Project **Derecognition**

Topic **Accounting for retained interests**

## Introduction

1. This paper sets out possible alternatives to addressing the perceived earnings manipulation opportunity under the alternative approach to derecognition of financial assets. The staff believes it is important that the Board consider whether and, if so, how this issue would be addressed if the alternative approach was pursued.

2. None of the alternatives described in this paper would impact the derecognition test of the alternative approach but they would address the accounting for retained interests (whether or not they are beneficial interests in an SPE) as a result of a transfer which qualifies for derecognition.

3. The paper includes a staff recommendation and asks which of the alternatives the board prefer as the appropriate accounting for retained interests.

## Respondents comments on the alternative approach

4. Many respondents to the ED did not support measuring the retained portion at fair value (as proposed under the alternative approach). They were concerned that an entity could sell only a small portion of a financial asset carried at amortised cost and trigger a gain or loss on the entire financial asset as opposed to only on the portion transferred.

5. The staff notes that the perceived earnings manipulation opportunity (suggested as a weakness of this approach) is already available (for readily obtainable assets) under the current derecognition requirements. The staff also notes that the issue is not due to the derecognition approach itself but arises because IAS 39 adopts a mixed measurement approach to financial instruments. It is

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

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however true that the alternative approach in its current form, will extend that effect to non readily obtainable assets.

6. Some respondents also suggested that any cash flows retained by a transferor should be treated as part of the asset previously recognised by the transferor (i.e. the 'old asset') because it is consistent with the view underlying the alternative approach (i.e. financial instruments comprise bundles of contractual rights and/or contractual obligations, and transfer transactions unbundle those rights and obligations and re-bundle them in different ways). Thus, as any retained interest is a component of the original asset and it should not be treated as a new asset but as part of the old asset, with no gains or losses recognised on the retained interest.

## The Issue

7. For transfers of part of a financial asset, the alternative approach would require the transferor to derecognise the entire financial asset and recognise as a new financial asset (rather than a part of the financial asset that the transferor recognised before the transfer) the retained interest in the financial asset. Similarly, the alternative approach would require a transferor to recognise as a new asset an investment that a transferor purchases in a transferee entity.

8. Under the alternative approach, any new assets (rights) received are considered part of the proceeds of the exchange, and any new liabilities (obligations) incurred are a reduction of the proceeds.

9. The alternative approach therefore would require a transferor to recognise on derecognition of a financial asset, the difference between (a) the carrying amount of the asset transferred, (b) the sum of the consideration received (including any new asset obtained less any new liability assumed) and any cumulative gain or loss that had been recognised in other comprehensive income, as gain or loss in the statement of financial performance in the reporting periods in which they arise.

10. This treatment would result in recognition of gain or loss, particularly, if a financial asset that had been carried at amortised cost is transferred with a

simultaneous purchase of a beneficial interest in the transferee vehicle or in a transfer of an interest in such an asset.

## The basis for treating retained interests as new assets under the alternative approach

11. In general, a beneficial interest in a transferee entity acquired by a transferor has a different set of cash flows and a different risk and rewards profile from the original financial asset. For example, a beneficial interest acquired in a transfer of receivables has different rights and obligations from the receivables. Because of these different economic characteristics, under the alternative approach, the retained beneficial interest is considered a new financial asset. Hence accounting for the retained interest as a component of the transferred asset does not reflect the change in the nature of the transferor's rights and would therefore not be a faithful representation.

12. A transfer of a partial interest in an asset also results in a change in the nature of the transferor's assets. Inspection of contractual arrangements involving transfers of an interest in a financial asset indicates that the transferor surrenders some, if not all, of its rights. Even if the transferor has retained a significant interest in the transferred assets, it no longer has control of the cash flows of those assets. After the transfer transaction, the transferor no longer has an exclusive interest in the asset previously recognised. Typically, after the transfer transaction, the transferor and the transferee(s) have varying interests in the asset (at times senior, residual, subordinated or proportionate). Also, in a transfer transaction in which the transferor retains a partial interest in the financial asset, the asset previously recognised by the transferor is fragmented and as such the nature of the asset has been transformed.

13. Hence, under the alternative approach, if an entity transfers an entire asset or an interest in a previously recognised financial asset and the transaction meets the derecognition criteria; the entity derecognises the entire asset or group of financial assets. The transferor recognises as a new financial asset the interest in the asset retained or the beneficial interest in the transferee entity acquired as part of the transfer arrangement.

14. The view under the alternative approach is that, in transfer transactions in which an asset is derecognised, rights are surrendered in exchange for cash and other rights or assets (eg a beneficial interest in the transferee or a retained interest in the transfer asset) and obligations, all of which are new assets and part of the sale proceeds or consideration. Consequently, any beneficial interest that the transferor receives from a transfer that qualifies as a sale or a retained interest in an asset transferred should form part of the proceeds of the sale.

15. As a result, under the alternative approach, a retained interest in a financial asset and a beneficial interest acquired in a transferee vehicle are accounted for similarly. This is necessary as a transfer of a partial interest in a financial asset may be structured as a sale of the entire asset coupled with an acquisition of a beneficial interest in the transferee (or the asset) or as a transfer of an interest in the asset. If these transactions are not treated similarly, it would lead to an asymmetrical treatment for economically identical transactions and creation of structuring opportunities.

16. Under today's mixed attribute accounting model, fair value gains and losses are recognised as they occur for some, but not all, financial instruments. If a transferred asset had been measured at fair value at each reporting date, the gain or loss would have been recognised as it occurred, and measurement of the interest retained or beneficial interest acquired at fair value on the transfer date would not have resulted in further gain or loss. Thus, it is appropriate to recognise any resulting gain or loss in profit or loss at the transfer date.

17. This view is consistent with the approach adopted by the Board in IFRS 3 Business Combinations for step acquisitions. For a business combination achieved in stages, the Board concluded that the acquirer should remeasure its previously held equity interest in the acquiree at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss.

18. Based on the reasons for the treatment of retained interests as new assets, the staff believes that the approach that may provide the most relevant information will require that retained interests be treated as new assets and a recognition of the associated gains or losses.

19. We however recommend some possible approaches to addressing the earnings manipulation concern raised by board members and our constituents.

## Possible alternatives to address the earnings manipulation concern

20. The following are the possible ways to addressing the earnings manipulation issue whilst maintaining the integrity of that approach (***a graphical summary of these alternatives are set out in appendix B***):

    (a) **Alternative A:** treat all retained interests as new assets as proposed in the ED BUT the recognition of the portion of the gain relating to the retained interest will follow the classification category that the retained interest will be assigned to (under the proposed classification and measurement guidance).

    (b) **Alternative B:** treat all retained interests as part of the asset previously recognised by the transferor (i.e. as part of the old asset), as currently required under IAS 39.

    (c) **Alternative C:** treat some retained interests as new assets (if the retained interest represents a disproportionate interest in the asset previously recognised) or as part of the asset previously recognised (if the retained interest represents a pro rata portion of the asset previously recognised by the transferor). If the retained interest is a new asset, the guidance under Alternative A will apply but if it is part of the old asset then the guidance under Alternative B will apply.

## Alternative A: Treat all retained interests as new assets

21. In view of the conceptual reasons for treating retained interests as new assets, the need for consistency across the new financial instruments standard and consistent treatment of economically identical transactions, the board could decide to treat retained interests as new assets. The board could require the accounting for the retained interest to be in accordance with the proposed classification and measurement guidance.

22. If the Board agrees that a retained interest is a new asset and thus it should initially be measured at fair value, the Board must also decide how to recognise the gains or losses that will result for retained interests.

23. The table in appendix A sets out the possibilities under this approach and their impact on the issue at hand. Based on that analysis we believe the only scenarios that the perceived earnings manipulation issue is present are:

    (a) where the asset recognised by the transferor before the transfer was carried at amortised cost and

    (b) to some extent (because of recycling of gains and losses to profit or loss) where the asset recognised by the transferor before the transfer was carried at fair value through OCI .

24. The board could require that all retained interests be treated as new assets (as proposed in the ED) BUT the recognition of the portion of the gain relating to the retained interest should follow the classification category for the retained interest (under the proposed classification and measurement guidance). The only exception will be that where the asset recognised by the transferor before the transfer was carried at amortised cost and the retained interest under the proposed classification guidance will be measured at amortised cost the guidance in (iii) or (iv) (see below) could be imposed by the board.

25. Consequently the accounting for retained interest will be that such interests will be recognised initially at fair value and the resulting gain will be accounted for as follows:

    (i) if based on the proposed classification and measurement guidance the retained interest is in the fair value through profit or loss category, then the gain or loss relating to the retained interest will also be recognised in profit or loss.

    (ii) if based on the proposed classification and measurement guidance the retained interest is in the fair value through OCI category, then the gain or loss on the retained interest will be recognised in OCI.

    (iii) if based on the proposed classification and measurement guidance the retained interest is in the amortised cost category, then the gain or loss on the retained interest could be recognised as a deferred credit on the statement of financial position and subsequently amortised through profit or loss through the term of the instrument or on the derecognition of the retained interest **OR**

(iv) alternatively, if based on the proposed classification and measurement guidance the retained interest is in the amortised cost category, then the gain or loss on the retained interest could be recognised in OCI and subsequently reclassified through profit or loss through the term of the instrument or will be recognised in profit or loss on the derecognition of the retained interest

**Any losses on the retained interest should be recognised immediately in profit or loss under (iii) and (iv).**

26. This alternative therefore proposes to use the proposed classification and measurement guidance as an indicator of whether it is appropriate to recognise the gain or loss on a retained interest through profit or loss immediately.

27. For example, if the original asset is a loan (previously measured at amortised cost) and the transferor retains a subordinated interest in the loan (which is to be measured at fair value) under this alternative the treatment will be that the gain or loss on the retained interest should be reflected immediately in profit or loss.

28. The staff notes that deferring recognition of a gain and recognising such a gain as a deferred credit may provide opportunity to smooth income artificially and will present less meaningful information about the retained interest after the date of transfer. The staff also believes that the deferral of gains results in recognition of credits that do not meet the definition of the elements of financial statements.

29. Therefore, the staff does not recommend alternative (iii) for retained interests to be measured at amortised costs. The staff prefers the alternative that provides for the gain on retained interest to be accounted for at amortised cost to be recognised in other comprehensive income and reclassified into income when the asset expires or the requirements for derecognition are met.

30. The staff believes that recognition of gains or losses in OCI is not a new phenomenon and provides to some extent transparency around the gain or loss recognition.

31. The staff therefore recommends Alternative A as a solution for addressing the earnings manipulation concern.

### Alternative B: Treat retained interest as part of the old asset

32. Under this approach no gains or losses will be recognised on any retained interest because the retained portion will continue to be measured in accordance with the previous measurement basis (i.e. the carrying value of the retained interest will be a percentage of the previous carrying value of the entire asset). This alternative is consistent with the view described in paragraph 6 that any retained interest is a component of the original asset.

33. Supporters of this approach argue that even though this approach changes significantly the treatment of retained interests under the alternative approach as drafted in the ED, the modified treatment does not necessarily contradict the core concept of the alternative approach. They note that the premise that a transfer of any part of the cash flows from an asset changes the nature of the asset previously recognised does not necessarily preclude an entity from treating the components retained as a part of the old assets, if the alternative approach also admits that any cash flows can be a unit of account.

34. While this treatment might mitigate the earnings management concern and may be consistent with the view of 'unbundling and re-bundling of financial instruments', this would change significantly the treatment of retained interests under the alternative approach as set out in the ED. Some Board members may find this modified treatment a departure from the core concept of the alternative approach that a transfer of any part of the cash flows from an asset changes the nature of the asset previously recognised.

35. One major criticism of this alternative is that this approach is not operational. For example, when an entity transfers an entire financial asset or a group of financial assets that meets the derecognition criteria and purchases an interest in the transferee, and if the transferee has liabilities or other assets (in addition to that transferred to it), the transferor would be required to split the interest purchased between a portion representing its interest in the transferred asset and an interest in the other assets and/or liabilities of the transferee. In some cases,

the transferor might not even be aware of all the assets and liabilities held by the transferee and would not be in position to do the split. Many of the respondents to the ED raised similar concerns.

36. The alternative will be to treat a sale of the entire asset coupled with an acquisition of a beneficial interest in the transferee (or the asset) differently from a transfer of an interest in the asset (as required under FAS 166). That is, a beneficial interests acquired in a transferee vehicle would be treated differently from that of a straightforward retained interest. This option raises a major concern. A transfer of a partial interest in a financial asset may be structured as a sale of the entire asset coupled with an acquisition of a beneficial interest in the transferee (or the asset) or a transfer of an interest in the asset. Hence under this option the two identical holdings would not be treated similarly and thus would lead to an asymmetrical treatment for economically identical transactions and the possible creation of structuring opportunities.

37. The staff believes this is a sub optimal approach and it might be difficult to incorporate into the model. Hence we do not recommend treating retained interests as part of the old asset.

### Alternative C: Treat some retained interests as new assets and some as old assets

38. The board could adopt a hybrid approach that combines the two approaches already outlined. Under this alternative some retained interests would be treated as new assets (if the retained interest represents a disproportionate interest in the asset previously recognised) or as part of the asset previously recognised (if the retained interest represents a pro rata portion of the asset previously recognised by the transferor). If the retained interest is a new asset, then the guidance in Alternative A will apply but if it is part of the old asset then the guidance under Alternative B will apply.

39. This approach inherits all the shortcomings of Alternative B but to a lesser degree.

40. The staff therefore does not recommend this alternative.

| Question for the Board |
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| Question– Does the Board agree with the staff recommendation in paragraph 31?<br><br>If not, which alternative does the Board prefer and why? |