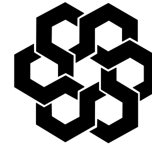

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
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:	**Transfers of a Component of an Asset = Different Asset after Transfer?** **Measurement of Retained Component (Agenda Paper 2C)**

Background

1. At the December 2008 IASB meeting the staff asked whether some non-recourse secured borrowings should be accounted for as a sale of the securing financial asset (see December Agenda Paper 10F). The Board did not make a decision.

2. During the December discussion one Board member asked the staff about how two particular non-recourse secured borrowings would be accounted under Flowchart 1.

3. However, in answering that question, the staff identified a follow-on issue:

   Does a transfer of a component of a financial asset change the nature of the financial asset, and therefore result in the original financial asset

ceasing to exist in its original form? That is, is the original financial asset replaced by beneficial interests in the original asset, some of which are held by the transferee (those purchased) and of which some are held (those retained) by the transferor[1]?

4. This paper:

   a. *answers the December 2008 question raised by the Board member*. That is, the paper describes the particular non-recourse borrowing transactions that the Board member raised at the IASB meeting in December 2008 and provides the staff's conclusion on the accounting for the transactions under *both* Flowchart 1 and Flowchart 2;

   b. *analyses the follow-on issue identified.* That is, the paper discusses whether a transfer of a component of a financial asset changes the nature of that asset or group of assets and addresses the related measurement issues.

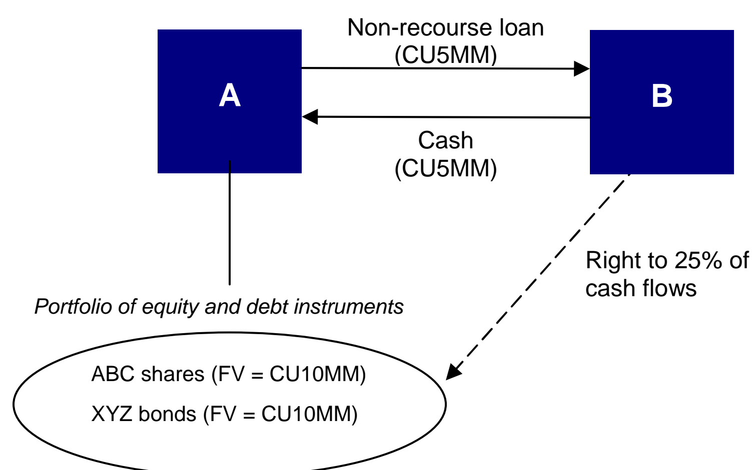
[1]A similar issue arises when a transferor sells financial assets to a transferee trust that issues beneficial interests of which some are purchased by the transferor and some by third parties. More to that point later in the paper.

Answering the December 2008 question

Description of transactions

5. The particular transactions raised at the December 2008 board meeting are set out below:

Transaction 1



a. A holds a portfolio of readily obtainable equity instruments and debt instruments. The fair value of the equities is CU10 million, and the fair value of the debt instruments is CU10 million. A has legal custody of the shares and bonds.

b. B lends CU5 million to A for five years. B agrees to look to only 25% (pro rata) of the cash flows of the portfolio for repayment of principal and interest (ie the loan by B to A is nonrecourse to A).

c. A transfers any dividends from the ABC shares first, then interest and principal cash flows from the XYZ bonds.

d. A retains the right to transfer any or all of the shares or bonds, but must replace any items transferred with similar assets of similar value.

Transaction 2

Same as Transaction 1, except that B agrees to look to only the *first* 25% (disproportionate) cash flows from the shares and bonds held by A for repayment of the principal and interest of the nonrecourse loan.

Analysis of transactions using Flowchart 1 and Flowchart 2

6. The analysis of these two transactions under Flowchart 1 and Flowchart 2 are set out in the following table. (For referencing purposes, we have included the two flowcharts in the Appendix).

Flowchart 1

Steps	Transaction 1	Transaction 2
The transfer	25% of cash flows from the portfolio of equity and debt instruments	*First* 25% of cash flows from the portfolio of equity and debt instruments
*Does the transferor presently have access, for its own benefit, to **all** of the cash flows of the financial asset that the transferor recognised before the transfer?*	**No**. After the 'transfer' (ie issuance of nonrecourse loan), A has access to only 75% (not 100%) of the cash flows that the portfolio of equity and debt instruments generates.	Same as for Transaction 1
*Does the transferor presently have access, for its own benefit, to **some** of the cash flows of the financial asset that the transferor recognised before the transfer?*	**Yes**. After the 'transfer' (ie issuance of nonrecourse loan), A has access to some (ie 75%) of the cash flows that the portfolio of equity and debt instruments generates.	Same as for Transaction 1
Accounting outcome?	A has passed control over 25% of the portfolio of ABC shares and XYZ bonds to B. As a result, the transfer qualifies for derecognition. How A and B apply derecognition accounting to their respective interests in the portfolio is the subject of this paper. See following discussion.	Same as for Transaction 1

Flowchart 2

Steps	Transaction 1	Transaction 2
What is 'the Asset' to which the derecognition steps/tests are to be applied?	**Asset 1: All ABC shares; Asset 2: All XYZ bonds** (Although the right to 25% of cash flows of the portfolio of ABC shares and XYZ bonds qualifies as a fully proportionate share of that group of financial assets, the assets being equity and debt instruments are not similar; thus the 25% interest does not qualify as a 'fully proportionate share of the cash flows from a group of *similar* financial assets' in the component definition of paragraph 16 of IAS 39.) *The subsequent 'continuing involvement' step and 'practical ability to transfer' test would have to performed for Asset 1 and Asset 2 separately. For ease, the staff has documented the step and test for both assets on a combined basis.*	**Asset 1: All ABC shares; Asset 2: All XYZ bonds** (The right to the *last* 25% of cash flows of the portfolio of ABC shares and XYZ bonds does not qualify as a fully proportionate share of that group of financial assets; furthermore, the assets being equity and debt instruments are not similar.)
Does the transferor have any continuing involvement in the Asset?	**Yes**. A has a right to 75% cash flows of the portfolio of ABC shares and XYZ bonds. Accordingly, A has retained a contractual right inherent in each Asset 1 (all of the ABC shares) and in Asset 2 (all of the XYZ bonds) through which it has an interest in the future performance of those assets.	Same as for Transaction 1
Does the transferee have the practical ability to transfer the Asset for its own benefit?	**No**. In light of A's interest in the portfolio of ABC shares and XYZ bonds, B cannot transfer – unilaterally and without imposing additional restrictions – either Asset 1 or Asset 2 to a third party for its own benefit.	Same as for Transaction 1

Accounting outcome?	A has *not* surrendered control of the 25% of the portfolio of ABC shares and XYZ bonds transferred to B. As a result, the transfer does *not* qualify for derecognition. A would continue to recognise the ABC shares and XYZ bonds and recognise a liability for the proceeds received. Depending on the Board's decisions on linked presentation (see Agenda Paper 2F), A might have to consider whether it must present the liability as a contra-asset to the portfolio of ABC shares and XYZ bonds on its statement of financial position. B would recognise a receivable for the cash paid.	Same as for Transaction 1

Note: Transaction 1 does not qualify for derecognition under Flowchart 2 because the group of financial assets in which A transfers the 25% interest to B contains assets that are dissimilar. If the transaction were structured so that those assets were similar, it would qualify for derecognition because

- the 25% interest would qualify as a proportionate share of the cash flows from that group and
- A would deemed not to have any continuing involvement in that 25% interest consequent to the transfer.

(See discussion of whether to remove 'similar' from the component definition in paragraph 16 of IAS 39 in Agenda Paper 2D.)

Analysing the follow-on issue identified

What the previous transactions illustrate

7. A (the transferor) starts off with a portfolio of ABC shares and XYZ bonds.

8. Subsequently, for Transactions 1 and 2 under Flowchart 1, A recognises *an interest* in those shares and bonds - the right to 75% (the *last* 75% in Transaction 2), of the cash flows from the portfolio. The question is whether A's interest represents:

   a. a retained component of the 'old' assets it recognised before the transfer (ie the ABC shares and XYZ bonds), or

   b. a 'new' (transformed) asset obtained in connection with the transfer of a component of previously recognised assets (ie the ABC shares and XYZ bonds).

9. Economically A has a 75% interest in a portfolio of shares and bonds (a subordinated interest for Transaction 2).

10. However, the answer to this question is important because it might affect the measurement of the interest on the date of, and subsequent to, the transfer (and thus the gain or loss recognised by A):

    a. If A's interest were treated as a retained component of the 'old' assets, A would continue to recognise ABC shares and XYZ bonds subsequent to the transfer. However, the carrying amount would be adjusted to derecognise the 25% transferred component (presumingly the adjustment would be done based on the relative fair values of the component transferred vs. retained pursuant to paragraph 27 of IAS 39). Subsequent to the transfer, presumably A would continue to use the same measurement attribute for the investment in ABC shares and XYZ bonds that it used before the transfer.

b. If A’s interest were treated as a new asset, A would presumably derecognise all of ABC shares and XYZ bonds (the old assets) and presumably recognise the new asset (75% interest in ABC shares and XYZ bonds) on the date of transfer at fair value. After the transfer, A would classify and measure the new asset accordingly.

11. So, in summary:

    a. Derecognising some or all of the old asset could result in a different gain or loss being reported by A (the transferor); and

    b. Subsequent measurement of the retained interest by A could be different depending upon the approach taken.

12. B (the transferee) would recognise its interest in the ABC shares and XYZ bonds consistent with how A were to recognise its interest if viewed as a new asset (see paragraph 10(b)). This is because for B the purchase of an interest in the shares and bonds is an initial recognition event. That being said, how B would present its interest on its statement of financial position is a different matter. To be consistent with mirror-image accounting, if A’s interest were treated as a retained component of the ABC shares and XYZ bonds, the interest that A transferred to B would have to also be treated as a component of those shares and bonds and hence B would report ABC shares and XYZ bonds on its statement of financial position. However if A’s interest were regarded as a new asset so should be B’s interest and so B should present a beneficial interest in the ABC shares and XYZ bonds.

So does a transfer of a component of a financial asset change the nature of the financial asset?

13. In the view of the staff, **yes**.

14. The financial asset of the transferor is changed after part of it has been transferred. Following the transfer of a part of a financial asset, the transferor and transferee each hold beneficial interests giving them the right to the cash flows that the original asset produces.

15. For the two transactions discussed in this paper, the fact that the certificates relating to the ABC shares and XYZ bonds continue to physically exist after the transfer is irrelevant to the accounting of the financial asset that the transferor and transferee each have. The financial asset of the transferor and the financial asset of the transferee is now an *interest* in the cash flows produced by the ABC shares and XYZ bonds.

16. The staff's view would treat the financial asset the transferor recognises and the financial asset the transferee recognises consequent to the transfer as being the same as it relates to the assets' form. This would result in symmetrical accounting (ie both parties would recognise beneficial interests as opposed to the transferor recognising a component of a previously recognised whole financial asset and the transferee recognising a beneficial interest in that asset).

17. This benefit of consistency in accounting amongst beneficial interest holders extends to securitisations.

18. Take, for example, the two previous transactions and assume that instead of transferring to B a right to 25% of the cash flows (first 25% for the second transaction) generated by the ABC shares and XYZ bonds, A would transfer *all* those shares and bonds to a trust.

19. Assume further that the trust would issue beneficial interests to A and B, which would entitle them to 75% and 25%, respectively, (for the second transaction, those interests would be subordinated and credit-enhanced, respectively) of the cash flows produced by the assets in the trust (ie the ABC shares and XYZ bonds).

20. Even though A continues to have access, for its own benefit, to some of the cash flows that the previously recognised shares and bonds generate and thus controls those cash flows (in accordance with the staff's proposed derecognition principle), the right to those cash flows reside in a different asset.

21. That is, the securitisation has apportioned the cash flows of the previously recognised financial assets (ie the shares and bonds) and in doing so, changed the

nature of those assets (after the transfer, A and B have an interest in the assets as a group, not the assets themselves).

22. The point in the previous paragraph would become even clearer if we assumed that other assets (say, third-party financial guarantees or derivatives) were added to the trust. Then the beneficial interests that A and B would hold would entitle them to the cash flows from the financial assets that A transferred to the trust *commingled with* those from the third party assets. If in that case A's beneficial interest were judged to be a retained component of the financial assets A transferred to the trust (which would require that A look through the trust, therefore ignoring the fact that A transferred whole financial assets), A would have to account for the portion of the cash flows of the third-party financial guarantees or derivatives that A is entitled to under its beneficial interest *separately from the component retained* - an outcome which would seem odd in light of the third-party guarantees or derivatives being embedded in the beneficial interests. This accounting would also be different from how the transferee would account for its beneficial interest.

23. The staff notes that others hold a similar view. For example, in his dissent to FASB Statement No. 125 (the preceding standard to FAS 140) *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, a former member of the FASB stated, in part, the following:

> [In] securitization transactions in which control is deemed under this Statement to be surrendered and in partial sales of financial assets, assets (or rights) are surrendered in exchange for cash and other rights and obligations, all of which are new.[14] The new assets (rights) received are part of the proceeds of the exchange, and any liabilities (obligations) incurred are a reduction of the proceeds. As such, those new assets and liabilities should be measured at fair value as they are in all other exchange transactions.
>
> [14] In case of a partial sale of a financial asset, the transferor generally has reduced the marketability of the asset because it can no longer sell the entire asset – it can only sell part of that asset. Consequently, the partial interest in the original asset has different rights and privileges than those embodied in the original asset and, therefore, is a new asset – different from the original asset.

24. The staff also points out that US GAAP in inconsistent in how it handles a transferor's interest in a previously recognised whole financial asset

    a. be that interest a retained part of a financial asset for which the transferor transferred the other part or

    b. be that interest an interest that the transferor purchased from a securitisation trust to which it transferred whole financial assets.

25. For example, the current FAS 140 treats a transferor's servicing assets as new assets; so does the exposure draft of the FAS 140 amendment regard beneficial interests obtained by a transferor in a securitisation transaction.[2,3]

26. On the other hand, for partial transfers the exposure draft of the FAS 140 amendment treats the part of the financial asset retained by the transferor as a component of the 'old' asset.[4]

27. In summary, the FASB treats transfers of portions of financial assets differently from transfers of whole financial assets to a transferee entity in which the transferor then takes back a beneficial interest in those assets, even though the transferor might be in the same economic position after the transfer. The staff notes that this also could be an issue for Flowchart 2 given the similarity of that

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[2]The staff notes that the latter represents a change in the FASB's thinking. Current FAS 140 permits a transfer to qualify for derecognition to the extent that consideration *other than beneficial interests* in the transferred assets is received in exchange. The exposure draft on the FAS 140 amendment proposes that beneficial interests obtained by a transferor in a securitisation transaction should be treated as part of the proceeds of the sale of the assets placed into the securitisation trust (ie as a new asset). This change in treatment of beneficial interests was largely based on the belief that 'a beneficial interest received in a securitisation is rarely the same asset that a transferor previously held because of the additional benefits of liquidity and risk diversification that are added to the asset in a securitisation vehicle' and that to the extent the transfer meets the FAS 140 sale criteria and the transferor does not consolidate the transferee trust, 'an event has occurred that changes the nature of 100% of the original asset sufficiently to warrant remeasurement'.

[3]Other sources in US GAAP that support that in at least some transactions a transferor can transform financial assets into retained interests that are not considered to be, nor do they get the same accounting as, the assets subject to the transfer supporting can be found in Appendix 2.

[4]Although it changed its view how to treat beneficial interests obtained by a transferor in a securitisation, the FASB did not change its view on partial transfers in the exposure draft of the FAS 140 amendment. For those transfers, the FASB believes that the transferor has not relinquished control of the component retained. A transferor continues to hold a component of the previously recognised whole asset; therefore, in the FASB's eyes it is not a new asset.

flowchart to the derecognition model in the exposure draft of the FAS 140 amendment. This issue is highlighted in Agenda Paper 2F.

Staff recommendation

28. The staff recommend that the Board staff adopt the following:

    a. The component of a financial asset or a group of financial assets that a transferor retains after the transfer of the other component of that asset or group of assets (with the transfer qualifying for derecognition) is accounted for as a new asset.

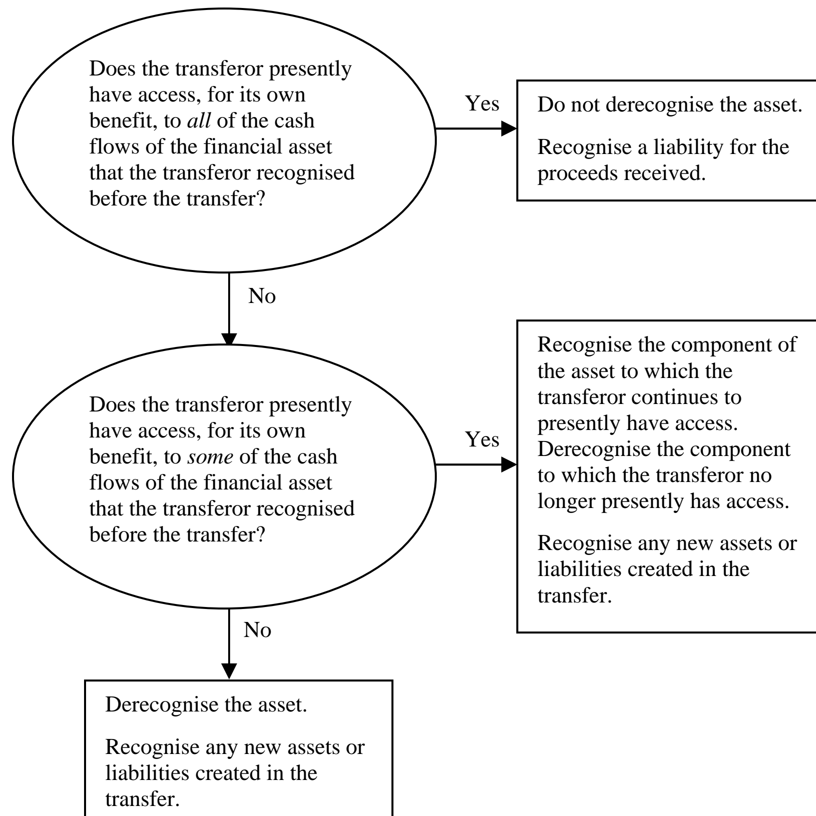
    b. A beneficial interest that a transferor purchases from a transferee trust in a securitisation is also accounted for as a new asset.

Questions for the Board

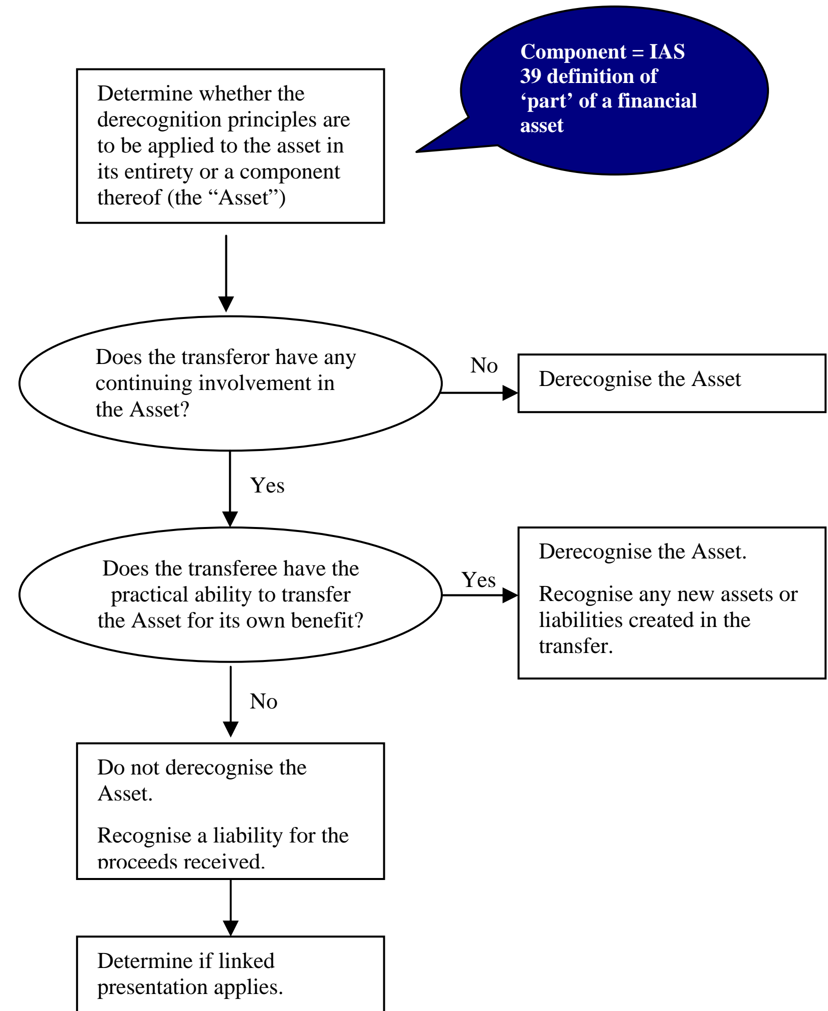
29. Do you agree with the staff's recommendations in paragraph 28(a) and 28(b)? If not, why not? What would you propose instead, and why?

Appendix 1

FLOWCHART 1



FLOWCHART 2



Appendix 2: Some US GAAP sources treating retained interests as new assets

1. A member of the SEC staff noted at the 1998 AICPA Conference on Current SEC Developments that

> [FAS 125] requires that a transferor of financial assets continue to carry in its statement of financial position any retained interests in transferred assets. A retained interest may include beneficial interests from a securitization of financial assets *or* retained undivided interests. FASB Statement No. 125 however, does not address the classification or subsequent accounting for those retained interests unless the interests may be contractually settled in a manner such that the holder would not recover substantially all of its recorded investment. For those interests, the accounting provided for available-for-sale or trading securities in FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities, is appropriate, whether or not the interests are deemed to be securities. The staff has been asked whether other types of interests retained in a securitization should be accounted for as securities. Some registrants have asserted that the application of FASB Statement No. 115 depends on whether those interests meet the definition of a security under the [Uniform Commercial Code (UCC)] code. However, for accounting purposes, FASB Statement No. 115 provides its own definition of a security. . . . Based on the accounting definition, the staff believes that interests in certificate form generally meet the definition of a security, regardless of whether the interests are considered securities under the current UCC code. In addition, the staff notes that even though these certificates may be in the form of equity, for accounting purposes they may be considered debt securities. . . .

2. FAS 65 *Accounting for Certain Mortgage Banking Activities* states in paragraph 6:

> After the securitisation of a mortgage loan held for sale, any retained mortgage-backed securities shall be classified in accordance with the provisions of FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities. However, a mortgage banking enterprise must classify as trading any retained mortgage-backed securities that it commits to sell before or during the securitisation process.

3. EITF Issue No. 02-9 *Accounting for Changes That Result in a Transferor Regaining Control of Financial Assets Sold* provides an example in which a transferor transfers to a securitisation trust (that meets the requirements for a qualifying special-purpose entity in the current FAS 140) a loan with a fair value of $100 for $82 in cash and a beneficial interest in the loan with a fair value of $18. The beneficial interest is subordinated and represents the portion of the loan *not* sold. The discussion in the example states:

> Transferor initially classifies its retained interest as available for sale and will subsequently account for it under the guidance in Statement 115 and Issue 99-20, "Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitised Financial Assets."