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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **January 2009, London**

Project: **IAS 39 Financial Instruments: Recognition and Measurement – Derecognition of Financial Assets**

Subject: **Linked Presentation – Measurement (Agenda Paper 2E-4)**

PURPOSE

1. Agenda Paper 2E-1 discusses whether the Linked Presentation model (LP) is appropriate.

2. Agenda Paper 2E-2 discusses which transactions should an entity evaluate whether they meet the LP principle (scope of the LP model) and the principle that should be used in determining when transactions, falling within the scope of LP, qualify for LP treatment.

3. Assuming the Board prefers LP to be shown on the face of the financial statement, the following analysis and recommendations are aimed at dealing with the other issues relating to the LP concept -

- **Measurement** – How a transfer of financial assets and related liabilities that is required to be presented linked be initially and subsequently measured and whether a gain or loss should be recognised at the time of transfer.

MEASUREMENT

4. There are three issues that must be addressed in regard to the measurement attributes for the LP model:

   (a) How the items qualifying for LP should be initially measured

   (b) How the linked items should be measured subsequent to the transfer

   (c) Whether any gains or losses should be recognised and if so how should they be presented in the statement of financial performance

INITIAL MEASUREMENT OF THE LINKED ITEMS

5. There are three feasible alternatives that the Board could adopt in providing guidance on initial measurement of the linked items –

   (a) Alternative A – Amortised cost or as required by IAS 39 today

   (b) Alternative B – Fair Value

   (c) Alternative C - Continuing Involvement Approach

Alternative A - Initially measure the linked items at amortised cost or as required by IAS 39 today

6. It is obvious that measuring the asset and the liability at amortised or historical cost would not yield a relevant net figure. Although this may signal to users there is a relationship between the asset and liability, users would not be able to quantify the entity’s net economic exposure to or interest in the asset.

7. This alternative does not achieve the objective of showing the entity’s net economic exposure to or interest in the transferred asset and fails to provide users any incremental information value.

8. The Board's primary objective in this project is to reduce the complexity of the derecognition requirements and the staff believes that the use of a mixed measurement model for the measurement principle is contrary to that objective.

9. The staff believes that having different measurement attributes for the various components in LP would create additional complexity and would not provide useful information about the relationship between the assets and liabilities that are linked.

Alternative B - Initially measure the linked items at fair value

10. Requiring fair value for both the financial assets and liabilities in LP eliminates the issues that arise from a mixed measurement attribute model. Additionally, the fair value approach is consistent with the Board's objective to move toward fair value as the preferred measurement attribute for all financial assets and liabilities.

11. The above discussion on the fair value approach is consistent with the conclusions reached by the Board in the Reducing Complexity in Reporting of Financial Instruments Discussion Paper -

'The many ways of measuring financial instruments and the associated rules are one of the main causes of today's complexity…..' (Paragraph IN4)

'Measuring all financial instruments the same way would make the reported information easier to understand and facilitate comparisons between entities and between periods. It also would eliminate many of the rules associated with measuring financial instruments in different ways, such as the need for criteria to distinguish between different types of financial instruments'. (Paragraph 1.9)

A long-term solution to address such measurement-related problems is to measure in the same way all types of financial instruments within the scope of a standard for financial instruments. ***Fair value seems to be the only measure that is appropriate for all types of financial instruments'*** *(Paragraph IN5) emphasis added*

12. The staff expects a great deal of opposition (from some constituents) to this alternative, judging by the current debate on fair value requirements under IFRS.

13. Another (and major) drawback of this approach is that the net amount provided by deducting the fair value of the liability from the fair value of the asset in most cases, will not represent the transferor's net economic exposure to or interest in the transferred asset.

14. For instance, under Approach 2 (Flow chart 2), a sale of a financial asset with an option will fail the practical ability to transfer test and hence will be accounted for as a secured lending transaction. If the transaction is deemed to qualify for LP, the asset transferred and the related liability will both be fair valued and presented linked on the face of the statement of financial position.

15. The following analysis illustrates how the net amount obtained by deducting the liability from the asset in the above case will not yield the value of the option.

16. If the option is a call option, the transferor would not be exposed any downside (or the downside below the strike price). If the value of the transferred asset is less than the strike price, the call option will be out of the money and the transferor would not exercise. On the other hand fair valuing the asset would reflect both all the upside and the downside movements in the value of the asset. Thus fair valuing the linked items will not yield an amount equal to the value of a call option (which is the transferor's net economic interest in the asset transferred).

17. The opposite applies to put options. With a transfer with a written put, the transferor is exposed to all the downside and non of the upside. If the asset value is higher than the put option, the transferee will not exercise. On the other hand the valuation of the asset (at fair value) will presumably include all the upside. Thus the net amount provided by LP will not be equal to the value of the put option (which represents the transferor's net economic exposure to the asset transferred).

18. The only case the staff thinks the net of the fair value of the asset and liability will represent the entity's net economic exposure to or interest in the transferred asset will be non recourse pass through arrangements or self liquidating non recourse transactions.

Alternative C - Initially measure the linked items at using the continuing involvement approach under IAS 39

19. Under continuing involvement measurement, the transferor generally recognises the transferred asset at fair value. The associated liability is measured so as to make the net amount equal to the extent to which the transferor continues to be exposed to the changes in the value of the transferred asset.

20. Where a guarantee causes the transaction to fail the derecognition test, the asset recognised at the date of transfer is measured at the lower of the carrying amount of the asset and the maximum amount of the consideration received in the transfer that the entity could be required to pay (the guaranteed amount). As the net amount of the asset and related liability should represent the fair value of the guarantee, the associated liability is the balancing number. The liability is usually measured at the guarantee amount plus the fair value of the guarantee.

21. Where a call option triggers failed sale accounting, the transferred asset is measured at fair value. As the net amount of the asset and the liability is always the fair value of the call option, the related liability is the balancing number. The liability is initially measured at (a) the lower of the fair value of the transferred asset or the strike price less (b) the time value of the option.

22. Where the option is in or at money, the liability is measured as the call option exercise price less the time value of the option. Where the option is out of the money, the liability is measured at the fair value of the transferred asset less the time value of the option.

23. With a sale of a financial asset with a written put, the transferred asset is initially measured at the lower of fair value and the option’s strike price, as the entity has no exposure to increases in fair value above the strike price. As the net amount of the transferred asset and the related liability has to be the fair value of the option the related liability is the balancing number. The liability is initially measured at the option strike price plus the time value of the option.

24. Although this alternative provides the most useful information ie the net figure to be displayed will be the transferor's net economic exposure to or interest in the transferred asset, it comes at a high cost.

25. This method generally requires fair value for the asset and the value of the liability is the balancing number that results in the net figure being the extent to which the entity is exposed to change in the value of the asset (as seen from the analysis above).

26. One wonders why preparers should be asked to go through such tortuous (roundabout) computation to show the net economic exposure or interest. If the net economic exposure or interest is the statistic sought, then why not ask for the net economic exposure or interest (ie the derivative or the retained interest) to be displayed instead, as in Flow Chart 1.

27. The staff understands that few preparers, users and auditors understand how this method is supposed to work. A couple of the IFRS guidance published by the Big Four firms emphasise this point clearly –

> "Continuing involvement is a unique model, and the IASB has provided limited guidance on how to apply it. There are challenges in interpreting this model, and it is not always easy to rationalise what it means" (a Big Four Derecognition Publication)

Staff Recommendation

28. Although the continuing involvement approach provides the most useful information, its requirements add to the complexity of the existing requirements and detract from the Board's objective for this project.

29. The staff recommends that a transferred asset and the related liability that meet the requirements for LP, be measured at fair value on the date of transfer to prevent a mixed attribute model, provide comparability in reporting transfers of financial assets, and provide useful information to users (an indication of the quantum of the entity's net economic exposure to or interest in the asset).

Question for the Board

30. Does the Board agree with the staff recommendation that initial measurement of the linked items should be at fair value? If not, why not?

31. If not, what alternative do you recommend?

SUBSEQUENT MEASUREMENT OF LINKED ITEMS

32. The staff believes there are two feasible alternatives for subsequent measurement: fair value and the fair value option. These alternatives only apply if the Board agrees with the staff recommendation that initial measurement should be at fair value. If the Board decides that initial measurement basis should be the same as the measurement basis used prior to transfer, subsequent measurement will not need to be addressed.

Alternative A - Fair Value Option

33. This alternative allows a transferor to choose whether to fair value either or both of the linked items. Under this alternative, upon meeting the LP criteria, the transferor can make a fair value option election.

34. The staff is concerned that this alternative would create or compound issues that users currently have with the mixed attribute model unless the fair value option is required to be elected for all components of LP and not on a contract-by-contract basis.

35. The staff does not recommend this alternative as it is concerned that this alternative would create or compound issues that users currently have with the mixed attribute model.

Alternative B - Fair Value

36. The other alternative is to subsequently measure the assets and the related liability at fair value.

37. The staff believes that requiring initial and subsequent measurement of assets and liabilities at fair value will impose discipline and prevent entities from using fair

value to obtain desired reporting results without reporting subsequent changes in fair value that might adversely affect the entity.

38. The staff also believes that fair value is consistent with the Board's long term goal for all financial instruments to be measured at fair value.

Staff Recommendation

39. The staff believes that fair value provides the most relevant information about the entity's assets and liabilities related to the LP transfer.

40. The staff believes that if fair value is required for initial measurement, it would be more consistent to require that fair value measurement be applied subsequently for both the assets and liabilities.

41. Hence the staff recommends Alternative B (ie the transferor should measure the asset and liability subsequently at fair value).

Question for the Board

42. Does the Board agree with the staff recommendation that the subsequent measurement of the linked items be at fair value? If not, why not?

43. If not, what alternative do you recommend?

Gain or Loss Recognition

44. If the Board agrees that fair value should be the measurement basis for the linked items, the Board must also decide how to recognise the gains or losses that will result from the initial and subsequent measurement of the linked items.

45. The staff believes there are three alternatives for initial gain or loss recognition:

(a) defer and amortise gains but recognise all losses at the time of a transfer, or

(b) recognise the portion of the gain or loss associated with the transferred portion of the financial asset through earnings and defer the remainder of the gain or loss.

(c) recognise all gains and losses through income at the time of transfer,

Alternative A: Defer Gains but Recognise Losses

46. One alternative is require entities to defer the entire gain and amortise it into income over the life of the transaction while recognising any losses at the time of the transfer.

47. Alternatively the gain could be permitted to be recognised in other comprehensive income and reclassified into income when the asset expires or the requirements for derecognition are met.

48. The staff notes that deferring recognition of a gain may provide opportunity to smooth income artificially and will present less meaningful information about the linked items after the date of transfer. Therefore, the staff does not recommend this approach.

Alternative B: Recognise a Portion of the Gain or Loss and Defer the Remainder

49. Both FAS 140 and IAS 39 require an allocation of the carrying value of the transferred assets between the assets sold and the retained interests, based on their relative fair values. A gain or loss is reported for the assets sold, while no gain or loss is reported for the retained interest(s).

50. Similar to the current accounting treatment for a sale of a part of an asset, this approach would require that the transferor perform a relative fair value calculation to determine the portion of the gain or loss that should be recognised through earnings and the portion that should be deferred.

51. As a result, the transferor would recognise a gain or loss only related to the portion of the financial asset that relates to the linked obligation and would defer the gain or loss associated with the portion of the transferred financial asset that is retained (ie the net asset in the LP).

52. The staff does not recommend this alternative as it is not consistent with the staff's recommendation to account for linked assets and liabilities at fair value both initially and subsequently (as discussed above).

Alternative C: Recognise All Gains and Losses through Income

53. The staff believes that gains and losses resulting from initial measurement should be reported immediately through earnings.

54. One concern that arises from the use of fair value as the measurement principle is that it will give transferors incentive to time gains and losses through earnings.

55. Those concerns may be mitigated by requiring that subsequent measurement be at fair value with gains and losses also reported in earnings. The staff notes that the informational value provided from fair value measurement outweighs concerns about the recognition of gains or losses at the time of transfer.

Staff Recommendation

56. The staff recommends Alternative C (ie gain or loss be recognised through income both at the time of the transfer and subsequently).

Questions for the Board

57. Does the Board agree with the staff's recommendation? If not, why not?

58. If not, what other alternative do you recommend?