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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:	**January 2009, London**
Project:	**Derecognition of Financial Assets and Liabilities**
Subject:	**'The Asset' in Flowchart 2: Transferred Portions of Derivatives, Hybrid Instruments with Embedded Derivatives or Equity Instruments (Agenda Paper 2B)**

Background

1. At the November meeting, the Board tentatively decided that 'the Asset' to be assessed for derecognition in Flowchart 2 is

   the component definition in paragraph 16 of International Accounting Standard 39 *Financial Instruments: Recognition and Measurement* (IAS 39), subject to consideration of specific guidance about

   i. transfers of groups of similar financial assets and

   ii. derivatives, hybrid instruments with embedded derivatives that require bifurcation and equity instruments.

   (See Appendix 1 for Flowchart 2)

2. This paper deals with the issue in paragraph 1(ii): Should components in Flowchart 2 be defined to explicitly exclude transferred portions of derivatives, hybrid instruments with embedded derivatives that require bifurcation or equity instruments, similar to how these items are treated in the definition of participating interests in the proposed amendment to FASB Statement (FAS) No. 140 *Accounting for Transfers of Financial Assets*?

3. This paper:

   a. explains the importance of knowing whether transferred portions of derivatives, hybrid instruments with embedded derivatives that require bifurcation or equity instruments qualify as components (ie 'the Asset') in Flowchart 2;

   b. researches whether the component definition in paragraph 16 of IAS 39 (which is how the Board decided to define components for Flowchart 2) can be applied (without any modification) to transferred portions of derivatives, hybrid instruments with embedded derivatives that require bifurcation or equity instruments;

   c. provides some alternatives of how to proceed with this issue; and

   d. provides a staff recommendation.

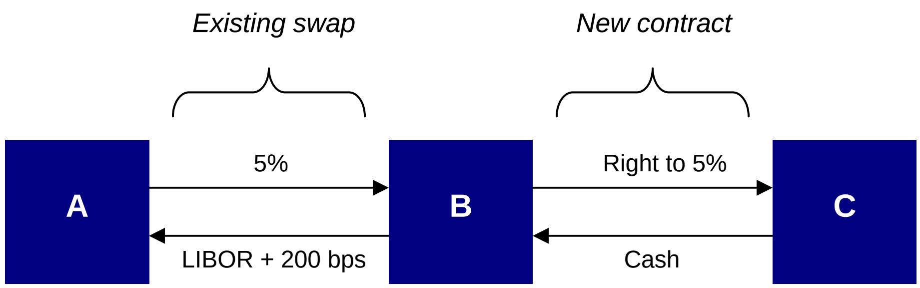
Why is it important to know whether derivatives, hybrid instruments with embedded derivatives or equity instruments qualify as components in Flowchart 2?

4. The criteria used to define whether the right to some cash flows of a financial asset qualifies as a component (and thus as 'the Asset') will affect whether more or fewer transfers qualify for derecognition. If components are defined broadly more transfers will qualify for derecognition. If components are defined narrowly fewer transfers will qualify for partial derecognition. This is because if components are defined more restrictively the 'continuing involvement' step and the 'practical ability to transfer' test in Flowchart 2 will have to be applied to the

whole financial asset even though the transfer involved only a portion of that asset.

5. Accordingly, the definition of components in Flowchart 2 effectively serves as an initial filter for which transferred portions of financial assets might qualify for partial derecognition.

6. Take the following transaction:



a. B has an interest rate swap outstanding under which it pays to A floating interest cash flows (say LIBOR plus 200 basis points) and receives from A fixed interest cash flows (say 5%) over the life of the swap.

b. The swap is settled each month on a net-cash basis.

c. A and B each report the swap as a derivative in their respective financial statements.

d. B subsequently sells to C the right to the fixed interest cash flows it receives from A under the swap. That is, B will pass onto C the portion of the net settlements that relate to the 5% receive leg of the swap (eg, say that at the next settlement date after the sale, B has to pay to A CU20 representing the net of +CU50 under the receive leg and of -CU70 under the pay leg of the swap. In that case, B would pay CU50 to C).

e. At the time B enters into the sale with C, the swap had positive value to B (ie B reported the swap as a derivative asset on its statement of position).

7. In this example, if the right to the cash flows of the receive leg of the swap qualifies as a component of the swap derivative (ie ‘the Asset’), the transfer would likely qualify for derecognition under Flowchart 2 because either:

   a. the transferor (Company B) might be judged as not having any continuing involvement in the ‘component’ (Company B’s interest in the swap comprising of the pay leg would be a separate component of the swap derivative apart from the receive leg component transferred), and/or

   b. the transferee (Company C) might be regarded as having the practical ability to transfer the right to the cash flows of the receive leg to someone else for its own benefit.

8. On the other hand, if the ‘right to the cash flows’ does not qualify as a component of the swap derivative, the derecognition test in Flowchart 2 is applied to the entire derivative. In that case, the entire swap derivative is ‘the Asset.’ As a result, the transfer would not qualify for derecognition because the transferor’s retained interest through the pay leg indicates that:

   a. it has continuing involvement in the swap derivative, and

   b. the transferee does not have the practical ability to transfer the whole swap derivative.

9. The staff points out that in connection with an IFRIC submission in 2006, the IASB indicated that transferred derivatives that could be assets or liabilities (such as interest rate swaps) would have to meet both the financial asset and financial liability derecognition criteria. However, it is not clear whether the Board’s view was intended to apply only to a transfer of a derivative in its entirety or also to a transfer of all or part of the receive leg or all or part of the pay leg of the derivative (which could be assets and liabilities in their own right).

Can the component definition in paragraph 16 of IAS 39 be applied to transferred portions of derivatives, hybrid

instruments with embedded derivatives that require bifurcation and/or equity instruments?

10. The definition of components in paragraph 16 of IAS 39 is reproduced in Appendix 2 to this paper.

11. In Appendix 3, the staff has used five examples to determine whether the component definition in paragraph 16 of IAS 39 is sufficiently clear for application purposes in Flowchart 2 or whether it requires modification. The five examples are the following::

    a. **Example 1 (derivative that can be either an asset or a liability)**: Transfer of a right to the cash flows of the receive leg of an interest rate swap

    b. **Example 2 (derivative that can only be an asset)**: Transfer of 80% of cash flows with respect to the potential payout under a credit default option

    c. **Example 3 (hybrid instrument with an embedded derivative that can only be an asset)**: Transfer of the value of a conversion option embedded in a bond

    d. **Example 4 (equity instrument)**: Transfer of dividend strip of ordinary shares

    e. **Example 5 (equity instrument)**: Transfer of the voting rights of ordinary shares

12. The analysis in Appendix 3 shows that the component definition in paragraph 16 of IAS 39 works reasonably well for financial instruments for which the portion transferred involves cash flows (Examples 1-2 and 4). However, the definition would have to be clarified that components of a financial asset include specifically identified and/or proportionate cash flows from a financial instrument that can be an asset or a liability over its life.

13. On the other hand, the component definition cannot be currently applied to financial instruments for which the portions transferred do not involve cash flows (Example 3). To apply to such instruments, the definition would have to be modified to apply to specifically identified and/or proportionate cash flows *or other future economic benefits* from a financial asset.

Some alternatives for dealing with this issue

14. The staff proposes the following four alternatives of how the Board might want to address the issue discussed in this paper (the alternatives are presented in order of most restrictive to least restrictive in terms of the items that would qualify as components (ie the Asset in Flowchart 2)):

   a. **Alternative 1 (FAS 140R ED approach - most restrictive):** Modify the component definition in paragraph 16 of IAS 39 to explicitly prohibit derivatives, hybrid instruments with embedded derivatives that require bifurcation or equity instruments from qualifying as components.

   Outcome: Portions of derivatives, hybrid instruments with embedded derivatives that require bifurcation or equity instruments would not qualify as components (ie the Asset) in Flowchart 2. Therefore, transfers of such portions would fail derecognition because the 'practical ability to transfer' test would be applied to the whole asset, not the portion transferred.

   b. **Alternative 2**: Don't modify the component definition in paragraph 16 of IAS 39

   Outcome: If the Board were to select Alternative 2, portions of the following instruments would not qualify as components (ie the Asset) in Flowchart 2:

      i. Derivatives or hybrid instruments with embedded derivatives that require bifurcation that over their life could be either assets or liabilities (eg interest rate swaps – see Example 1 in Appendix 3)

ii. Derivatives or hybrid instruments with embedded derivatives that require bifurcation that involve cash flows but for which the cash flows are not specifically identified or proportionate

iii. Equity instruments (unless the portions of the equity instruments transferred involve specified and/or proportionate cash flows)

Accordingly, transfers of such portions would fail derecognition because the 'practical ability to transfer' test would be applied to the whole asset, not the portion transferred.

On the other hand, relative to Alternative 1, transferred portions of freestanding or embedded derivatives (that can only be an asset) or equity instruments that involve specified and/or proportionate cash flows would qualify as components. Therefore, transfers of such portions would not automatically fail derecognition – whether they do will depend on whether the transferee can transfer 'the component' for its own benefit.

c. **Alternative 3**: Modify the component definition in paragraph 16 of IAS 39 to indicate that components of a financial asset include specifically identified and/or proportionate cash flows from a financial instrument that can be either an asset or a liability over its life.

Outcome: If the Board were to select Alternative 3, portions of equity instruments (unless the portions of the equity instruments transferred involve specified and/or proportionate cash flows) would not qualify as components (ie, the Asset) in Flowchart 2. Thus transfers of such portions would fail derecognition because the 'practical ability to transfer' test would be applied to the whole asset, not the portion transferred.

On the other hand, portions of derivatives or hybrid instruments with embedded derivatives that require bifurcation that involve specified and/or proportionate cash flows (including those that over their life could be either assets or liabilities) would qualify as components. Hence transfers of such portions would not automatically fail derecognition – whether they do will depend on whether the transferee can transfer 'the component' for its own benefit.

d. **Alternative 4 (least restrictive)**: Same as Alternative 3 but add 'other future economic benefits' to allow for transferred portions of equity instruments that do not involve cash flows to qualify as components.

In that case, components of a financial asset would be defined as to include specifically identified and/or proportionate cash flows or *other future economic benefits* from a financial instrument that can be either an asset or a liability over its life.

Outcome: If the Board were to select Alternative 4, portions of the following instruments would qualify as components (ie the Asset) in Flowchart 2:

i. Derivatives or hybrid instruments with embedded derivatives that require bifurcation that involve specified and/or proportionate cash flows or other future economic benefits (eg shares) (including those instruments that over their life could be either assets or liabilities), and

ii. equity instruments that involve specified and/or proportionate cash flows or other future economic benefits (eg shares).

As previously said, whether the related transfers qualify for derecognition will depend on the 'practical ability to transfer' test.

15. The following table provides a summary of which portions of instruments qualify as components under each of the four alternatives (see next page):

Alternatives	Portions of D/HI/EI that involve specified and/or proportionate cash flows	Portions of D/HI/EI that involve specified and/or proportionate cash flows *(incl those instruments that could be assets or liabilities)*	Portions of D/HI/EI that involve specified and/or proportionate cash flows *or other future economic benefits* (incl those instruments that could be assets or liabilities)
Alternative 1	**No**	**No**	**No**

Alternative 2	**Yes**	**No**	**No**
Alternative 3	**Yes**	**Yes**	**No**
Alternative 4	**Yes**	**Yes**	**Yes**

D/HI/EI = Derivatives, hybrid instruments with embedded derivatives that require bifurcation or equity instruments

Staff Recommendations

16. The staff recommends that the Board adopt Alternative 4. If the Board agreed with the staff's recommendation, **components of a financial asset would be defined as to include specifically identified and/or proportionate cash flows or other future economic benefits from a financial instrument that can be either an asset or a liability.**

17. The staff understands that its recommendation appears to be in conflict with the Board's decision in IAS 39 (similar to FAS 133 *Accounting for Derivative Instruments and Hedging Activities*, as amended) to permit the bifurcation of the fair value of derivative hedging instruments for hedge designation purposes in only limited circumstances. The basis for Board's decision was the perceived difficulty in (and resulting complexity of) separately measuring bifurcated components of derivative hedging instruments. The staff believes that this measurement difficulty does not apply (or if it does, at least not to the same extent) to components of derivatives that are transferred and/or those that are retained. This is because the transferor and transferee arguably must be able to value the component of the derivative that is the subject of the transfer (and in the case of the transferor, also the component retained) otherwise they would not be able to price it.

18. The staff is not aware of a good reason for prohibiting transfers of portions of derivatives, hybrid instruments with embedded derivatives that require bifurcation or equity instruments from qualifying as components in Flowchart 2 (and as a result from qualifying for derecognition) other than for the sake of minimising structuring opportunities.

19. The staff believes that this was the FASB's objective in setting this specific prohibition in the FAS 140R exposure draft (although it is not clear from the draft or the minutes of the FASB meeting leading up to it). That being said, the staff understands that quite a number of constituents have questioned the conceptual merits of excluding derivatives, hybrid instruments with embedded derivatives that require bifurcation or equity instruments from the component definition. As a result, the FASB plans to redeliberate this issue - the staff notes that the FASB might not have started or finalised those redeliberations by the time the Board plans to issue the derecognition exposure draft.

Questions for the Board

20. Do you agree with the staff's recommendation in paragraph 16?

21. If you agree, are there any improvement(s) you suggest we make to the component definition?

22. If you do not agree, why not and which alternative would you prefer instead and why?

Implication for Flowchart 1

23. At the December meeting, the Board tentatively decided that 'the Asset' determination and 'continuing involvement' steps and the 'practical ability to transfer' test should be eliminated from Flowchart 1. Instead, Flowchart 1 should 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.

24. The examples in Appendix 3 have highlighted the difficulty of applying any derecognition tests to transfers of portions of financial instruments that do not involve cash flows (eg, share-settled derivatives).

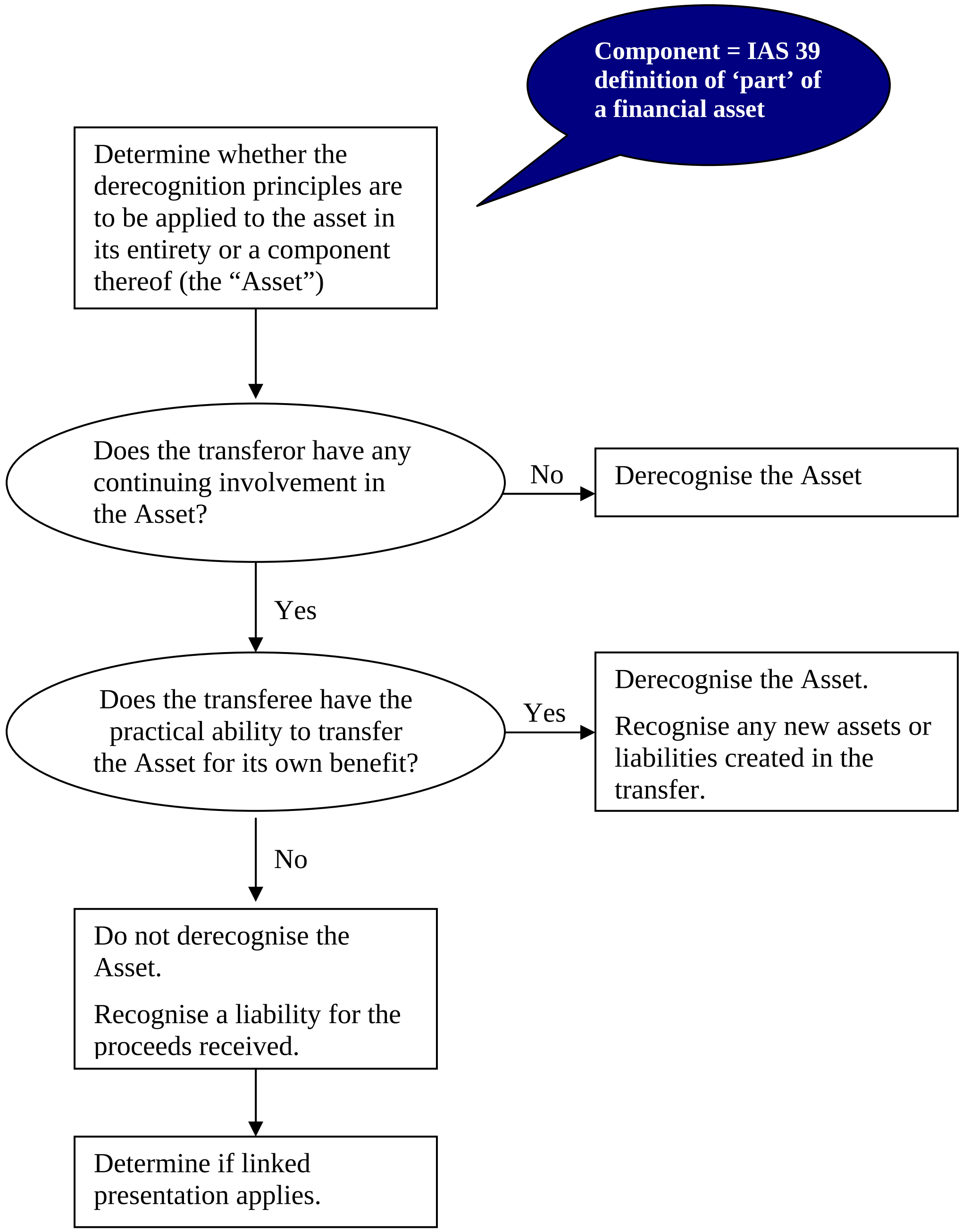
25. In light of the foregoing, **the staff recommends that the Board modify the derecognition tests in Flowchart 1 to refer to 'cash flows *or other future economic benefits*'.** The tests would then read:

> Does the transferor presently have access to all ['some' in subsequent derecognition test] of the cash flows or other future economic benefits of the financial asset that the transferor recognised before the transfer?

Question for the Board

26. Do you agree with the staff's recommendation in paragraph 25. If not, why not?

Appendix 1: Flowchart 2



Appendix 2: Definition of a Part a Financial Asset in IAS 39

Paragraph BC53

[The Board] decided that an entity should apply the derecognition principles to a part of a financial asset only if that part contains no risks and rewards relating to the part not being considered for derecognition...

Paragraph 16

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.

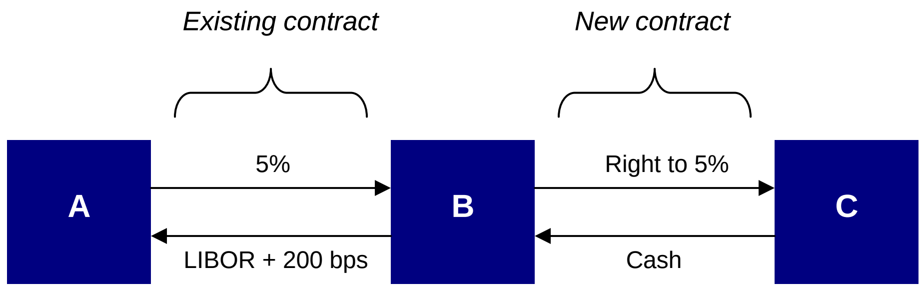
   (iii) The part comprises only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, when an entity enters into an arrangement whereby the counterparty obtains the rights to a 90 per cent share of interest 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.

Appendix 3: Application of Component Definition in Paragraph 16 of IAS 39 to Some Transactions

Example 1 (derivative that can be either an asset or a liability): *Transfer of a right to the cash flows of the receive leg of an interest rate swap*



Facts

- B has an interest rate swap outstanding under which it pays to A floating interest cash flows (say LIBOR plus 200 basis points) and receives from A fixed interest cash flows (say 5%) over the life of the swap.

- The swap is settled each month on a net-cash basis.

- A and B each report the swap as a derivative in their respective financial statements.

- B subsequently sells to C a right to the fixed interest cash flows it receives from A under the swap. That is, B will pass onto C the portion of the net settlements that relate to the 5% receive leg of the swap (eg, say that at the next settlement date after the sale, B has to pay to A CU20 representing the net of +CU50 under the receive leg and of -CU70 under the pay leg of the swap. In that case, B would pay CU50 to C).

- At the time B enters into the sale with C, the swap had positive value to B (ie B reported the swap as a derivative asset on its statement of position).

Analysis

1. In this example, Company B sells the right to the fixed cash flows of the receive leg of an existing interest rate swap.

2. The staff believes that this right arguably meets the component definition in paragraph 16(a) of IAS 39 because the fixed cash flows of the receive leg (albeit they are netted against the variable cash flows of the pay leg when the swap settles) represent 'specifically identified cash flows' from the swap[1].

3. The staff holds this view irrespective of whether the whole swap derivative was in an asset or liability position before the sale of the receive leg (in the example, B reported the swap as an asset). This is because the right to the cash flows of the receive leg are 'specifically identified cash flows' from the swap. However, the staff notes that if the swap were in a liability position when B sold the receive leg to C, some might judge the receive leg as not qualifying as a component of the swap liability because paragraph 16 of IAS 39 deals with transfers of components of financial *assets*. As a result, the staff believes that to the extent the Board agrees with the staff's view, it will have to clarify that paragraph.

4. In the same token, the staff believes that if in this example, B were to pay C (with the agreement of the swap counterparty) to take on the obligation relating to the pay leg of the swap (but retain the right to the fixed cash flows under the receive leg), the obligation relating to the pay leg (ie the underlying cash outflows) would represent 'specifically identified cash flows' and thus should qualify as a component of the swap.[2] The staff uses 'should' because the component

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[1]The staff is aware that at least one of the 'Big 4' accounting firm has the view that to the extent the pay and receive leg settle net on the same dates the receive leg would not qualify as a component under paragraph 16 of IAS 39. This is because the specifically identified cash flows from the swap that are observable on each settlement date are net flows and thus likely different from the cash flows relating to only the receive leg of the swap.

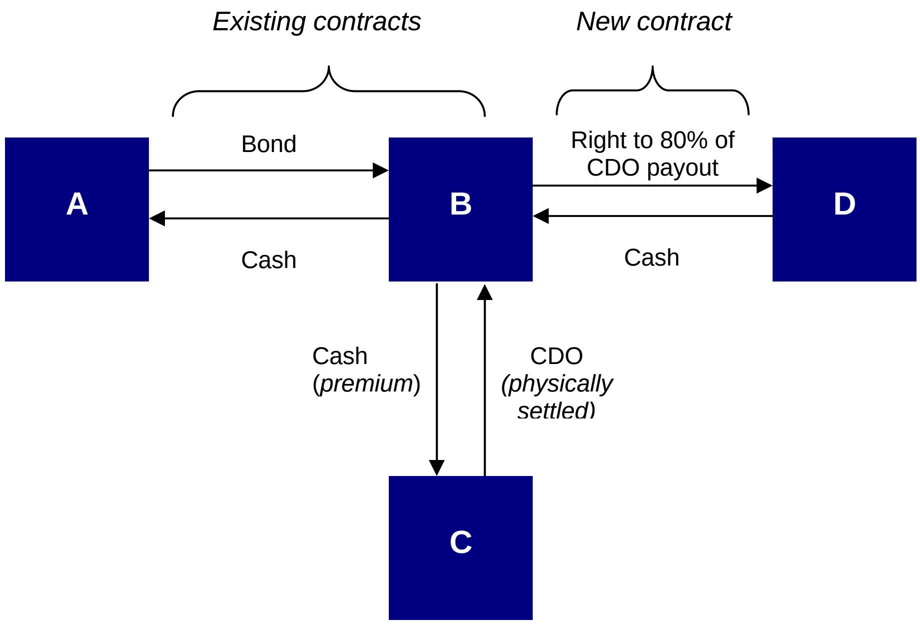
[2]Whether a transfer of the obligation to pay the cash flows of the pay leg would qualify for partial derecognition of the swap derivative is a separate issue. To achieve partial derecognition in that case, the staff believes that a transferor would have to find a third party to agree to legally assume the pay leg of the swap or alternatively agree to legally take on both the pay and receive legs of the swap (in the latter case the transfer would qualify for full derecognition). This is because only then would B be relieved of its present obligation to pay the cash flows of the pay leg to the counterparty to the swap. The staff believes

definition in paragraph 16 of IAS 39 focuses on financial *assets* (ie that definition as currently worded does not address a transfer of a portion of a financial liability or of the liability portion of an instrument that can be both an asset or a liability over its life).

5. In summary, the staff believes that the component definition in paragraph 16 of IAS 39 could be applied to the transferred receive or pay legs (or portions thereof) of an interest rate swap. However, that definition would have to be clarified to apply those transfers irrespective of whether the financial instrument is in an asset or liability position at the time of transfer.

this view to be consistent with the staff's proposed derecognition principle for financial liabilities, which the Board tentatively decided on at the December meeting.

Example 2 (derivative that can only be an asset): Transfer of 80% of cash flows with respect to potential payout under a credit default option (CDO)



Facts

- A issues a fixed-rate bond to B.
- B enters into a credit default option with C whereby C would reimburse B for any losses that B would incur if A were to default on the bond.
- The CDO is physically settled (ie upon a default by A, B has to deliver to C the referenced bond in exchange for C paying cash to B equal in amount to any loss incurred by B).
- B subsequently decides to transfer to D a right to 80% of the cash flows that B would receive from C under the settlement of the CDO.

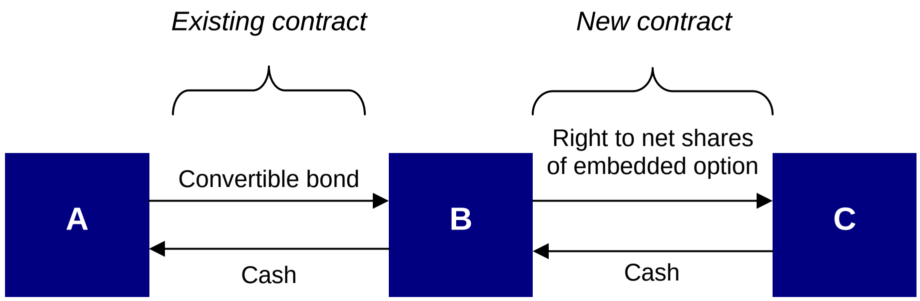
Analysis

1. In this example, B transfers to D the right to 80% of the cash flows from the settlement of a CDO.

2. The staff believes that this right qualifies as component of the CDO derivative asset (from the perspective of B, the transferor, the CDO is a purchased option and unlike the interest rate swap in the previous example can only be an asset for B). This is because the right to 80% of the payout of the CDO represents ‘a fully proportionate (pro rata) share of [all] cash flows’ from the CDO asset as so defined in paragraph 16(b) of IAS 39.

3. In summary, the staff believes paragraph 16 of IAS can be applied to this example.

Example 3 (hybrid instrument with an embedded derivative that can only be an asset): *Transfer of the value of a conversion option embedded in a bond*



<u>Facts</u>

- A issued to B a convertible bond. The embedded conversion option (purchased call option from B's perspective) is net-share settled. That is, upon settlement of the option, A will deliver, in addition to paying the principal in cash, to B a number of A's ordinary shares equal in value to the value of the option.

- B accounts for the conversion option as a derivative asset separately from the bond (the staff notes that albeit the conversion option meets the definition of an equity instrument in IAS 32 *Financial Instruments: Presentation*, it is in the scope of (and meets the requirements for separation as a derivative in) IAS 39 because the scope exception for equity instruments in IAS 32 does not extend to the holders of those instruments).

- B subsequently enters into a contract with C whereby it agrees to pass onto C any of A's ordinary shares that B receives under the net settlement of the conversion option with A (B effectively has written to C a mirror call option on A's ordinary shares). – B remains the counterparty to the conversion option with A.

- The conversion option can be exercised by B only on maturity of the bond. The contract with C obliges B to exercise the option if the option is in the money on that date.

Analysis

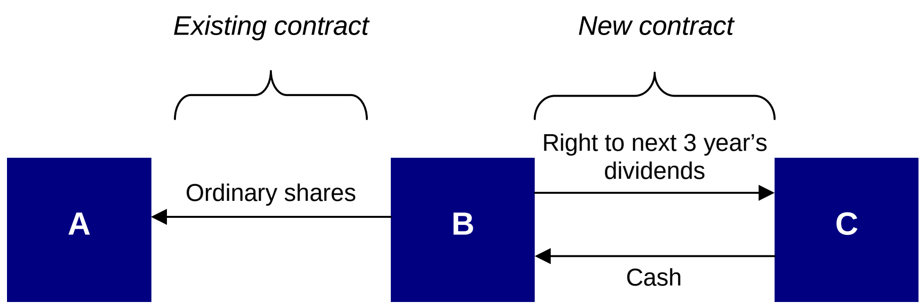
1. In this example, an entity that invested in a convertible bond transfers the value of the call option embedded in the bond to a third party by way of agreeing to pass onto the third party any of the ordinary shares the entity might receive upon settlement of the option with the issuer of the bond.

2. Interestingly, paragraph 10 of IAS 39 regards the embedded call option as 'a *component* of a hybrid (combined) instrument that that also includes a non-derivative host contract [bond in the example]'.

3. The foregoing being said, the staff does not believe that the component definition in paragraph 16 of IAS 39 can be applied to the transferred call option. The definition in paragraph 16 focuses on cash flows from a financial asset. In contrast, in this example the transferee (Company C) would receive ordinary shares if B exercised the option with the issuer of the convertible bond. So it appears as if the issue is not that paragraph 16 cannot be applied to embedded derivatives but rather that that paragraph cannot be applied to embedded derivatives *that do not involve cash flows*.

4. The staff notes that to the extent the Board wants to allow embedded derivatives that do not involve cash flows to qualify as a component of the host financial asset, it could achieve that goal by changing the wording in paragraph 16 of IAS 39 to refer to specified and/or proportionate cash flows *or other future economic benefits* from a financial asset.

Example 4 (equity instrument): Transfer of dividend strip of ordinary shares



Facts

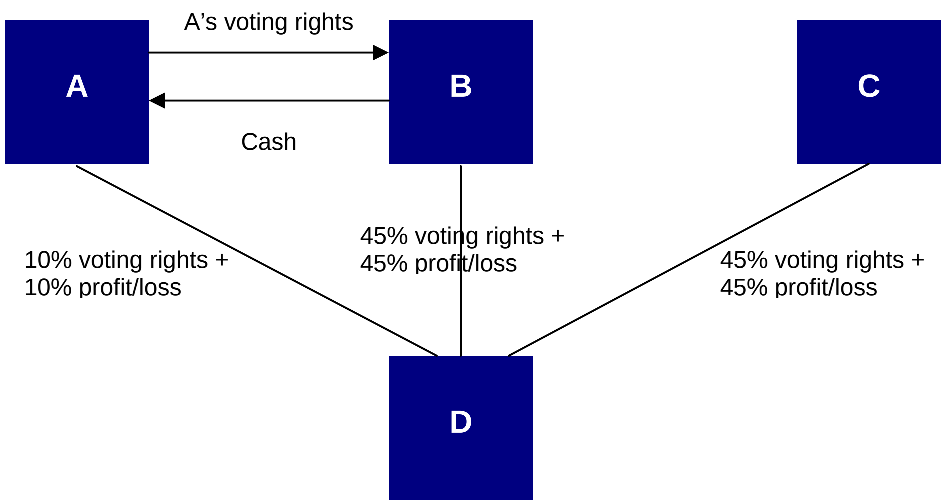
- B holds ordinary shares in A.
- B decides to enter into a contract with C whereby it agrees to pass onto C any dividends paid by A over the next three years.
- Assume that the likelihood that A will not pay any dividends over the next three years is remote. This might be because A might be a public utility that historically has paid dividends each quarter, and that the number of ordinary shares that underlie the three-year dividend strip might be small relative to the number of A's ordinary shares that are outstanding and traded in the marketplace.

Analysis

The staff believes that the right to the dividends on A's ordinary shares for the next 3 years represent specifically identified cash flows from those shares. Therefore, paragraph 16 of IAS can be applied to this example.[3]

[3]The staff is aware that at least one of the 'Big 4' accounting firm has the same view for this type of fact pattern.

Example 5 (equity instrument): Transfer of the voting rights of ordinary shares



Facts

- A, B and C each own 10%, 45% and 45%, respectively, of the outstanding ordinary stock of D. Assume C's 10% interest in D is in the scope of IAS 39 pursuant to paragraph 2(d) of that Standard.
- A and B subsequently enter into a contract whereby A agrees to vote on any matters involving D according to B's directions (and A is paid by B for this in-substance transfer of A's voting rights).
- Any profits and losses by D continue to be split 10%, 45% and 45% between A, B and C, respectively, after the transfer of A's voting rights to B. Although B now controls D it is contractually prohibited from changing the profit/loss allocation of A (or C) unless A (or C) agrees to any such change.

Analysis

1. The staff believes that a transfer of voting rights would not be in the scope of derecognition. This is because voting rights are not a financial asset as so defined in paragraph 11 of IAS 32. They are neither an 'equity instrument' because they are not 'a contract that evidences a residual interest in the assets of an entity after

deducting all of its liabilities' (it is the ordinary shares in which the voting rights were embedded before the transfer which evidence that residuality) nor are they 'a contractual right to receive cash or another financial asset from another entity'.

2. If a transfer of voting rights were in the scope of derecognition (ie setting the staff's conclusion in the previous paragraph aside for a moment), the staff believes that those voting rights would not qualify as components of the underlying ordinary shares as so currently defined in paragraph 16 of IAS 39. This is because they do not represent 'specifically identified and/or proportionate *cash flows* from a financial asset'.

3. In the analysis for Example 3, the staff indicated that the Board might consider modifying the component definition in paragraph 16 to refer to cash flows *or other future economic benefits* from a financial asset (this proposed change was to address transferred portions that involve shares). Some might wonder whether 'other future economic benefits' could include voting rights. The staff would think that not to be the case because voting rights in or by themselves do not qualify as future economic benefits as so defined in the Framework. Paragraph 53 of the Framework defines future economic benefits embodied in an asset as

> the potential to contribute directly or indirectly to the flow of cash and cash equivalents to the entity…It may … take the form of convertibility into cash or cash equivalents…

4. Voting rights in or by themselves (without owning the underlying shares) do not have the potential to contribute/convert into cash. To the contrary, it is the shares that entitle the holder to dividends (take an example of two classes of ordinary stock where both participate in profits and losses of the entity but only one class is voting – a scenario that is not uncommon).

5. The staff also believes that to qualify as a component of a financial asset, the component must be an asset in its own right. Voting rights (without owning he underlying shares) fail in that regard as well because they do not represent

> a present economic resource [something that is capable of producing cash inflows or reducing cash outflows] to which an entity has a right or other access that others do not have.

The economic resource that has the capability to generate cash flows are the ordinary shares, not the voting rights.