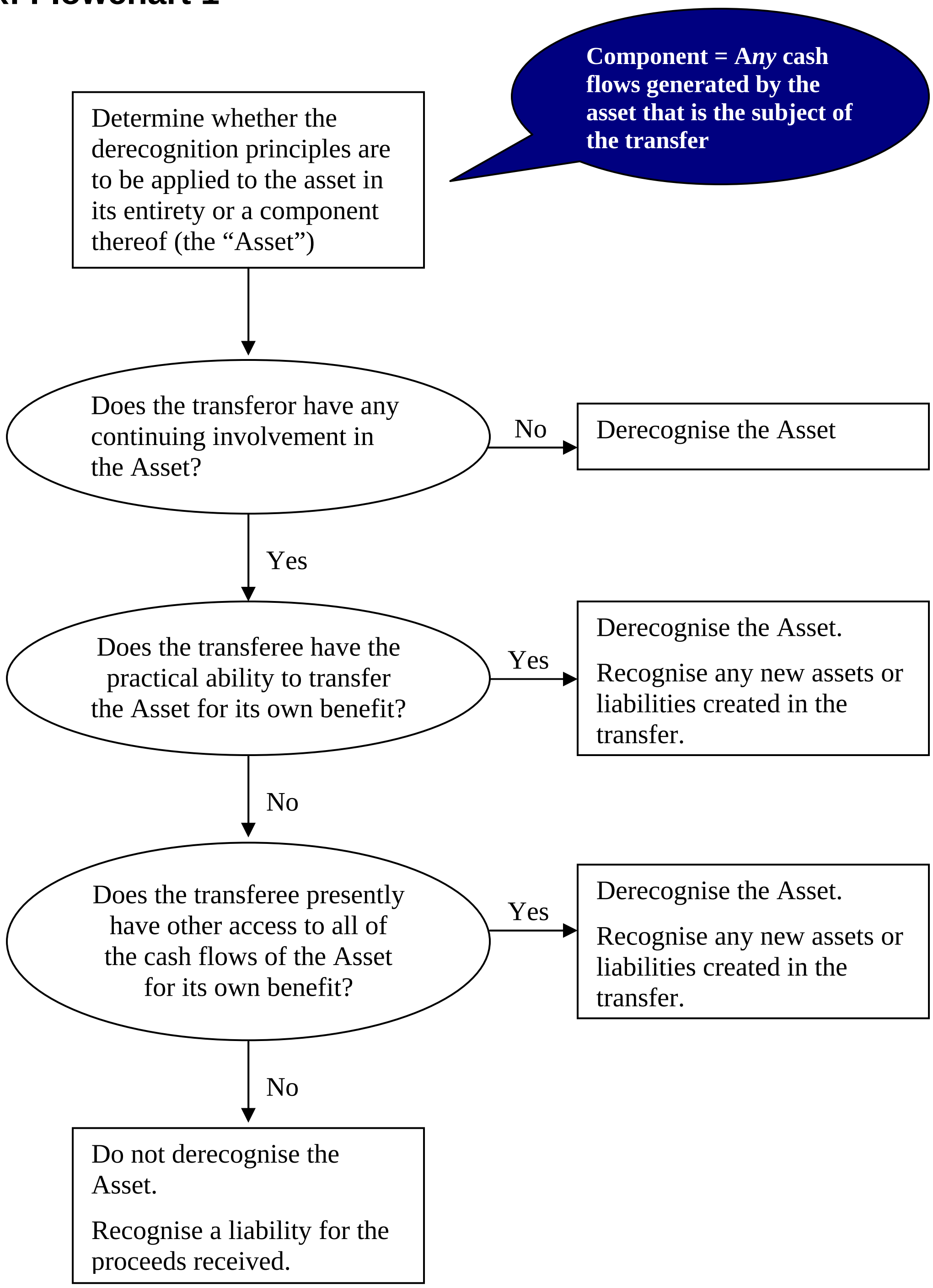
35 **Do you agree with the staff’s recommendation? If not, why not?**

36 **If you do not agree with the staff recommendation:**

a) **do you want to pursue Approach 1 further, and why? or,**

b) **what other alternative ways of dealing with those circumstances in which a transferee does not have the practical ability to transfer a financial asset do you want to consider, and why?**

Appendix: Flowchart 1



Appendix: Flowchart 2