Derecognition and Consolidation
Round table meeting

Staff Paper

Date **June, 2009**

Project **Derecognition**

Introduction

1. In April 2005 the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) added a project to their respective research agendas to improve and potentially bring to convergence the derecognition requirements in IAS 39 *Financial Instruments: Recognition and Measurement* and FASB Statement No. 140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SFAS 140). The boards made this decision because of the perceived complexity of the current requirements and the resulting difficulty in applying them in practice.

2. In June 2008, the IASB decided to proceed directly to the publication of an exposure draft in response to the global financial crisis and the recommendations of the Financial Stability Forum. Following that decision, the Board moved the project from its research agenda to its active agenda.

3. Similarly, the FASB decided to publish an exposure draft as a result of the financial crisis and requests by the US Securities and Exchange Commission to address urgently inconsistencies in how some concepts in SFAS 140 are applied in practice. In September 2008 the FASB published the exposure draft proposing amendments to SFAS 140.

4. In March 2009, the IASB published an exposure draft ('ED') to amend IAS 39 derecognition guidance and IFRS 7, *Financial Instruments: Disclosures,* guidance relating to transfer of financial assets and liabilities.

This paper has been prepared by the technical staff of the IASB for the purposes of discussion at a public round table meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper and do not purport to represent the views of any individual members of the Board or the IASB.

The meeting at which this paper is discussed is a public meeting but it is not a decision-making meeting of the Board.

Official pronouncements of the IASB are published only after the Board has completed its full due process, including appropriate public consultation and formal voting procedures.

5. The proposed amendments would replace the approach to derecognition of financial assets in IAS 39. The Board believes that the proposed approach is less complex to understand and apply than the current requirements in IAS 39 and thus is an improvement to financial reporting. The Board also believes that the proposed approach arguably provides fewer opportunities for structuring and it is overall consistent with and addresses users request for transparency in accounting for transfer transactions and calls for improvement to and convergence of, derecognition requirements.

6. The proposed amendments would also revise the approach to derecognition of financial liabilities in IAS 39 to be more consistent with the definition of a liability in the IASB *Framework*. The proposed amendments to IFRS 7 *Financial Instruments: Disclosures* would enhance the disclosures in that IFRS to improve the evaluation of risk exposures and performance in respect of an entity's transferred financial assets.

Convergence

7. In February 2006 the IASB and FASB published a Memorandum of Understanding (MoU). The MoU set out the relative priorities within the boards' joint work programme in the form of milestones to be reached by 2008. The MoU included the derecognition project and aimed for a due process document relating to the staff's research on this subject to be published by 2008.

8. At their joint meeting in April 2008 the boards affirmed their commitment to developing common, high quality standards and agreed on a pathway to completing the MoU projects. For the derecognition project, the boards set as targets:

   (a) the publication of IASB and FASB exposure drafts in 2008 or early 2009;

   (b) the issue of final standards in 2009 or 2010; and

   (c) a decision in 2008 on a strategy to develop a common standard.

9. At their joint meeting in March 2009, the boards agreed that:

(a) the FASB would complete its short-term project of amending SFAS 140 by issuing a final statement in 2009;

(b) they would jointly deliberate (with the objective of reaching common conclusions) the comments the IASB receives on this exposure draft; and

(c) at the conclusion of those deliberations, the IASB would issue a standard amending the derecognition requirements in IAS 39, and the FASB would expose the IASB's amendment of IAS 39 to its constituents for public comment.

Next Steps

10. The Board invites comments on all matters in the ED, in particular on the questions set out in the ED. Comments should be submitted in writing so as to be received no later than **31 July 2009**.

11. The proposals (proposed and alternative approaches) may be modified in the light of the comments received before being issued in final form as amendments to IAS 39 and IFRS 7.

12. The IASB would be holding public round tables in June 2009 to discuss the proposals. The Board expects to issue final amendments to IAS 39 and IFRS 7 in the first half of 2010.

Derecognition of financial assets

13. The Board was divided on the appropriate approach to derecognition of financial assets. A majority of the Board favoured (and decided on) the derecognition approach proposed in the ED. However, five Board members preferred an alternative approach.

14. Like the proposed approach, the alternative approach bases the decision of whether an entity should derecognise a transferred financial asset on whether the entity has surrendered control of the asset.

15. However, unlike the proposed approach, the alternative approach assesses control differently, and with that, has a different perspective of what the asset that is the subject of the transfer is. The proposed and alternative approaches are described in detail in the ED.

16. The staff has met with several users, prepares, auditors and regulators to discuss the proposed amendments. Following those discussions, the staff has identified aspects of the proposed amendments that respondents have concerns about and that might require further clarification or guidance. Based on the comments received, the issues to be debated at this round table session have been reduced to allow for a more effective debate and feedback. Hence, this paper does not include all the questions posed in the ED.

17. This paper sets out:

    (a) those aspects (paragraphs) of the proposed approach referred to in paragraph 16 -

    i. Determination of the 'Asset' to be assessed for derecognition

    ii. Definition of 'transfer'

    iii. Determination of 'continuing involvement'

    iv. 'Practical ability to transfer for own benefit' test

    v. Disclosures

    vi. Interaction between consolidation and derecognition

    (b) The Alternative View to derecognition of financial assets

    (c) a summary of the basis for arriving at those conclusions and

    (d) questions relating to those aspects of the ED.

Determination of 'the Asset' to be assessed for derecognition

> **16A An entity applies paragraphs 17A and 18A to a part of a financial asset (or a part of a group of financial assets) only if that part comprises specifically identified cash flows or a proportionate share of the cash flows from that financial asset (or that group of financial assets) (ie the performance of the part retained does not depend on the performance of the part transferred, and vice versa). If there are two or more transferees, no transferee is required to have a proportionate share of the cash flows from the asset (or the group of financial assets) provided that the transferring entity has a proportionate share. In all other cases, paragraphs 17A and 18A are to be applied to the financial asset (or group of financial assets) in its entirety. In paragraphs 17A and 18A, the term 'the Asset' refers to either a part of a financial asset (or a part of a group of financial assets) as identified in this paragraph or, otherwise, a financial asset (or a group of financial assets) in its entirety.**

(Note: The criteria proposed in paragraph 16A are the same as those in IAS 39.)

18. In choosing these criteria, the Board noted that

    (a) financial instruments are made up of contractual rights or contractual obligations that might be financial assets or financial liabilities in their own right,

    (b) many transfer transactions separate those rights and obligations and then combine them in different ways, usually for a commercial reason, and

    (c) if financial statements are to give a faithful representation of transactions and events, the derecognition approach (and hence 'the Asset' criteria) adopted needs to reflect the separation and packaging of those rights and obligations.

19. In its purest form, a part of an asset may be defined as the 'rights and obligations (ie assets and liabilities) embedded in that asset'. This would mean that the right to receive any of the cash flows of a financial asset would in itself qualify as an asset that should qualify for derecognition if the derecognition criteria are met.

20. However, the Board was concerned that if it had defined 'the Asset' that can be assessed for derecognition as a right to *any* cash flows of a financial asset, it would have allowed an entity to achieve derecognition of a transferred part of a financial asset even though the part transferred included some or all of the risks

or rewards of the part retained or even though the performance of one part was dependent on that of the other part (ie the parts were interdependent).

21. The Board believes that it would be inappropriate to specify that any subdivision of an asset (no matter how small that subdivision is)—indeed any provision inserted into a contract that does not produce a separate cash flow under the contract—is an asset in its own right that may qualify for derecognition.

22. As a result, the Board decided to restrict the types of interests in a financial asset that might qualify for derecognition to those parts that meet the 'parts' definition in paragraph 16 of the current version of IAS 39.

23. For a transfer of a part of a financial instrument that can be an asset or a liability over its life (eg the 'receive' leg of an interest rate swap), the Board concluded that 'the Asset' to be assessed for derecognition is the entire instrument. This is because the cash flows relating to the asset part of the instrument are likely to be netted with the cash flows relating to the liability part. Accordingly, the 'specifically identified cash flows' from the instrument that would be observable would be net flows, and thus they would be different from, and less than, the cash flows relating to the asset part only.

Questions for participants

24. Do you agree with the criteria proposed in paragraph 16A for what qualifies as the item (ie the Asset) to be assessed for derecognition? If not, why? What criteria would you propose instead, and why?

Definition of 'transfer'

A *transfer* takes place when one party passes, or agrees to pass, to another party some or all of the economic benefits underlying one or more of its assets. The term 'transfer' is used broadly to include all forms of sale, assignment, provision of collateral, sacrifice of benefits, distribution and other exchange. (A transfer does not necessarily result in derecognition.) – Paragraph 9

25. The Board decided to define 'transfer' broadly. The Board's intention was that the scope of transactions that are considered for derecognition should be consistent with the underlying objective that all transactions that (irrespective of how they are documented or effected) are economically transfers of financial assets should be assessed for derecognition. The Board believes that the proposed definition ensures that irrespective of their form, qualifying transactions will be assessed for derecognition.

Questions for participants

26. **Do you agree with the proposed definition of a transfer? If not, why? How would you propose to amend the definition instead, and why?**

Determination of 'continuing involvement'

> **17A An entity shall derecognise the Asset if:**
>
> **………**
>
> **(b) the entity transfers the Asset and has no continuing involvement in it; or**
>
> **……….**
>
> **18A A transferor has no continuing involvement in the Asset if, as part of the transfer, it neither retains any of the contractual rights or obligations inherent in the Asset nor obtains any new contractual rights or obligations relating to the Asset. None of the following constitutes continuing involvement:**
>
> **(a) normal representations and warranties relating to fraudulent transfer and concepts of reasonableness, good faith and fair dealings that could invalidate a transfer as a result of legal action;**
>
> **(b) the retention of the right to service the Asset in a fiduciary or agency relationship; or**
>
> **(c) forward, option and other contracts associated with reacquiring the Asset for which the contract (or exercise) price is the fair value of the transferred Asset.**

27. The Board decided that if following a transfer an entity is not involved in the transferred financial asset in any way, it no longer controls the economic benefits of that asset (ie after the transfer, the transferee's ability to obtain and restrict others' access to those benefits is not constrained). This will be the case for many simple transactions, in which one entity transfers all its rights and obligations relating to a financial asset to another entity and acquires no new rights or obligations relating to that asset. Hence, the Board decided that once an entity identifies the asset to be assessed for derecognition, if the entity does not have any continuing involvement in that asset, the entity derecognises the asset.

28. The Board concluded that an entity does not have continuing involvement in the Asset if it has neither an interest in the future performance of the Asset nor a

responsibility under any circumstances to make payments in respect of the Asset in the future.

29. The Board considered some types of involvement in transferred financial assets after the transfer to be commonplace and consistent with its ‘control of an asset’s economic benefits’ principle. Hence, the Board decided to exclude them from the ‘continuing involvement’ definition (even though technically they would meet that definition).

Questions for participants

30. Do you agree with the ‘continuing involvement’ filter proposed in paragraph 17A(b), and also the exceptions made to ‘continuing involvement’ in paragraph 18A? If not, why? What would you propose instead, and why?

'Practical ability to transfer for own benefit' test

> **17A An entity shall derecognise the Asset if:**
>
> **……..**
>
> **(c) the entity transfers the Asset and retains a continuing involvement in it but the transferee has the practical ability to transfer the Asset for the transferee's own benefit.**

(Note: Other than the 'for the transferee's own benefit' supplement, the 'practical ability to transfer' test proposed in paragraph 17A(c) is the same as the control test in IAS 39.)

31. The principle the Board applies to derecognition of financial assets is whether an entity has the present ability (a) to obtain (access) the future economic benefits inherent in the asset (or a part of it) and (b) to restrict others' access to those benefits. The future economic benefits embodied in an asset may flow to an entity in a number of ways. For example, an entity can obtain the economic benefits of a financial asset by exchanging it for other assets, by using it to settle a liability or by distributing it to the owners of the entity.

32. If the transferee is free and able to transfer a financial asset in any of these ways, the transferee can obtain the economic benefits. To the extent that the transferee can restrict others' access to those benefits (ie if it is entitled to receive and keep for itself the proceeds from any such potential subsequent transfer), the transferee controls the economic benefits of the asset.

33. This interpretation is consistent with the notion that the entity with an asset is the one that, within the limits set by the nature of the benefit or the entity's right to it, can use it as it wishes. An entity is able to give control of an asset to a third party only if the entity itself has that control.

34. For a transferee to have the practical ability to transfer the Asset for its own benefit, it must be in a position immediately after the transfer from the transferor to transfer, for its own benefit, the Asset to an unrelated third party *unilaterally* and *without having to impose additional restrictions* on that transfer.

35. The Board believes that the assessment of whether the transferee has the practical ability to transfer the asset that is the subject of a transfer—unilaterally

and without having to impose additional restrictions—and whether the transferee has that ability for its own benefit (ie whether it can obtain the full economic benefits of that asset) will require judgement and can be made only after considering all the relevant facts and circumstances. The Board decided that the important issue regarding the ability to transfer an asset is what the transferee is able to do in practice, rather than what contractual rights or contractual prohibitions the transferee has regarding the asset.

For the transferee's own benefit

36. If the transferee has the practical ability to transfer to an unrelated third party the financial asset that is the subject of the transfer with the transferor, it has the ability to obtain the asset's economic benefits. Having that ability in isolation, however, is not evidence of the transferee having control of the asset. The transferee also must be able to restrict others' access to those benefits. The transferee controls the asset only if it is in a position to keep for itself the consideration it would receive from a third party if it were to transfer the asset to that party. Accordingly, if the transferee has an obligation to pass the consideration from the third party to the transferor, it will not have the practical ability to transfer the asset 'for its own benefit'.

Factors to consider in assessing 'practical ability to transfer'

37. Determining whether a transferee has the practical ability to transfer the Asset requires judgement, after considering all the relevant facts and circumstances. Some factors to consider in making that determination are:

    a. the terms of the transfer (contractual) arrangement, including other contracts or arrangements entered into in relation to the transfer
    b. the nature of the Asset (fungibility and obtainability)
    c. the market for the Asset
    d. the transferee's ability to obtain the full economic benefits of the Asset
    e. economic constraints

Reassessment of the 'practical ability to transfer' test

38. A transfer that does not qualify for derecognition because the transferee is deemed not to have the practical ability to transfer the Asset to a third party for

its own benefit would subsequently qualify for derecognition if conditions changed so as to give the transferee that ability (for example, the Asset, which was not readily obtainable at the date of transfer, subsequently becomes readily obtainable). Subsequent events that change the probability of an option being exercised (other than the exercise or expiration of the option itself) would not trigger (nor would they be factored into) any reassessment. Once a transferor derecognises the Asset because it judges that the transferee has the practical ability to transfer that asset to a third party for the transferee's own benefit, it does not re-recognise the Asset if conditions subsequently change resulting in the transferee no longer having that practical ability.

Practice implications of the 'practical ability to transfer' test

39. A major implication of the 'practical ability to transfer for its own benefit' test is that if that test is met, the transferor will derecognise the Asset, irrespective of the nature of the transferor's continuing involvement in the Asset. Because most sale and repurchase agreements involving financial assets (repo transactions) concern the transfer of one readily obtainable security in exchange for another readily obtainable security, an implication of this test is that most repo transactions will be treated as a sale of the transferred assets. That means that each party to the transaction will derecognise the security it had recognised before the transaction, and each will recognise the security received in return. In most jurisdictions, this will represent a fundamental change in accounting treatment because, to date, sale and repurchase agreements generally have been treated as secured borrowings, and stock lending transactions generally have not affected the assets and liabilities recognised in the statement of financial position.

40. The Board recognises that this change will have a major impact on the reported financial position of many entities. Nevertheless, for the reasons set out above the Board believes its proposal will improve financial reporting.

Questions for participants

41. Do you agree with the proposed 'practical ability to transfer' derecognition test in paragraph 17A(c)? If not, why? What would you propose instead, and why?

42. **Do you agree with the 'for the transferee's own benefit' test proposed as part of the 'practical ability to transfer' test in paragraph 17A(c)? If not, why? What would you propose instead, and why?**

Proposed approach to derecognition of financial assets

17A An entity shall derecognise the Asset if:

(a) the contractual rights to the cash flows from the Asset expire;

(b) the entity transfers the Asset and has no continuing involvement in it; or

(c) the entity transfers the Asset and retains a continuing involvement in it but the transferee has the practical ability to transfer the Asset for the transferee's own benefit.

Questions for participants

43. **Do you agree that the proposed approach as a whole should be established as the new approach for determining the derecognition of financial assets? If not, why?**

The Alternative View

44. Under the alternative approach, when the rights to identified cash flows are transferred, the transferor derecognises the previously recognised asset and recognises all the rights and obligations either retained or obtained in the transfer transaction. For example, forward contracts, puts, calls, guarantees or disproportionate involvement with respect to transferred cash flows would not result in failed sales or result in the recognition of a liability for the proceeds received. Any involvement would be recognised and measured at the date of transfer at fair value.

45. The objective would be to recognise any rights and obligations associated with a transferred asset as if those rights and obligations related to an asset that had not previously been owned.

46. Under the alternative approach, a transferor could be required to apply the same disclosure guidance as proposed by the amendment to IFRS 7. The proposed amendment to IFRS 7 would provide adequate information to enable users to evaluate the nature of and risks associated with the transferor's continuing involvement in derecognised financial assets. The full exposure (including the nature, timing, ranking, amount and uncertainty of any obligations or cash outflows relating to the entity's continuing involvement in a transferred asset and the details about those assets) would be provided in one note (disclosure). Hence, the proposed disclosures would provide clear information both on the allocation of risks and on their potential impact on the financial condition of the transferor.

47. An implication of the alternative approach is that if an entity transfers part of a financial asset, it generally will derecognise the previously recognised asset and will recognise as a new asset the economic benefits retained. The retained economic benefits would be treated as a new asset because its characteristics typically differ from those embodied in the previously recognised asset. Consistently with the other requirements in IAS 39, the new asset would be measured at fair value and any gain or loss resulting from the transfer would be recognised in profit or loss.

48. In many instances, a transferor carries at amortised cost in its statement of financial position a financial asset that is the subject of a transfer.

49. Respondents have indicated that the alternative approach would permit an entity to change the measurement attribute from amortised cost to fair value at will and would hence lead to the selective recognition of fair value and an opportunity for earnings management. For example, a sale of a one per cent proportionate interest in a loan would require the 99 per cent retained interest to be measured at fair value.

50. The staff believes these concerns could be addressed by

    (a) Requiring the retained interest to be subsequently measured at fair value through profit and loss just as a continuing involvement that is a derivative would be accounted for subsequently or

    (b) Deferring the gain and amortising it to profit and loss on an appropriate basis (presumingly a loss would be immediately recognised in profit or loss) or

    (c) Requiring retained interest to be subsequently measured using the same measurement attribute as that previously used for the underlying asset

Questions for participants

51. Do you believe that the alternative approach set out in the alternative views should be established as the new derecognition approach instead, and, if so, why? If not, why? What alternative approach would you propose instead, and why? Would any of the suggested solutions to addressing the earnings management issue resolve any concerns you may have?

Disclosures

52. The Board proposes requiring disclosures that enable users of financial statements: (a) to understand the relationship between transferred financial assets that are not derecognised and associated liabilities; and (b) to evaluate the nature of and risks associated with the entity's continuing involvement in derecognised financial assets.

Transferred financial assets that are not derecognised

42B An entity may have transferred financial assets in such a way that part or all of the financial assets do not qualify for derecognition (see paragraphs 15A–18A of IAS 39). The entity shall disclose information that enables users of its financial statements to understand the relationship between those assets and associated liabilities after the transfer. The entity shall disclose for each class of such financial assets:

(a) the nature of the assets.

(b) the nature of the risks to which the entity remains exposed.

(c) the carrying amounts of the assets and of the associated liabilities.

(d) a description of the nature of the relationship between the assets and the associated liabilities, including any restrictions on the entity's use of the assets.

(e) when the counterparty (or counterparties) to the associated liabilities has (have) recourse only to the assets, a schedule that sets out the fair value of the assets, the fair value of the associated liabilities and the net position.

53. When financial assets are transferred but not derecognised, there has been a contractual event that may not be captured fully by the accounting that treats any cash received as a secured borrowing. In those situations, the Board concluded that it is useful to understand the relationship between those financial assets and the associated liabilities that an entity recognises. Understanding the relationship between the assets and associated liabilities helps users of financial statements in assessing both an entity's cash flow needs and the cash flows available to the entity from its assets. IFRS 7 requires disclosures about transferred financial

assets that are not derecognised. The Board decided to carry over those disclosures because they provide some information useful in understanding the relationship between transferred financial assets that are not derecognised and associated liabilities.

54. The Board believes that the disclosures proposed would provide information useful in assessing the extent to which the economic benefits generated from assets of an entity cannot be used in an unrestricted manner, as is implied when assets are controlled and recognised in an entity's statement of financial position. In addition, it would also provide information about liabilities that will be settled entirely from the proceeds received from specific assets, and thus identifies liabilities for which the counterparties do not have claims on the assets of the entity in general. For those assets for which the underlying cash flows are committed to be used to satisfy related liabilities, the linked presentation disclosure (in addition to showing the cash flow relationship between those assets and liabilities) also provides a means of understanding the net exposure of an entity following a transfer transaction that fails derecognition.

Questions for participants

55. Do you agree with the proposed amendments to IFRS 7 (for transferred assets that are not derecognised)? If not, why? How would you propose to amend those requirements instead, and why?

Transferred financial assets that are derecognised

56. When an entity retains continuing involvement in financial assets that it has derecognised, the Board concluded that users of financial statements would benefit from information 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.

57. IFRS 7 does not require disclosures about transferred assets that have been derecognised. The Board was asked by the Financial Stability Forum and others to review the disclosure requirements for what are often described as 'off

balance sheet' activities; derecognised financial assets form part of such activities.

58. The Board reasoned that a combination of disclosures about the fair value of the derecognised assets, the strike price or repurchase price to repurchase assets, the fair value of its continuing involvement, the maximum exposure to loss and qualitative information about an entity's obligations to provide financial support are relevant in understanding the risks retained by an entity.

59. In addition, information about an entity's gain or loss on derecognition and the timing of recognition of that gain or loss provides information about the proportion of an entity's profit or loss that arises from transferring financial assets in which the entity also retains continuing involvement. Such information is useful in assessing the extent to which an entity generates profits from transferring financial assets while retaining some form of continuing involvement and thus exposure to risk.

60. The Board observed that IFRS 7 already requires some of the proposed disclosures by class of financial instrument or by type of risk. However, IFRS 7 asks for the information at an aggregated level, so information specific to derecognition transactions is often not available. In response to requests from users and others the Board is now proposing disclosures specific to derecognition transactions.

Questions for participants

61. Do you agree with the proposed amendments to IFRS 7 (for transferred assets that are derecognised)? If not, why? How would you propose to amend those requirements instead, and why? If you agree with the proposed amendments to IFRS 7 (for transferred assets that are derecognised), would you suggest that the proposed disclosures be extended to all derivatives?

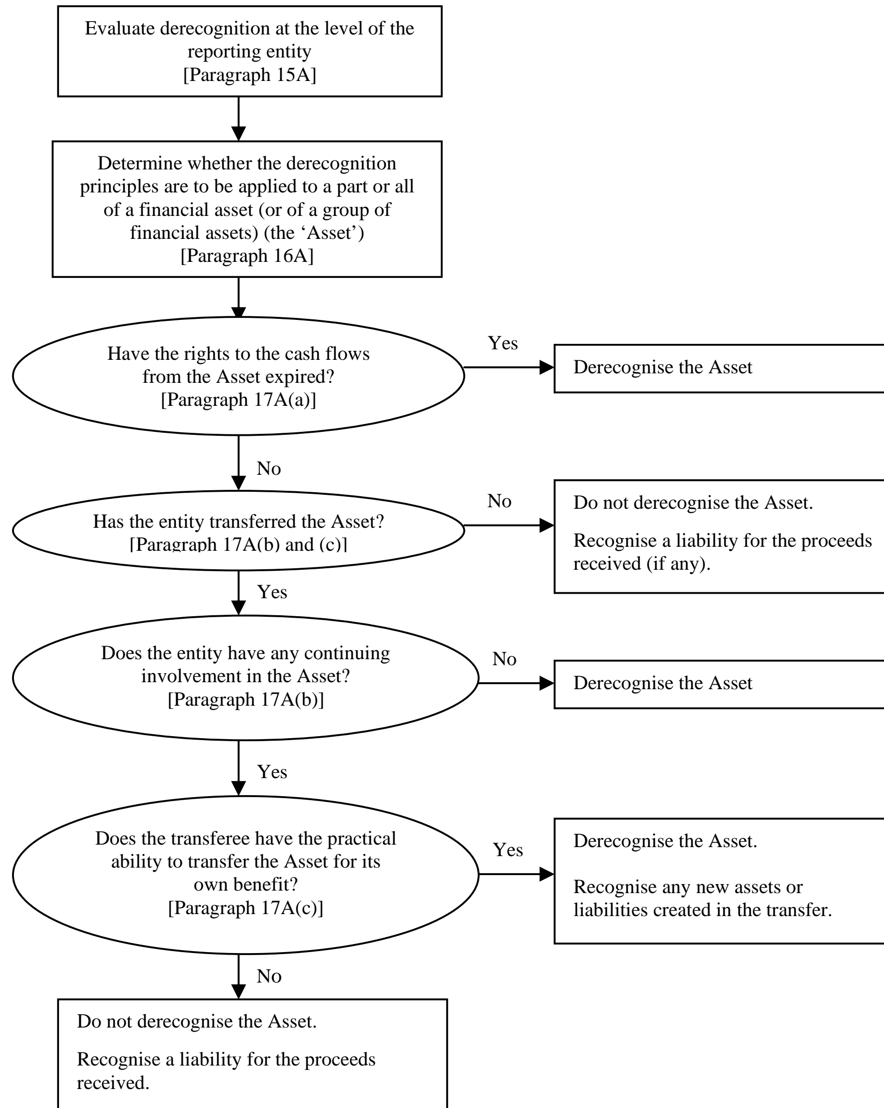
Interaction between consolidation and derecognition

62. In December 2008, the Board issued an exposure draft ED 10 *Consolidated Financial Statements*. The Board believes that its proposed approach to derecognition of financial assets in the ED is similar to the approach proposed in ED 10 (albeit derecognition is applied at the level of assets and liabilities, whereas consolidation is assessed at the entity level).

Question for participants

63. Do you agree that the proposed derecognition and consolidation approaches are compatible? If not, why? Should the Board consider any other aspects of the proposed approaches to derecognition and consolidation before it finalises the exposure drafts? If so, which ones, and why? If the Board were to consider adopting the alternative approach, do you believe that that approach would be compatible with the proposed consolidation approach?

Appendix 1: Flowchart – Proposed approach to derecognition of financial assets



Appendix 2: Flowchart – Alternative approach to derecognition of financial assets