Project **Derecognition**

Topic **Way forward: Two derecognition approaches for financial assets**

Introduction

1. At the IASB meeting in September 2009 we presented a summary analysis of the comments that the Board received on the Exposure Draft ED/2009/3 *Derecognition (proposed amendments to IAS 39 and IFRS 7)* and the feedback that we received during our extensive outreach efforts.

2. To recap:

   (a) Few expressed support for the approach to derecognition of financial assets that the Board proposed in the ED.

   (b) Some supported maintaining (and perhaps improving) the current derecognition requirements in IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39).

   (c) Many supported the alternative approach or a form of the alternative approach that was described in the ED. Some suggested that the alternative approach should form *the basis* for a new derecognition model for financial assets but that the Board modify the approach (i) to treat repo and securities lending transactions as financings and (ii) to disallow recognition of gains or losses if only a small portion of a financial asset is transferred.

3. At the September meeting we highlighted some possible approaches that the Board could take to replacing the IAS 39 requirements for derecognition of financial assets. However we neither discussed the approaches with you in

detail nor did we ask you to vote for one approach. However, we informed you that we would ask you for a decision at this meeting.

4. This paper:

   (a) provides you with two approaches that we see as possible candidates to replace the current derecognition requirements in IAS 39

   (b) sets out the merits and weaknesses of each approach

   (c) provides a recommendation for one approach and

   (d) asks you to decide on the recommended approach.

5. In the appendix to the paper, we also have applied the two derecognition approaches to some transactions.

6. **We believe that it is important that the Board decide on one approach if it wants to achieve its objective of issuing a final standard before 2011.**

Approaches to replacing the IAS 39 derecognition guidance on financial assets

7. Two clear messages emerged from the comment letter process and the outreach program:

   (a) Some believe an entity's retention of risks of a transferred financial asset (or part thereof) should be the main, if not the sole, determinant for whether the asset (or part) qualifies to be derecognised. Thus it did not come as a surprise that they expressed support for the current derecognition requirements in IAS 39 because those requirements include a primary test that assesses a transferor's exposure to the risks and rewards of a transferred asset (or part thereof) after the transfer.

   However, many of those who embrace risks as the foundation for a derecognition approach acknowledge that the model in IAS 39 presents many application issues. Therefore, they would prefer to retain the focus on risk but otherwise make the model simpler to apply.

   (b) Many respondents to the *Derecognition* ED are attracted to the conceptual merits and simplicity of the alternative approach. They believe that that approach could stand the test of time and once implemented would not require continuous tinkering to make it operational. Some asked the Board to make an exception for repo and securities lending transactions and also address the perceived opportunity to selectively recognise gains or losses on the transfer of an insignificant portion of a financial asset.

8. In light of the foregoing and also considering efforts previously made by the Board and others in addressing the issue of derecognition, we believe the following are the two possible approaches going forward:

   (a) **Approach 1:** This approach starts with the derecognition model for financial assets in IAS 39 but then modifies it:

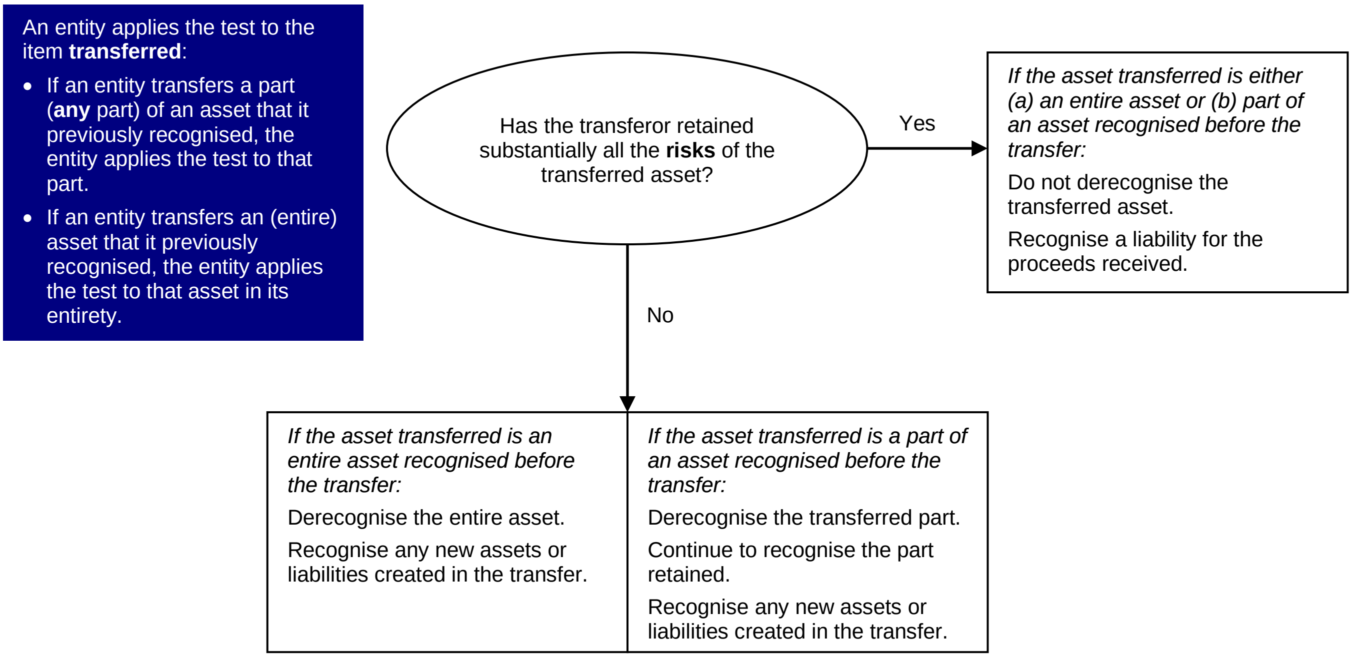
      i. to eliminate the restrictions on when a transferred part of a financial asset qualifies to be assessed for derecognition

      ii. to remove the 'rewards' part in the 'has the transferor *retained* substantially all of the risks and rewards' test

      iii. to eliminate the control test (ie the test that requires the transferor to assess whether the transferee has the practical ability to sell the asset)

      iv. to eliminate the 'to the extent of the entity's continuing involvement' measurement guidance

   If the Board were to adopt Approach 1, the flowchart for that approach would be as follows (see next page):



Note: For ease of comparison, we have focused only on the derecognition *tests* of the derecognition model in IAS 39. As a result, the flowchart above does not include the steps of the flowchart in AG36 of IAS 39 that relate to

i. the requirement to first consolidate all subsidiaries,

ii. the assessment of whether the rights to the cash flows of the asset have expired, and

iii. the criteria for when a transfer is in the scope of derecognition.[1]

(b) **Approach 2:** This approach represents the alternative approach described in the *Derecognition* ED subject to any modifications that the Board might decide on when it deliberates the issues in Agenda Papers 11A–C. For example, the Board might change its view on the

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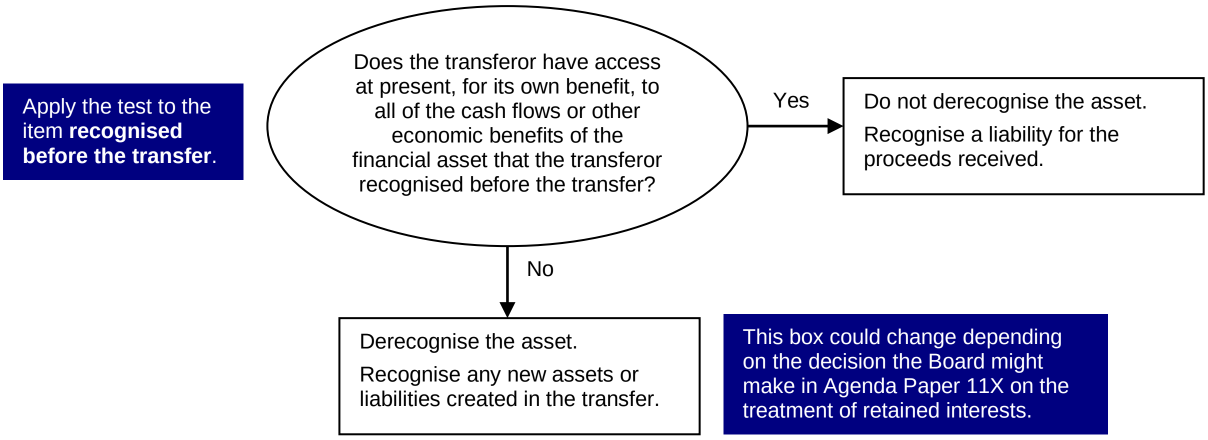
[1] To be in the scope of the derecognition requirements of IAS 39, an entity must either (a) transfer the contractual right of a financial asset or (b) retain that right but assume a contractual obligation to pass through the cash flows from the asset (in the latter case, the transfer must meet specified 'pass-through' criteria to qualify as a transfer).

accounting for repo and securities lending transaction and decide to treat them as financings. Similarly, the Board might also decide that in a transfer of a part of a financial asset the transferor could recognise a gain or loss only on the part transferred (and not on the entire asset recognised before the transfer), or the Board might decide to fix the perceived opportunity to manage earnings under the alternative approach in some other manner.

If the Board made any such decisions, Approach 2 would be a modified alternative approach. However, we note that the decisions the Board might make with respect to the issues in Papers 11A–C would not impact the derecognition test of the alternative approach (although the treatment of the retained interest could be affected). Thus the flowchart for Approach 2 remains substantially the same as that presented in the ED.



Merits and weaknesses of two derecognition approaches for financial assets

Merits of Approach 1 (modified IAS 39 approach)

9. **Reduces complexity**. Approach 1 would eliminate many of the items in the IAS 39 derecognition model that have been criticised as being difficult to apply (eg ‘continuing involvement’ measurement, control test, restrictions on transferred part of financial assets). In addition it is based on only one

derecognition concept (risks) as opposed to a combination of concepts (risks and rewards and control).

10. **Focuses on substance**. Some respondents to the ED were concerned that the alternative approach (Approach 2 in this paper) had too much of an emphasis on the form of a transfer transaction rather than on its substance. They believe that a derecognition model that focuses on the risks of a transferred financial asset (or part thereof) to which a transferor remains exposed to after the transfer would more appropriately capture the substance of the transfer. Approach 1 would address those concerns.

11. **Resolves the issues with the alternative approach**. Because in a repo or securities lending transaction the transferor retains substantially all the risks of the financial asset transferred, Approach 1 would require the transferor to treat those arrangements as financings. Similarly in a transfer of a small part of a financial asset that qualifies for derecognition Approach 1 would require the transferor to treat the part retained as part of the asset the transferor recognised before the transfer. Hence Approach 1 would ensure that the transferor recognise a gain or loss on only the part transferred. Thus Approach 1 would address the two main concerns respondents had about the alternative approach (Approach 2 in the paper).

Weaknesses of Approach 1 (modified IAS 39 approach)[2]

12. **History matters**. By including a test that focuses on the transferor's retention of the risks of a transferred financial asset (or part thereof), Approach 1 would result in very different accounting by two entities with identical contractual rights and obligations only because one of those entities once owned that asset (or part).

[2]The following paragraphs highlight the main weaknesses of Approach 1. For a complete list of weaknesses, we refer to Agenda Paper 16C discussed at the IASB meeting in September 2009. That paper discussed in detail the issues that the Board would have to address if it adopted the current derecognition model in IAS 39 as the way forward. However, we note that because risks and rewards play a central role in the model in IAS 39, many of the weaknesses identified in Agenda Paper 16C would also apply to Approach 1 (albeit some of the tests, and with that some of the weaknesses, of the model in IAS 39 are eliminated in Approach 1).

13. Take an example where an entity transfers a financial asset and writes a fixed-price put option to cover any and all losses from the asset. In light of the put option the transferor remains exposed to all of the risks of the asset. Approach 1 thus would require the transferor to continue to recognise the transferred asset in its entirety (we note that this conclusion holds true regardless of how the put option is settled (ie gross or net)). Yet if a third party had written a similar (stand-alone) put option on the asset the recognition guidance in IAS 39 would require the third party to recognise only the put option.

14. Hence, under Approach 1 ownership history affects the accounting. Thus it does not offer any improvement over the model in IAS 39 in that regard.

15. **Inconsistent with the IASB *Framework***. Basing derecognition on the transferor's retention of risks of a transferred asset is not consistent with how an asset is defined in the IASB *Framework* (the focus there is on the control over an asset's future economic benefits). As a result, Approach 1 would result in the recognition of assets and liabilities in the statement of financial position that are not consistent with the *Framework*.

16. Take an example where an entity transfers the first 80 per cent of the cash flows from a financial asset that it has recognised in its statement of financial position. After the transfer, the entity no longer controls *all* of the cash flows of the asset. The entity has no right to the first 80 per cent of the cash flows from the asset. For those cash flows, the entity is merely acting as servicer on behalf of the counterparty who purchased the right to those cash flows and as a result has access to them and if collected can keep them for itself. Thus if the entity were required to continue to recognise the asset in its entirety because the part of the asset it retained (ie the last 20 per cent) carries substantially all of the risks of the part transferred (ie the first 80 per cent), it would recognise an asset that does not meet the definition of an asset in the *Framework*.

17. Similarly the fact that the part it retained is subordinated to the part it transferred does not cause the entity to have a '*present* obligation that is expected to result in an outflow of resources embodying economic benefits'. If the underlying asset fails to generate cash flows, the entity has no obligation to

the counterparty (it only has an obligation *when and if* the asset generates cash flows, in which case it would be obliged to pass on those cash flows to the counterparty). Thus the retention of some of the risks of the transferred part does not constitute a liability that the entity would have to, or should, recognise. Rather, the risks of the transferred part that the entity is exposed to as a result of the part it retained will be reflected in the measurement of the part retained (it will reduce the value of that part). Hence if the entity were required to recognise a liability because it could not derecognise the asset, it would recognise a liability that does not meet the definition of a liability in the *Framework*.

18. To emphasise, due to its lack of consistency with the *Framework,* Approach 1 would perpetuate the inconsistency between recognition and derecognition requirements for financial assets.

19. **Inconsistent with the derecognition model for financial liabilities.** Approach 1 would not be consistent with the derecognition principles for financial liabilities in IAS 39 (and also those proposed in the *Derecognition* ED). In accordance with IAS 39, if a creditor releases a debtor from its present obligation to make payments, but the debtor assumes a guarantee obligation to pay if the party assuming primary responsibility for the obligation defaults, the debtor derecognises the original liability and recognises a new financial liability on the basis of the fair value of its obligation for the guarantee. However, if an entity transfers a previously recognised financial asset and writes a guarantee to cover any losses relating to the asset, the transfer would fail derecognition and hence the transferor would be required to continue to recognise the asset. If the financial liability derecognition model in IAS 39 is judged to be conceptually sound, one wonders why the same approach is not applied to financial assets.

20. **Increases complexity in some respects.** The 'risks and rewards' tests of the IAS 39 derecognition model has been criticised as being difficult to apply. The elimination of 'rewards' would eliminate some of the difficulties with that test. However, difficulties would remain:

(a) Does the transferor have to identify each risk and then determine whether it has surrendered substantially all of each of those risks (eg substantially all of the interest rate risk, substantially of the liquidity risk, substantially all of the credit risk, substantially all of the prepayment risk, etc)?

(b) Are some risks more important than others? That is, does the transferor have to identify each risk and then weigh them on the basis of importance and then apply the 'substantially all' part of the test to the risk judged to be most important? For example, some might regard credit risk or asset-specific risks as trumping market risks. Take a floating rate asset that is transferred at the same time as the seller enters into a vanilla interest rate swap with the buyer (SPE) to take back the floating rate and pay fixed. Should the risks and rewards that form part of the analysis be only those specific to the asset such as credit risk or prepayment risk and market-based interest rate cash flow risk and foreign exchange risk be excluded?

(c) How should 'substantially all' be interpreted in the evaluation of whether a transferor has retained substantially all the risks of a transferred asset?

(d) How is the test applied to equity instruments (eg shares)?

(e) How should the transferor consider its beneficial interests in a securitisation vehicle in determination of whether it has retained substantially all the risks of the assets transferred to the vehicle? Should it look through the vehicle to make that determination? How should the transferor make that determination if at the time of the transfer, the securitisation vehicle already has other assets and liabilities and through the tranching it is not clear whether (and if so, how and to what degree) the transferor is exposed to the risks of the assets it transferred or the risks of those assets/liabilities transferred into the vehicle by other parties?

(f) The 'risks and rewards' test in IAS 39 is a quantitative test. It requires an entity 'to compute and compare the entity's exposure to the variability in the present value of the future net cash flows of the transferred asset before and after the transfer'. Would Approach 1 require a similar test to assess whether an entity has retained substantially all the risks of a transferred asset (perhaps the test would focus only on the negative variability from the future NPV)? If so, what methodology should be used to measure variability? Does the choice of risk management tools (hedging strategy) matter? For example, the incorporation or exclusion of risk management products in original assets may have a significant impact on the derecognition test. It is in the entity's favour to have variable interest rates included in computing the risk exposure before the transfer and a fixed interest rate in the post transfer risk exposure evaluation, as the variability in cash flows would be clearly reduced. It is also in the entity's favour to exclude a credit guarantee in the before transfer exposure and include a credit guarantee in the post transfer exposure. The incorporation of credit guarantees in the before scenario may be perceived as penalising companies with effective risk management strategies.

21. **Tried but failed approach in the past.** Approach 1 bases derecognition on whether a transferor's exposure to the risks of an asset that it recognised before the transfer (and now has transferred) has significantly changed after the transfer. Implicit in Approach 1 thus is a focus on the substance of a transfer – was the transfer a sale or a financing? (In fact, the terms 'risks' and 'substance' in the context of derecognition are often used interchangeably.)

22. Approaches that at least partially focus on the substance of a transfer, or more specifically on drawing a clear distinction between transfers that are sales and transfers that are financings, have been tried many times in the past (eg Financial Reporting Standard 5 *Reporting the Substance of Transactions*, the Draft Standard *Financial Instruments and Similar Items* published by the Financial Instruments Joint Working Group of standard setters, IAS 39, etc). However for various reasons (including those enumerated in paragraphs 12–20)

these approaches have not stood the test of time. In addition, those models that made it into a final standard have required continuous maintenance by the respective boards to make them more operational and also to ensure they appropriately address transactions that had developed, at times, with the intention to structure around the models to achieve a specific accounting outcome.

Merits of Approach 2 (alternative approach as described in the ED, but subject to any modifications concluded on by the Board in Papers 11A–C)

23. Approach 2 is based on a single concept (control).

24. It would result in the recognition of assets and liabilities that are consistent with the *Framework*.

25. It would result in the faithful representation of the transferor's and transferee's contractual rights and obligations (which would include reflecting the risks and uncertainties the transferor remains exposed to after the transfer *in the measurement* of those contractual rights and obligations rather than affecting whether or not items are recognised).

26. It would resolve the 'stickiness' issue (ie two entities with identical contractual rights and obligations would account for those rights and obligations consistently, irrespective of how they obtained them) and thus would make derecognition symmetrical with recognition.

27. It would be applied by both transferors and transferees and therefore result in mirror image accounting.

28. It would be consistent with the derecognition principle for financial liabilities.

29. It is consistent with the way participants in the financial markets structure financial instruments to manage risk and hence would reflect the economics of the market place.

30. It provides an unambiguous, internally consistent and workable approach to derecognition and has sufficient flexibility to analyse non-standard transactions in a coherent and consistent manner.

Weaknesses of Approach 2 (alternative approach as described in the ED, but subject to any modifications concluded on by the Board in Papers 11A–C)

31. **Representation of some transactions**. Approach 2 would result in the reporting of repo and securities lending transactions as sales, which many respondents to the *Derecognition* ED found to be inconsistent with the substance of those arrangements.

32. **Opportunity for earnings management**. Approach 2 requires that in a transfer of a part of a financial asset the transferor derecognise the asset in its entirety and recognise the part retained as a new asset and initially measure it at fair value. The basis for initially measuring the retained part as a new asset is that that part is in nature different from the (entire) asset recognised before the transfer. That is, the transfer has ‘transformed’ the previously recognised asset into something new. Approach 2 acknowledges that ‘transformation’ by requiring that the retained part be accounted for as a new asset and hence initially be measured at fair value.

33. Many respondents to the ED did not support measuring the retained portion at fair value. 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.

34. Some also disagreed at a conceptual level in that they viewed the retained portion not to be necessarily a ‘different’ asset from that recognised before the transfer. For example, if the portion retained is a proportionate share of the cash flows of the financial asset previously recognised, the transferor is exposed to the same nature/type of risks and rewards of the asset as the transferee, albeit in a different proportion. In this instance, those respondents would treat the retained part as a part of the previously recognised asset and thus would allow for gain or loss recognition on only the part transferred. However, if the portion retained was disproportionate, those respondents regarded the portion as a ‘different’ (ie new) asset and thus would allow for gain or loss recognition on the previously recognised whole asset.

35. Other respondents argued that any retained portion of a financial asset is part of that ‘old’ asset because irrespective of how the cash flows are allocated between the retained and transferred parts (ie whether proportionately or disproportionally), it is the underlying ‘old’ asset that generates those cash flows. In other words, because the unit of account under the alternative approach is the cash flows of a financial asset, any cash flows that a transferor has not transferred and surrendered control over (ie those it retained) by default must be part of the ‘old’ asset. Because the cash flows the transferor has retained are part of the ‘old’ asset, they must be measured using the same measurement attribute as the one applied to the previously recognised whole asset.

36. **Expansion of fair value measurement.** Approach 2 requires that the retained portion of a financial asset and any other assets or liabilities created in a transfer that qualifies for derecognition initially be measured at fair value. Because the approach will likely result in more transfers qualifying for derecognition, some respondents were concerned that the requirement to measure any new assets or liabilities obtained or incurred in connection with a transfer at fair value will significantly expand the use of fair value and with that the complexity involved in determining such value, and would thus decrease the reliability of items recognised in the statement of financial position.

Impact on Approach 2 from any decisions by Board on issues in Papers 11A–C

37. If the Board were to decide in Papers 11A–C that repo and securities lending transactions should be reported as financings and that a transferor should not be able to easily manipulate earnings by selling a small part of a financial asset and as a result triggering a gain or loss on the entire asset, Approach 2 would be a modified alternative approach that would accommodate the Board’s decisions on the issues in Papers 11A–C. We note that a modified alternative approach would have similar merits as those noted for the ‘pure’ alternative approach (see paragraphs 23–30) and in addition would resolve some of the perceived

weaknesses of that approach, namely those mentioned in this paragraph and also enumerated in paragraph 31–35).

38. However, we note that addressing the concerns about the accounting outcome under the alternative approach for repo/securities lending transactions and about the potential for earnings manipulation might create new problems:

    (a) By continuing to recognise the asset transferred under a repo or securities lending arrangement and recognising a liability for the transfer proceeds (instead of derecognising the asset and recognising a forward derivative), the transferor will not faithfully recognise its contractual rights and obligations after the transfer and thus recognise assets and liabilities that are inconsistent with the *Framework*. This will also mean that some ‘stickiness’ is introduced into the alternative approach (albeit limited to some specific transfer transactions).

    (b) The Board might decide to address the perceived opportunity to manage earnings under the alternative approach by requiring that in a transfer of a part of a financial asset the transferor recognise a gain or loss only on the part transferred (not on the entire asset), or the Board might decide to address the issue in some other manner. Depending on how it addresses the issue, the Board could create an inconsistency within the alternative approach in that a retained interest might be classified and measured differently depending on whether a transferor obtained the interest on a stand-alone basis or as part of a transfer of a financial asset (we note that such an inconsistency already exists in the derecognition model in IAS 39 and would also exist in Approach 1).

Staff recommendation

39. **We recommend Approach 2.**

40. We find the merits of Approach 2 stated in paragraphs 23–30 convincing. In particular, for us the most important benefit of Approach 2 is that it is rooted in the *Framework*. By focusing on the transferor’s and transferee’s contractual rights and obligations after a transfer, Approach 2 will result – with perhaps an

exception for some limited transfer transactions – in the recognition of assets and liabilities that meet the definition of assets and liabilities in the *Framework* and thus will eliminate many of the weaknesses of Approach 1.

41. Because the IAS 39 derecognition model shares the weaknesses of Approach 1 (plus has some more), Approach 2 by logic also will be a significant improvement over the model in IAS 39.

42. We acknowledge the concerns that Approach 2 would result in the recognition of 'new and perhaps unusual' assets and liabilities (eg interests retained in entire assets and liabilities) and thus would increase the use of fair value and as a result increase the measurement complexity. However, we disagree with those concerns for the following reasons:

    (a) We do not believe that Approach 2 would result in the recognition of many 'new and unusual' assets and liabilities. Many retained interests that Approach 2 would require to be recognised will be similar in nature to assets and liabilities that are already being recognised under IAS 39 today.

    (b) Approach 2 reflects how market place participants transact in financial instruments and hence reflects the economics of the market. As a result, we would expect that when entities carry out transactions that unbundle assets into components they will have had to determine the fair value of those components to ensure that they have correctly priced the transactions and fully understood the implications thereof. This means that the entities generally will have established the valuation methodology and sources of information needed at the outset, thereby significantly reducing the likelihood of subsequent measurement difficulties. As a result, we do not believe that the fair value of those items (ie the interests/components retained) will be any more difficult to determine than the fair value of other financial instruments.

43. In summary, we recommend that the Board adopt Approach 2 for further development. We note that if the Board were to agree with our

recommendation, we think that we could develop Approach 2 into a technically sound solution within a reasonable time period.[3]

Question
Does the Board agree with the staff recommendation as set out in paragraph 38? If not, why and which alternative derecognition approach for financial assets does the Board prefer, and why?

[3]One issue that we think the Board would have to consider in developing Approach 2 into a final standard is the definition of transfer. Some have commented that as it was worded in the ED the scope of the definition was too broad and unclear. Another issue the Board needs to think about is whether it should re-expose Approach 2. Some have commented that the alternative approach in the ED lacked application guidance and a basis for conclusions. If the Board adopted Approach 2, we would bring papers on these issues to the Board at future IASB meetings.

Appendix

A1. In this appendix, we have applied Approach 1 and Approach 2 to the following transactions:

1:	Transfer of a bond with a fixed-price forward purchase
2:	Transfer of shares with a fixed-price purchased call option
3:	Transfer of a loan with a fixed-price written put option
4:	Transfer of a loan portfolio into a securitisation vehicle with a residual interest in the vehicle

A2. We also have noted, where applicable, the impact on the accounting outcome under Approach 2 of any decisions by the Board on the issues in Agenda Papers 11A–C.

Transaction 1

Entity A transfers to Entity B a US government bond with a principal amount of CU100 and fair value of CU100 in exchange for CU80. Entity A also enters into a forward with Entity B that obliges Entity A to repurchase the bond (or a similar bond) for CU85 in one month. Entity A is entitled to receive, and thus Entity B is obliged to pass on, any cash flows that the bond generates in the interim (ie before the forward settles).

Analysis

<table>
<tr><th>Approach 1
(Modified IAS 39 Approach)</th><th>Approach 2
(Alternative Approach)</th></tr>
<tr><td>The transfer fails derecognition.

Through the fixed-price forward, Entity A (the transferor) has retained substantially all the risks of the transferred bond.</td><td>The transfer qualifies for derecognition.

After the transfer, Entity A (the transferor) does not have access at present to any of the cash flows of the bond.
Entity A does not have access to the cash flows that the bond might produce before the forward settles. Entity A’s right to receive any cash flows in the interim is a right on cash flows that are similar, or referenced, to those of the bond. This becomes apparent when Entity B (the transferee) sells the bond to a third party before the forward settles.
Entity A also does not have access at present to the cash flows of the bond beyond the settlement of the forward. Entity A must pay Entity B the forward contract price to get access to those cash flows. Because Entity A will not make that payment until the settlement of the forward, it does not have access at present to those cash flows.</td></tr>
<tr><td>Transferor’s journal entry
DR. Cash CU80
    CR. Liability CU80

Transferee’s journal entry
DR. Loan CU80*
    CR. Cash CU80
*This is the loan to Entity A, not the bond that Entity A is required to continue to recognise as a result of the failed transfer.</td><td>Transferor’s journal entry (ignoring any gain or loss that Entity A would recognise on the bond if it carried the bond at amortised cost or FVTOCI (if it classified the bond at available for sale))
DR. Cash CU80
DR. Derivative asset (forward) CU20
    CR. Investment in Bond CU100

Transferee’s journal entry
DR. Investment in Bond CU100
    CR. Cash CU80
    CR. Derivative liability (forward) CU20</td></tr>
</table>

If the Board decided in Paper 11X that repos and securities lending arrangements should be accounted for as financings, the outcome under Approach 2 would change as follows:

- If the forward were **gross**-settled, the transfer would fail derecognition (ie same outcome as under Approach 1).
- If the forward were **net**-settled, the transfer would qualify for dereognition.

Transaction 2

Entity A transfers to Entity B 100 ordinary shares of Entity X worth CU100. Entity A also purchases an option from Entity B that gives Entity A the right to repurchase the shares for CU105 over the term of the option (say, 3 years). Entity A receives CU90 net in cash.

Analysis

<table>
<tr><th>Approach 1
(Modified IAS 39 Approach)</th><th>Approach 2
(Alternative Approach)</th></tr>
<tr><td>The transfer qualifies for derecognition.

Through the purchased call option, Entity A (the transferor) has retained the upside (above CU105) but given up the downside of the shares. Thus Entity A has transferred substantially all the risks of the shares to Entity B.</td><td>The transfer qualifies for derecognition.

After the transfer, Entity A (the transferor) does not have access at present to any of the shares’ economic benefits (ie dividends by Entity X). Through the purchased call option, Entity A has a right to get access to the shares’ economic benefits, but until it exercises the option and pays the strike price, it does not currently have access to those benefits.</td></tr>
<tr><td colspan="2">Transferor’s journal entry(ignoring any gain or loss that Entity A would recognise on the shares if it carried them at cost or FVTOCI (if it classified them at available for sale))
DR. Cash CU90
DR. Derivative asset (call option) CU10
    CR. Investment in Entity X 100

Transferee’s journal entry
DR. Investment in Entity X CU100
    CR. Cash CU90
    CR. Derivative liability (call option) CU10</td></tr>
</table>

Transaction 3

Entity A transfers to Entity B a loan with a principal amount of CU100 and a fair value of CU85. Entity A also writes a put option to Entity B that gives Entity B the right to sell the loan back to Entity A for CU100 over the loan's term. In exchange for the loan and put option, Entity A receives CU100 in cash.

Analysis

Approach 1 (Modified IAS 39 Approach)	Approach 2 (Alternative Approach)
The transfer fails derecognition. Through the written put option, Entity A (the transferor) has retained substantially all the risks of the loan.	**The transfer qualifies for derecognition.** After the transfer, Entity A (the transferor) does not have access at present to any of the cash flows of the loan. It is Entity B (the transferee) who currently has access to all of the loan's cash flows given that it can hold onto the loan until maturity and receive, and keep for itself, all of its cash flows. Until Entity B exercises the put, Entity A does not have access to the loan's cash flows.
Transferor's journal entry DR. Cash CU100 CR. Liability CU100 **Transferee's journal entry** DR. Loan CU100***** CR. Cash CU100 **This is the loan to Entity A, not the loan that Entity A is required to continue to recognise as a result of the failed transfer.*	**Transferor's journal entry** (*ignoring any loss that Entity A would recognise on the loan if it carried the loan at amortised cost*) DR. Cash CU100 CR. Loan CU85 CR. Derivative liability (put option) CU15 **Transferee's journal entry** DR. Loan CU85 DR. Derivative asset (put option) CU15 CR. Cash CU100

Transaction 4

The facts are as follows.

(c) Entity A transfers to a securitisation vehicle a loan portfolio that has an aggregate principal amount of CU100 and an aggregate fair value of CU60.

(d) In exchange, Entity A receives CU50 in cash and an equity interest in the vehicle that is worth CU10 and that entitles Entity A to the last 20% of cash flows from the loan portfolio in the vehicle. Entity A's interest in the vehicle is intended to cover the losses that the loans are expected to generate.

(e) The securitisation vehicle does not have any assets other than the loans that it purchased from Entity A.

(f) Entity A retained the right to service the loans in the vehicle in return for fees that are at market rates.

(g) The securitisation vehicle is restricted from selling the loan portfolio.

Analysis

Approach 1 (Modified IAS 39 Approach)	Approach 2 (Alternative Approach)
The transfer fails derecognition. The equity interest is intended to cover the losses that the loans in the securitisation vehicle are expected to generate. Thus, through the equity interest, Entity A (the transferor) has retained substantially all the risks of the loan portfolio.	**The transfer qualifies for derecognition.** After the transfer, Entity A (the transferor) does not have access at present to *all* the cash flows of the loan portfolio. Through its equity interest, Entity A has access to some of the loan portfolio's cash flows, but not to all.
Transferor's journal entry DR. Cash CU50 CR. Liability CU50 **Transferee's journal entry** DR. Loan CU50***** CR. Cash CU50 **This is the loan to Entity A, not the loan portfolio that Entity A is required to continue to recognise as a result of the failed transfer.*	**Transferor's journal entry** (*ignoring any loss that Entity A would recognise on the loans if it carried them at amortised cost*) DR. Cash CU50 DR. Investment in securitisation vehicle CU10 CR. Loans CU60 **Transferee's journal entry** DR. Loans CU60 CR. Cash CU100 CR. Equity CU10