Project **Derecognition**

Topic **Summary of proposed derecognition approach for financial assets and liabilities**

Introduction

1. The purpose of this paper is to provide a summary overview of the proposed derecognition approach for financial assets and liabilities.
2. The paper also sets out an explanation of some of the key terms used in the derecognition criteria for financial assets and the basis for the derecognition criteria (see appendix 1).

Definitions

3. The following are some of the key terms that are used in the proposed derecognition approach, the definitions of which are necessary for a full understanding of the requirements of the proposed approach.

    (a) ***Derecognition*** of an asset or liability is the removal of a previously recognised financial asset or financial liability from an entity's statement of financial position.

    (b) ***Transferor*** refers to the entity that recognised the asset or liability prior to a transaction that requires assessing the asset or liability for derecognition

    (c) ***Transferee*** refers to the party that enters into a transaction with a transferor that results in a previously recognised asset or liability of the transferor being assessed for derecognition

    (d) ***Economic benefits*** encompass the economic benefits associated with both the financial and nonfinancial components of a contract within the scope of IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9: *Financial Instruments*, provided that the economic benefits associated with the nonfinancial component of the contract have not separately been recognised.

Proposed approach for derecognition of financial assets

4. The following paragraphs set out the proposed approach to derecognition of financial assets.

Derecognition criteria

5. **An entity shall derecognise a financial asset when it no longer qualifies as an asset of the entity.**

6. **A financial asset no longer qualifies as an asset of an entity if the economic benefits no longer exist or the economic benefits exist but the entity ceases to have the ability (a) to obtain all of the future economic benefits inherent in the asset and (b) to restrict others' access to those benefits. An entity no longer has that ability if it ceases to have present access, for its own benefit, to all of the cash flows or other economic benefits of the asset.**

7. An entity shall apply paragraph 7 (the derecognition criteria) to an entire financial asset or group of financial assets (except for a transaction that meets the conditions in paragraph 10 (ie repos and securities lendings) or financial instruments that meet the conditions in paragraph 11 (ie instruments that can be both an asset and a liability at any point during their contractual maturity)).

8. In applying paragraph 7 (the derecognition criteria), an entity shall consider the whole arrangement, including any side agreements or sets of simultaneous agreements entered into contemporaneously with or in contemplation of the transfer transaction.

Exception for sale and repurchase agreements, securities lending arrangements and similar transactions

9. An entity shall not apply the requirements in paragraph 7 (ie the derecognition criteria) to any transaction between two counterparties that meets the following criteria:

   (a) The agreement both entitles and obligates the transferor to repurchase or redeem the financial assets from the transferee

(b) The financial assets to be repurchased or redeemed are the same or substantially the same as those passed to the transferee.

(c) The agreement is to repurchase or redeem the assets before maturity, at a fixed or determinable price.

(d) The agreement is entered into contemporaneously with, or in contemplation of, the transfer transaction.

Derivative instruments

10. An entity shall not apply paragraph 7 (ie the derecognition criteria) to:

    (a) a transaction involving a financial instrument, that can be either an asset or a liability over its life (eg an interest rate swap), unless the counterparty to that financial instrument has expressly consented to the transfer transaction.

    (b) a transaction involving a portfolio that includes a financial instrument that can be either an asset or a liability over its life (eg an interest rate swap), unless the counterparty to that financial instrument has expressly consented to the transfer transaction.

Measurement of retained interests and beneficial interests

11. When a transferor derecognises a financial asset in accordance with paragraph 7 (ie the derecognition criteria), the transferor shall apply paragraphs 14 – 16 to transactions in which the transferor retains a disproportionate interest or retains no interest in the asset previously recognised to determine whether and in what form to recognise any retained interest in that asset and any new contractual rights acquired and obligations assumed in connection with the transfer.

12. When a transferor derecognises a financial asset in accordance with paragraph 7 (ie the derecognition criteria), the transferor shall apply paragraphs 17 – 20 to transactions in which the transferor retains a fully proportionate interest in the asset previously recognised to determine whether and in what form to recognise any retained interest in that asset and any new contractual rights acquired and obligations assumed in connection with the transfer.

Disproportionate interests or no interests

13. If the financial asset or group of financial assets qualifies for derecognition, the transferor shall recognise as a new financial asset (rather than as a part of the financial asset that the transferor recognised before the transfer) a retained interest in the asset (or in the group of financial assets).

14. Similarly, if the financial asset or group of financial assets qualifies for derecognition, a transferor shall recognise as a new asset an investment in a transferee that the transferor purchases as part of the transaction.

15. For all transactions that meet the criteria in paragraphs 14 and 15, the transferor shall measure at fair value, on initial recognition, all assets and liabilities resulting from the transaction.

Fully proportionate interests

16. If the financial asset or group of financial assets qualifies for derecognition, a transferor shall not account for a part of an asset (or group of assets) retained or for an investment in a transferee that the transferor purchases as part of the transaction, as a new asset, if the part or the investment acquired comprises a fully proportionate (pro rata) share of the cash flows from a previously recognised financial asset (or a group of financial assets).

17. If a transaction meets the conditions in paragraph 17, the entity shall allocate the carrying amount of the financial asset previously recognised between the part retained and the part not retained on the basis of the relative fair values of those parts on the date of the transaction.

18. If a transaction involving an entire financial asset or a group of financial assets qualifies for derecognition and, as part of the transaction, the transferor purchases an interest in the transferee (which gives it the right to some of the cash flows from that asset or group of assets), and the rights retained meet the conditions in paragraph 17 (ie where the retained interest is fully proportionate part), the entity shall treat such right as a part of the asset or group of assets previously recognised.

19. If the transferee has other financial assets or liabilities in addition to those received from the transferor, the transferor shall split the interest purchased following the guidance in paragraph 18 between

    (a) an interest in the previously recognised asset or group of assets, and

    (b) an interest in new assets or new liabilities.

Gain or loss on derecognition

20. For all transactions that meet the criteria in paragraphs 14 and 15 (ie transactions in which the transferor retains a disproportionate interest or retains no interest in the asset previously recognised), the transferor shall

    (a) recognise in profit or loss the difference between:

        i. the carrying amount of the asset (or group of assets derecognised) and

        ii. the sum of the consideration received (including any new asset obtained less any new liability assumed)

21. For all transactions that meet the conditions in paragraph 17 (ie those in which the retained interest is a fully proportionate part), the entity shall recognise in profit or loss the difference between:

    (a) the carrying amount allocated to the part not retained and

    (b) the sum of the consideration received (including any new assets obtained less any new liabilities assumed).

Transfers that do not qualify for derecognition

22. If a transfer does not result in derecognition because the financial asset qualifies as an asset of the entity or the transaction meets the conditions in paragraph 10 (ie repos and securities lendings), the transferor shall continue to recognise the transferred asset in its entirety and shall recognise a financial liability for the consideration received. In subsequent periods, the transferor shall recognise any income on the transferred asset and any expense incurred on the financial liability.

23. If a transferor provides non-cash collateral (such as debt or equity instruments) to the transferee and the transaction does not meet the requirements of paragraph 7 (ie the derecognition criteria), the transferor shall continue to recognise the collateral as its asset.

24. If an asset continues to be recognised, the asset and the associated liability shall not be offset. Similarly, the entity shall not offset any income arising from the asset with any expense incurred on the associated liability.

Accounting for agreements that entitle the transferor to repurchase or redeem the asset before the maturity of the asset

25. For a transaction that meets the conditions in paragraph 10 (ie repos and securities lendings), if a transferor provides non-cash collateral (such as debt or equity instruments) to the transferee, the accounting for the collateral by the transferor and the transferee depends on whether the transferee has the right to sell or pledge the collateral and on whether the transferor has defaulted. The transferor and transferee shall account for the collateral as follows:

    (a) If the transferee has the right by custom or contract to sell or repledge the collateral, then the transferor shall reclassify that asset in its statement of financial position (eg as a loaned asset, pledged equity instruments or repurchase receivable) separately from other assets.

    (b) If the transferee sells collateral pledged to it, it shall recognise the proceeds from the sale and a liability measured at fair value for its obligation to return the collateral.

    (c) If the transferor defaults under the terms of the contract and is no longer entitled to redeem the collateral, it shall derecognise the collateral, and the transferee shall recognise the collateral as its asset initially measured at fair value or, if it has already sold the collateral, derecognise its obligation to return the collateral.

    (d) Except as provided in (c), the transferor shall continue to carry the collateral as its asset, and the transferee shall not recognise the collateral as an asset.

Transferee's accounting

26. When accounting for a transaction that does or does not meet the derecognition criteria in paragraph 7, the transferee applies the requirements of IFRS 9 in recognising its obligations or rights assumed or acquired as part of the transfer (except for a transaction that meets the conditions in paragraph 10, ie sale and repurchase agreements, securities lending arrangements and similar transactions).

27. To the extent that a transaction does not qualify for derecognition, the transferee does not recognise the transferred asset as its asset. The transferee derecognises the cash or other consideration paid and recognises a receivable from the transferor.

Derecognition of a financial liability

28. An entity shall derecognise a financial liability (or a part of it) when it (or the part) no longer qualifies as a liability of the entity. A financial liability ceases to qualify as a liability of an entity if the present obligation is eliminated and the entity is no longer required to transfer economic resources in respect of that obligation.

29. If an entity exchanges one debt instrument with the creditor for another debt instrument or an entity and a creditor agree to modify substantially the terms of a debt instrument (whether or not as a result of the financial difficulty of the entity), it derecognises the financial liability associated with the previous debt instrument and recognises a new financial liability if the contract giving rise to that liability is substantially modified. The contract is substantially modified if the contract is altered in such a manner that

    (a) the timing, amounts or uncertainty of the cash flows under the new or modified contract are substantially different from those under the original contract, or

    (b) it changes the nature of the debtor's obligation or the nature of the investment that the contract represents - for example:

i. A change in the currency in which the principal or interest is denominated
ii. Addition or removal of contingent interest rate or shared appreciation features
iii. A change in liquidation preference or ranking of the instrument
iv. A change from variable interest rate to fixed rate or vice versa
v. A change that requires the consent of other class of creditors of the entity
vi. Addition or deletion of cross collateralisation provisions
vii. Addition of repayment provisions or prepayment premium clauses

The assessment as to whether a contract has been substantially modified should be on a contract by contract basis. Hence, an entity shall not apply the substantial modification guidance to a part of a financial liability.

30. If an entity derecognises a financial liability, it shall:

(a) recognise the modified or new contract as a new liability and initially measure it at fair value;

(b) recognise any equity issued as consideration and initially measure it at fair value;

(c) recognise in profit or loss the difference between the carrying amount of the derecognised liability and the consideration paid (including any non-cash assets transferred or liabilities assumed or equity instruments issued) less any assets acquired or liabilities in connection with the transaction; and

(d) include any transaction costs or fees incurred related to the extinguishment of the original liability in the gain or loss recognised on extinguishment, unless any part of that cost can be directly attributed to the new liability.

31. If the entity identifies some of the costs and fees as being attributable directly to the issue of the debt instrument associated with the new liability, it shall follow

the initial and subsequent measurement guidance in paragraphs 43 and 47 of IAS 39 (or the guidance in IFRS 9, as required). In making this decision, an entity should consider all relevant facts and circumstances relating to the transaction.

32. If an entity does not derecognise a financial liability in connection with an exchange or modification, it adjusts the carrying amount of the liability for any costs or fees incurred and amortises the new carrying amount over the remaining term of the liability.

Partial extinguishment

33. If an entity derecognises a part of a financial liability, the entity shall allocate the previous carrying amount of the financial liability between the part that it continues to recognise and the part that it derecognises according to the relative fair values of those parts on the date of derecognition. The entity shall recognise in profit or loss the difference between:

    (a) the carrying amount allocated to the part derecognised and

    (b) the consideration paid (including any non-cash assets transferred or liabilities assumed or equity instruments issued) for the part derecognised.

Symmetry in liability derecognition requirements between debtor and creditor

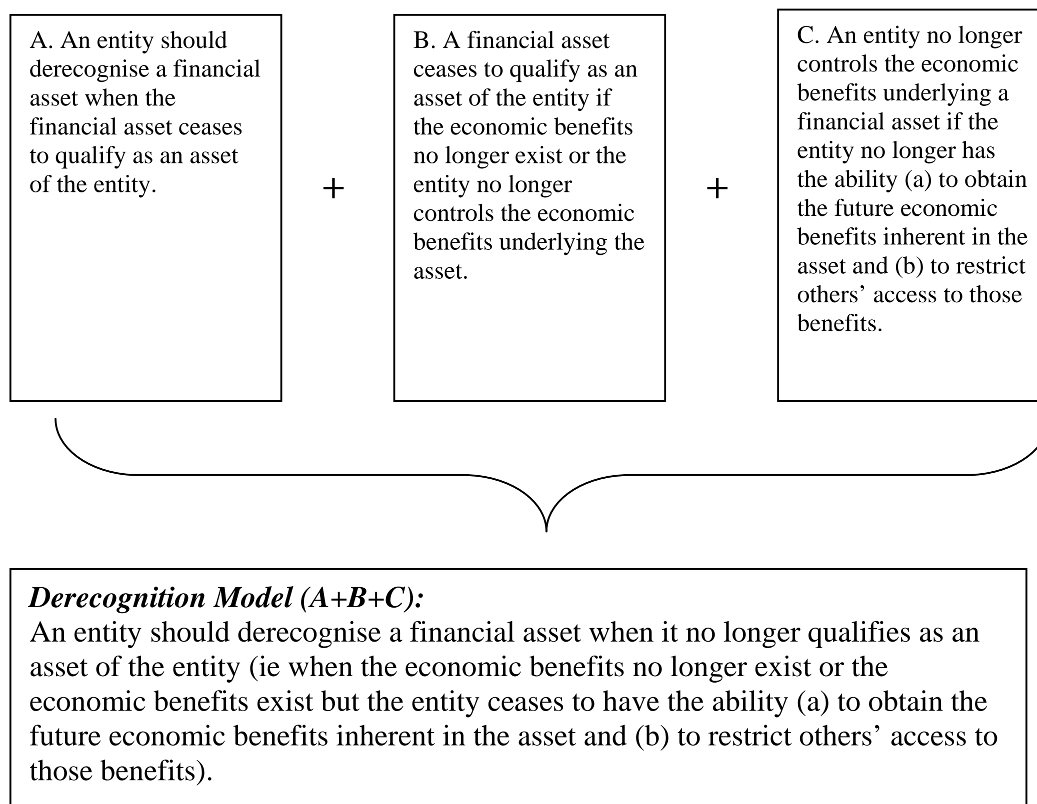
34. If an amendment to a contract meets the substantial modification criteria, the accounting between the debtor and creditor should be symmetrical. This means that when there is a substantial modification to a financial liability that results in extinguishment (derecognition) of the original liability and recognition of a new liability, the holder of the related financial asset should also derecognise the old asset and recognise a new financial asset (initially at fair value).

APPENDIX 1: Explanation of key terms used in the derecognition criteria for financial assets

Derecognition of financial assets

1. The basis for the derecognition principle under the proposed derecognition approach can be graphically summarised as follows.

General Overview



Derecognition principle

An entity should derecognise a financial asset when the financial asset ceases to qualify as an asset of the entity.

2. The definitions of the elements of financial statements are a significant first step in determining the content of financial statements. The definitions of the

elements impose limits or restraints on what can be included in assets and liabilities. Thus, when an item fails to qualify as an asset of an entity (ie meet the definition of an asset under the Framework) the entity should not recognise the item as its asset. Hence transferors and transferees should recognise and measure, after the transaction, the financial statement elements (assets, liabilities, gains and losses) each has as a result of the transaction.

3. The *Framework* defines an 'asset' as:

   'a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.'

4. Based on the definition of an asset, future economic benefit and control of that benefit are the essence of an asset and an item does not qualify as an asset of an entity if it lacks one or both of these essential characteristics.

5. Therefore to assess whether a particular item constitutes an asset of a particular entity at a particular time requires a consideration of:

   (a) whether the item obtained by the entity embody future economic benefits in the first place;

   (b) whether all or any of the future economic benefits remain at the time of assessment; and

   (c) if the future economic benefits exist, whether the entity controls them.

6. The appropriate derecognition approach is, in effect, to ask whether the transferor has surrendered control of the economic benefits underlying the asset 'transferred'. If control over the future economic benefits has been surrendered, the asset has been sold and should be derecognised and vice versa.

A financial asset ceases to qualify as an asset of the entity if the economic benefits no longer exist or the item does not embody future economic benefits.

7. For an item to qualify as an asset of the entity, the right or access must be capable, singly or in combination with other assets, of yielding economic benefits. Thus if the economic benefits underlying the financial asset cease to

exist or are extinguished, the entity should remove the asset from its financial statements.

8. Paragraph 53 of the IASB *Framework* states that – 'the future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. That potential may be a productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production'.

9. Future economic benefits eventually result in net cash inflows to the entity. Assets are not, however, always direct representations of cash inflows: they are rights and other access (which others do not have) to the future economic benefits that can generate or be used to generate future cash flows.

10. The future economic benefit embodied in a financial asset tends generally to be the contractual right to future cash flows or other economic benefits. For example, receivables are expected to generate cash, which is their only function.

11. However, some recognised financial assets might also include *nonfinancial* contractual rights and obligations, such as the right to vote or subscribe. Unless they are initially required to be separated (or unless they are acquired separately), any nonfinancial components of a contract that in its entirety is accounted for as a financial asset are typically included in the measurement of that asset.

12. The reason why the nonfinancial components of a financial asset normally are not accounted for as a separate (nonfinancial) asset or liability is because the unit of account in IAS 39 and IFRS 9 is the contract as a whole and only in limited circumstances does IAS 39 allow or require for a contract to be split into components that are accounted for separately. For example, a hybrid instrument that is within the scope of IAS 39 might contain embedded derivatives that require separation.

13. If the unit of account were the individual rights and obligations within the contract, the issue of whether 'economic benefits' as that term is used in the proposed derecognition approach extends to nonfinancial rights and obligations

would be quite simple. An entity that enters into a contract that encompasses both financial and nonfinancial rights and obligations would account for the financial rights and obligations under the financial instruments standard and for the nonfinancial rights and obligations under other IFRSs. When the entity subsequently transfers the nonfinancial rights or obligations it would look to those other IFRSs to determine the accounting for the transfer. This would mean that 'economic benefits' used in the financial instruments standard would only relate to financial rights and obligations.

14. When an entity transfers the nonfinancial rights or obligations that are embodied in a financial asset, it is clear that something has happened to the asset. If the entity has carried the financial asset at fair value through profit or loss, this 'something' would be quite visible, simply because the fair value of the asset would decrease to reflect that the asset no longer includes these nonfinancial benefits.

15. Thus, logically, if an entity is required to look to the financial instruments standard to determine whether it should *recognise* as a financial asset or liability a contract into which it has entered and which is comprised of both financial and nonfinancial rights and obligations, the entity should also be required to look to the financial instruments standard to determine whether it should *derecognise* that asset or liability as a result of a transfer of some of those rights and obligations (whether they are the financial or nonfinancial ones).

16. The foregoing leads to defining 'economic benefits' as to include both financial and nonfinancial contractual rights (eg the right to future cash flows but also the right to vote or subscribe). With respect to the proposed derecognition approach, this would mean that when an entity transfers any nonfinancial economic benefits inherent in a financial asset that it has recognised, the entity no longer has present access to *all* the economic benefits of that asset. As a result, the entity would derecognise the financial asset and recognise a new financial asset (one that would no longer include the nonfinancial components transferred). (This assumes that the nonfinancial benefits have not already been separated from the related financial asset at initial recognition).

An entity no longer controls the economic benefits underlying a financial asset if the entity no longer has the ability (a) to obtain the future economic benefits inherent in the asset and (b) to restrict others' access to those benefits.

17. To assess whether a particular item constitutes an asset of a particular entity at a particular time also requires a consideration of (if the future economic benefits exist) whether the entity controls the economic benefits underlying the asset.
18. 'Control' in terms of an asset is the means by which the entity ensures that the economic benefits accrue to it and not to others. 'Control' of the economic benefits has two aspects: the ability to obtain (or access) the economic benefits and the ability to prevent or limit the access of others to those benefits. To have control, an entity must have both of these abilities.
19. Hence, 'control' in the context of financial assets means, in general terms, the ability to obtain (gain access to) the future cash inflows or other economic benefits underlying the asset and the ability to restrict others' access to those future cash inflows or other economic benefits.

Derecognition criteria (Access to economic benefits for its own benefit)

20. **To make the derecognition principle for financial assets operational, it is proposed that an entity should derecognise an asset if the entity ceases to have present access, for its own benefit, to all the cash flow or other economic benefits of the asset.**

Does the transferor presently have access, for its own benefit, to all of the cash flows or other economic benefits of the asset?

21. Under the current definitions (and proposed definition) of an asset, **only the present ability** to obtain the future economic benefits is an asset under the definition. Present here means that on the date of the financial statements the entity has the right or other access that others do not have (ie controls the economic benefits).

22. Thus both the control of the economic benefits and the economic benefits themselves must exist. If control has been relinquished, but the economic benefits still exist, then the entity no longer has an asset. Similarly, if control is present, but the economic benefits no longer exist, then the entity no longer has an asset.

23. In the same way, an entity has no asset for a particular future economic benefit if the entity would have access to and control of the benefit in the future. Also, an entity is considered still to have an asset if the entity's access to and control of the economic benefit would be removed, but the event that would remove its access or control of the economic benefits is in the future.

24. This also means that an ability to get access to a financial asset's cash flows that is conditioned on something else is not equivalent to having control over that asset. Accordingly, the right to get access is not the same as a right entitling the entity access now (to the cash flows or other economic benefits).

Does the transferor presently have <u>access</u>, for its own benefit, to all of the cash flows or other economic benefits of the asset?

25. Access is used here to mean ability to obtain the economic benefits underlying an asset.

26. For an asset to qualify as an asset of an entity, the future economic benefits underlying that asset should be controlled by the entity or should accrue to the entity.

27. 'Control', in terms of an asset, is the means by which the entity ensures that the economic benefits accrue to it and not to others. 'Control' of the economic benefits has two aspects: the ability to obtain (or access) the economic benefits and the ability to prevent or limit the access of others to those benefits. To have control, an entity must have both of these abilities.

28. Hence, if an entity does not have the ability to access (or obtain) the economic benefits underlying the asset, as a result of a transaction or an event, control over the future economic benefits has been surrendered and hence the asset should be derecognised and vice versa.

29. However being able to obtain or access the economic benefits is not a conclusive test of an entity's control over the economic benefits of the asset (as explained in paragraphs 30 - 33).

Does the transferor presently have access, <u>for its own benefit</u>, to all of the cash flows or other economic benefits of the asset?

30. As noted in paragraph 29, being entitled to receive all of the cash flows or economic benefits of a financial asset is not sufficient to establish control over those cash flows. This is because the entity might be required by contract or otherwise to pass on the cash flows it receives to someone else.

31. The definition of an asset requires access to future economic benefits to be controlled by the entity. An entity will control the access if it has the ability to obtain the economic benefits for itself (i.e. have the ability to keep the economic benefits, to deploy and benefit from their deployment, or to prevent or limit others' access to those economic benefits).

32. For example, a trustee is required to act in a predetermined way and has the power to deploy the trust's benefits, but the beneficiaries benefit from their deployment, not the trustee.

33. Similarly, in a pass through or sub-participation loan arrangement, the bank that sells a pool of originated loans will continue to receive the interest and principal cash flows from the underlying debtors. However, it will not receive the cash flows for its own benefit because it must forward all the cash flows to the buyer (transferee) of the loans. Therefore, the bank's role in collecting the cash flows and distributing them to the buyer (transferee) is that of an agent. As a result, the buyer (transferee), not the bank, has control over all the cash flows of the loan portfolio.