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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**February 2009, London**
Project:	**IAS 39 Financial Instruments: Recognition and Measurement – Derecognition of Financial Assets**
Subject:	**Approach 1 (Flow Chart 1) (Agenda paper 2A)**

PURPOSE

1. This paper summarises the key features of Approach 1. Paper 2B summarises the key features of Approach 2. Paper 2B also includes in the appendix a summary of the accounting outcomes for the transactions the project team have used throughout this project under both approaches (and IAS 39 today).

2. Both Papers 2A and 2B include an overview of the key disclosure requirements. Paper 2D includes a more detailed review of disclosures.

3. Paper 2B asks which approach the Board would like to adopt as the basis for the Exposure Draft.

BACKGROUND

4. At the October joint meeting with FASB, the Board supported the need to replace the derecognition requirements of IAS 39 *Financial Instruments: Recognition and Measurement*. The Board decided that the Standard is difficult to understand and apply, and is internally inconsistent (the Standard combines the requirements of a control approach with those of a risks and rewards approach).

5. The Board members who supported Approach 1 agree that if a transferee has the practical ability to transfer an asset for its own benefit, control has passed to the transferee. However, those Board members disagree with the view taken in Approach 2 - that in the absence of such ability, the transferor has maintained control over the asset.

6. Those Board members also believe that Approach 2 results in recognising assets and liabilities that do not meet the definitions of those elements in *The Framework.* In addition, they believe that the application of the approach does not faithfully measure the contractual rights and obligations (economic exposure or interest) of the transferor. For example, if a transferor transfers a non readily obtainable asset with a right (call option) to buy it back, under Approach 2 the transferor would not derecognise the asset transferred and would not recognise the call option either. Approach 1, on the other hand, focuses only on the right retained by the entity (the call option) and would not record the underlying transferred asset (but a credit for the cash received).

7. Approach 1 proposes far-reaching changes to accounting for derecognition of financial assets; the application of Approach 1's derecognition principle in some instances may generate results that differ considerably from present practice. In summary, the proposed principle is likely to decrease reported assets of transferors and increase reported assets of transferees (compared to current practice).

SUMMARY OF APPROACH 1

Derecognition Principle

8. The basic derecognition principle is that an entity should derecognise a financial asset when it no longer qualifies as an asset of the entity (see paragraphs 23 - 25).

Derecognition criteria

9. Approach 1 provides criteria to be used to determine when a financial asset no longer qualifies as the asset of the transferor. In particular, Approach 1 would require an assessment of whether the transferor presently has access, for its own benefit, to all of the cash flows or other economic benefits of the financial asset that the transferor recognised before the transfer (see paragraph 26).

Retained interests and beneficial interests

10. For transfers of part of (or an interest in) a financial asset or group of assets, Approach 1 would require the transferor to derecognise the entire financial asset (or group of financial assets) and recognise as a new financial asset (rather than as a part of the financial asset that the transferor recognised before the transfer) the retained interest in the financial asset (or group of financial assets). Similarly, Approach 1 requires a transferor to recognise as a new asset an investment that a transferor purchases from a transferee securitisation entity (see paragraph 27).

Measurement of retained interests and beneficial interests

11. Approach 1 would require a transferor to measure at fair value, both on recognition and subsequently, any new asset resulting from a transfer of a financial asset (see paragraphs 28).

Transfer of part of a derivative, hybrid instrument or an equity instrument

12. Absent specific consent of the original counterparty, Approach 1 would specifically prohibit transfer of an interest in a financial instrument that can be either an asset or a liability over its life (e.g. an interest rate swap). However, the right to receive future cash flows (the asset or receive leg) is eligible for derecognition.

13. Similarly, Approach 1 prohibits transfer of an interest in a portfolio or an entire portfolio, if the portfolio includes financial instruments that can be either assets or liabilities over their life (e.g. interest rate swaps).

14. Approach 1 does allow for transfer of interests in equity instruments, derivative assets (other than those that can be assets or liabilities over their life) and hybrid financial assets with embedded derivatives that require bifurcation.

Non-recourse relationships

15. Approach 1 recognises in some situations the interaction (and consequences of that interaction) between the derecognition principle for financial assets and liabilities.

16. The staff thinks under Approach 1 the Board should require that, for some non recourse 'loan' arrangements, the transferor should derecognise the associated asset and recognise its net economic interest in the asset.

17. In particular, this treatment will apply to non recourse transactions where the finance (both principal and interest) will be repaid only from proceeds generated by the specific asset it finances (or by transfer of the item itself) and to the extent that sufficient funds are generated by the asset. In addition the entity should not be obliged to support any losses from the financial asset and if the funds generated by the asset are insufficient to pay off the provider of the finance, it does not constitute an event of default for the entity. (see paragraphs 29-33).

Gain or loss on derecognition

18. Approach 1 would require a transferor to recognise on derecognition of a financial asset, the difference between (a) the carrying amount of the asset transferred and (b) the sum of the consideration received and the fair value of the rights or obligations retained or assumed in the income statement in the reporting periods in which they arise (see paragraph 35)

Disclosures

19. Approach 1 proposes amendments to IFRS 7 *Financial Instruments: Presentation* to require disclosure of an entity's risk positions and performance in respect of an entity's risks associated with a transferred asset and other information necessary to provide the context for understanding and evaluating information about transfer of financial instruments and the associated risks. It also provides specific guidance in achieving that objective. (see paragraphs 40 – 42).

OTHER DETAILS ABOUT APPROACH 1

Core Principles

20. Approach 1 is founded on four basic principles:

    a. the primary objective of financial statements is to provide information about the financial position, financial performance and the amounts, timing and certainty of future cash flows of an entity;

    b. financial statements should present fairly the financial position, financial performance, and cash flows of an entity. Fair representation requires faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets and the other elements of financial statements;

    c. only items that are assets (the total resources that underlie future cash flows and on which income will be earned in the future) or liabilities (the means by which they are financed) should be recognised and measured as such in the statement of financial position; and

    d. an entity should not rectify inappropriate accounting policies either by disclosure of the accounting policies used or by notes or explanatory material.

Definitions

21. A transfer occurs when one party passes to or undertakes to pass to another party some or all of the cash flows or other economic benefits underlying its assets. The term "transfer" is used broadly to include all forms of sale, assignment, and provision of collateral, sacrifice, distribution and other exchange. It does not include origination, issuance or expiry.

Consolidation vs. Derecognition

22. The derecognition provisions in IAS 39 shall first be applied in the separate financial statement of all entities in a group before the entities are consolidated in accordance with IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation – Special Purpose Entities*.

Derecognition Principle

> **An entity should derecognise a financial asset when the financial asset ceases to qualify as an asset of the entity.**

23. A financial asset 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. (see Appendix 1 - IASB Update extract – October 2008)

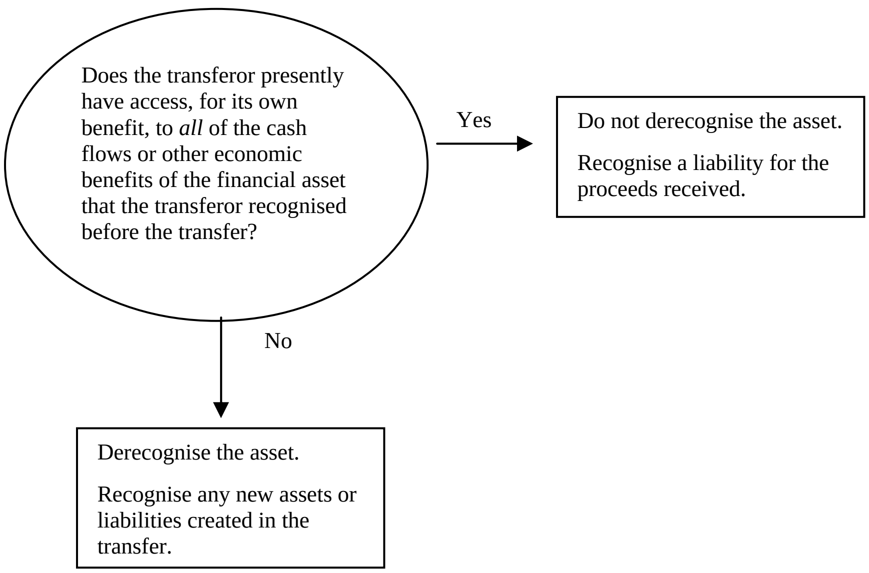
24. An entity no longer controls the economic benefits underlying a financial asset if the entity no longer has the ability, presently, to (a) obtain the future economic benefits inherent in the asset and (b) restrict others' access to those benefits.

25. In assessing whether the entity has present access to all of the cash flows or other economic benefits of the asset, the transferor shall consider the whole arrangement, including any side agreements or sets of simultaneous agreements or entered into contemporaneously with or in contemplation of the transfer of the financial asset

Derecognition Criteria

Does the transferor presently have access, for its own benefit, to all of the cash flows or other economic benefits of the financial asset that the transferor recognised before the transfer?

26. The following flow chart illustrates the evaluation of whether a financial asset is derecognised (see Appendix 1 – IASB Update Extract – December 2008):



Beneficial and Retained Interests

27. If an entity transfers an interest in a previously recognised financial asset or group of financial assets, the entity shall apply the derecognition principle (and criteria) to the entire asset or group of financial assets and recognise as a new financial asset (rather than as a part of the financial asset that the transferor recognised before the transfer) the part of or interest in the asset (or of the group of financial assets) retained. Similarly, a transferor entity shall recognise as a new asset an investment that the transferor entity purchases from a transferee vehicle (see Appendix 1 – IASB Update extract – January 2009 meeting).

28. An entity shall measure at fair value, on initial recognition, all assets falling under paragraph 28 and any other assets or liabilities resulting from a transfer of a

financial asset (or group of financial assets) and, notwithstanding the requirements of paragraphs 45 and 46 of IAS 39, should re-measure all such financial instruments at fair value at each subsequent measurement date and recognise any gains or losses in profit or loss (Note: the staff believes this treatment is consistent with views expressed by many Board members).

Non recourse arrangements

29. At the December meeting the Board discussed the accounting for nonrecourse loans but the Board did not decide on how to account for some of the non recourse loan transactions. Although the Board did not reach a consensus on this issue, the staff continues to believe such transactions are so common and significant that they merit further attention by the Board.

30. The staff proposes the following treatment for self liquidating nonrecourse transactions (see below) for flow chart 1. The staff view will avoid potential inconsistencies in the application of the existing guidance on derecognition of financial liabilities and conflicts between the derecognition models for financial assets and financial liabilities.

31. The staff believes the recommended treatment is consistent with decisions already made by the Board in respect of Approach 2.

32. If a non recourse transaction or arrangement meets the following criteria, then the requirements in the next paragraph shall apply:

    a. the finance will be repaid only from proceeds generated by the specific asset it finances (or by transfer of the item itself);

    b. there is no possibility whatsoever of a claim on the transferor ("borrower") entity being established other than against funds generated by that asset (or the asset itself);

    c. the transferor ("borrower") entity is not obliged to support any losses from the financial asset;

d. the provider of the finance ("transferee") has agreed in writing (in the finance documentation or otherwise) that it will seek repayment of the finance, as to both principal and interest, only to the extent that sufficient funds are generated by the specific asset it has financed and that it will not seek recourse in any other form; and

e. if the funds generated by the asset are insufficient to pay off the provider of the finance, this does not constitute an event of default for the entity.

33. If the requirements of the preceding paragraph are met, the transferee entity ("lender") shall recognise the asset the finance finances and the transferor entity ("borrower") shall recognise any rights or obligations assumed. An arrangement or transaction involving an asset previously recognised by the transferor entity that meets these criteria shall be accounted for as a sale of that asset (Note: the staff believes this is consistent with the views of the supporters of Approach 1).

Servicing Assets and Liabilities

34. If an entity transfers a financial asset in a transfer that qualifies for derecognition and retains the right to service the financial asset for a fee, it shall recognise either a servicing asset or a servicing liability for that servicing contract. If the fee to be received is not expected to compensate the entity adequately for performing the servicing, a servicing liability for the servicing obligation shall be recognised at its fair value. If the fee to be received is expected to be more than adequate compensation for the servicing, a servicing asset shall be recognised at its fair value (Note: this treatment is consistent with the current requirements in IAS 39 for servicing assets and liabilities).

Gain or loss recognition

35. On derecognition of a financial asset or group of financial assets, the difference between:

a. the carrying amount and

b. the sum of (i) the consideration received (including any new asset obtained less any new liability assumed) and (ii) any cumulative gain or loss that had been recognised in other comprehensive income

shall be recognised in profit or loss.

Transfers that do not qualify for derecognition

36. To the extent that a transfer of a financial asset does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset. The transferee derecognises the cash or other consideration paid and recognises a receivable from the transferor (see Appendix 1 – IASB Update extract).

37. If a transfer does not result in derecognition because the financial asset qualifies as an asset of the entity, the entity shall continue to recognise the transferred asset in its entirety and shall recognise a financial liability for the consideration received. In subsequent periods, the entity shall recognise any income on the transferred asset and any expense incurred on the financial liability.

38. If a transferred asset continues to be recognised, the asset and the associated liability shall not be offset (unless the offset requirements in IAS 32 *Financial Instruments: Presentation* are met). Similarly, the entity shall not offset any income arising from the transferred asset with any expense incurred on the associated liability.

39. If a transferor provides non-cash financial asset collateral (such as debt or equity investments) to the transferee and the transaction does not meet the derecognition requirements, the transferor shall continue to carry the collateral as its asset, and the transferee shall not recognise the collateral as an asset (see Appendix 1 – IASB Update extract).

Disclosures

40. Agenda Paper 2C splits the proposed disclosure requirements into two distinct sections, for which there are different disclosure objectives:

Disclosure requirements about:	**Disclosure objectives** **To provide users of financial statements with information:**
transferred financial assets that are derecognised (**both Approach 1 and Approach 2)**	(1) about the nature and risks associated with an entity's continuing involvement with derecognised financial assets.
	(2) that will help to reconstruct an entity's financial statements on the basis of a 'no continuing involvement' approach to derecognition.
transferred financial assets that are not derecognised **(Approach 2 only)** [1]	(3) about the relationship between assets and associated liabilities when an entity transfers but continues to recognise financial assets.

Only disclosure Objectives (1) and (2) are relevant for Approach 1.

<u>Disclosure objective (1): Risks associated with continuing involvement</u>

41. Both Approach 1 and Approach 2 permit, in some instances, the derecognition of financial assets, when an entity retains continuing involvement. When an entity retains continuing involvement in financial assets that it has derecognised, we think that users of financial statements should be informed about the risks to which the entity remains exposed. Information about the risks associated with an entity's continuing involvement provides users with information relevant in assessing the amount, timing and uncertainty of the entity's future cash flows.

<u>Disclosure objective (2): 'No continuing involvement' approach to derecognition</u>

[1] Because the vast majority of transfers of financial assets will be derecognised according to Approach 1, we do think that it is necessary to require disclosures about those that are not derecognised for Approach 1. See paper 2C for further discussion.

42. As noted above, both Approach 1 and Approach 2 permit, in some instances, the derecognition of financial assets, when an entity retains continuing involvement. We understand that, for analysis purposes, users of financial statements would like information to be able to reconstruct an entity's financial statements on the basis of a 'no continuing involvement' approach to derecognition—i.e. financial assets being derecognised only when the transferor has no continuing involvement with the transferred assets. Therefore, we have proposed some disclosures specifically to meet this objective.

APPENDIX

DECISIONS MADE IN RESPECT OF APPROACH 1 (Extracts of IASB UPDATE)

OCTOBER 2008

In June 2008 the Board added derecognition of financial instruments to its active agenda. At this meeting, the Board discussed two possible approaches to derecognition of financial assets. The IASB and the FASB discussed this topic further at their meeting on 20 and 21 October. No decisions were made.

NOVEMBER 2008

The Board continued its discussion of two possible approaches to making a derecognition principle for financial assets operational, and made the following tentative decisions:

- *For transfers involving an entire asset, transferring the right to the cash flows of a financial asset is akin to transferring the asset itself.*
- *For transfers involving a part of a financial asset, the following item would be assessed for derecognition:*

  (a) within approach 1 - any cash flows that are generated by the financial asset or group of financial assets
- *The derecognition tests would be applied from the perspective of the transferee, not the perspective of the transferor. The Board asked the staff to illustrate whether Approach 1 might be improved by adopting the perspective of the transferor.*

DECEMBER 2008

The Board continued its discussion of the two approaches to derecognition that the staff presented at the joint meeting with the US Financial Accounting Standards Board (FASB) in October. The Board made the following tentative decisions:

- *For Approach 1, to focus solely on whether, after the transfer, the transferor has access to all or some of the cash flows of the financial asset that the transferor recognised before the transfer.*

- *The Board also tentatively adopted the following derecognition principle for financial liabilities:*

  "An entity should derecognise a financial liability or component thereof when it no longer qualifies as a liability of the entity (i.e. when the present obligation is eliminated and the entity is no longer required to transfer economic resources in respect of that obligation)."

The Board also discussed secured borrowings with or without recourse, security lending arrangements and repurchase agreements (repos). For secured borrowings with recourse and security lending arrangements and repos, the Board made the following tentative decisions:

- *Secured borrowings with recourse and securing assets should be accounted for similarly to unsecured borrowings and unpledged assets.*
- *Any restrictions on a debtor's ability to benefit from the securing asset should be addressed by disclosure.*
- *Security lending arrangements and repos involving readily obtainable financial assets should qualify for derecognition.*

The Board made no tentative decisions on the accounting for secured borrowings without recourse and the related securing assets.

JANUARY 2009

The Board resumed its discussion of the two approaches to derecognition originally presented at the Board's joint meeting with the US Financial Accounting Standards Board in October 2008. The Board made the following tentative decisions:

for Approach 1:

- *To modify the derecognition test to focus on whether the transferor presently has access to the cash flows or other future economic benefits of the financial asset it recognised before the transfer. An accounting outcome of applying the derecognition test is that a transfer of a component of an equity investment may qualify for derecognition.*
- *To treat as a new financial asset (rather than as a part of the financial asset that the transferor recognised before the transfer) the component of a financial asset or group of financial assets retained in a transfer that qualifies for derecognition.*
- *To treat as a new asset an investment that a transferor purchases from a transferee securitisation vehicle.*