Project	**Derecognition**
Topic	**Transfer definition**

Introduction

1. This paper deals with the definition of 'transfer' that the Board proposed in the Exposure Draft ED/2009/3 *Derecognition*. The paper sets out the transfer definition, lists the concerns raised by respondents to the ED with respect to this definition and provides the staff's recommendations about whether and, if so, how to best address these concerns.

'Transfer' definition in ED

2. The ED states:

> 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.)

3. The objective of this definition is to ensure that, irrespective of its legal form, a transaction that economically passes, or will pass, some or all of the economic benefits of an asset to another party is assessed for derecognition.

4. For example, an entity might borrow funds that it must repay from the cash flows of one of its financial assets. If the asset does not generate sufficient cash flows to pay the principal and interest of the borrowing, the entity is not obliged to make the lender whole for the loss suffered. The lender has a security interest in the financial asset, and thus the entity is precluded from selling or pledging the asset without the lender's approval. In this situation the ED indicates that

the entity should view the transaction as a transfer of the securing financial asset (and assess it for derecognition as such) rather than as a nonrecourse borrowing.

Concerns by respondents to ED relating to 'transfer' definition

5. Respondents to the ED requested clarification on the transfer definition in the following areas:

*Concerns about '**agreeing to pass** economic benefits'*

(a) Does the transfer definition encompass derivatives that are entered into on a stand-alone basis or as part of a hedging relationship (eg forward sales, total return swaps or interest rate swaps (physically or net settled, and/or prepaid))?

(b) At which point in time does the transfer take place and should the derecognition test thus be performed? For example, in the following two scenarios, does the transfer take place on 1 January or 31 March?

(i) Scenario 1: Agreement on 1 January to pass cash flows occurring after 31 March

(ii) Scenario 2: Agreement on 1 January to sell an asset for delivery on 31 March

(c) Are the 'pass through' criteria in IAS 39.19, in particular the requirement for the transferor to remit cash received without material delay, still relevant for determining whether a transfer has taken place?

(d) For a transaction for which legal title has not passed or will not pass to qualify as a transfer, must the transferee have a security interest in the asset and/or must the transferor be prohibited from selling or pledging the asset during the term of the arrangement?

(e) Paragraph AG38A of the ED states that transferring the cash flows of an entire financial asset is akin to a transfer of the asset itself. Some respondents to the ED believe that this guidance would result in special-purpose entities (SPEs) that through the issuance of beneficial interest distribute all the cash flows from their assets becoming 'empty shells'. These respondents questioned whether this outcome is appropriate given that the stakeholders of the SPEs believe they have invested in an entity that has assets. Furthermore, the respondents also note that 'empty SPEs' would render the consolidation standard meaningless.

(f) Does the sale of units in an insurance fund in which the insurer has agreed to pass onto the policyholder the economic benefits of the underlying linked investments constitute a 'transfer'?

(g) To qualify as a transfer, must the transferor convey all the economic benefits of a financial asset, or could it also pass on only a specific portion of those benefits, such as only the upside or the downside of economic benefits?

(h) Some examples in the application guidance of the ED (eg AG52L(f)-(g)) seem to establish transfer criteria. Some respondents commented that if the Board believed that those criteria were necessary for a transfer to take place, the criteria should form part of the transfer definition.

Other concerns

(i) Is 'economic benefits' meant to be broader than 'cash flows', which is the focus of the transfer definition in IAS 39.18?

(j) Does 'economic benefits' include voting rights and/or subscription rights, which are all inherent in the contractual terms of a financial asset and through which the cash flows underlying the asset are controlled?

(k) The ED proposes a number of additional disclosures for financial assets that an entity transfers and derecognises and in which the entity has continuing involvement. As transfers are defined broadly in the ED, some respondents stated that these additional disclosures might pose a reporting burden.

Staff analysis of, and recommendation for, concerns in paragraph 5(a)-(h)

6. As mentioned in paragraph 3, the Board proposed in the ED to change the transfer definition in IAS 39 to broaden the scope of transactions that would have to be assessed for derecognition. Respondents to the ED generally agreed with the objective of the proposed changes, but noted that these changes did not clearly articulate how strong the link between (a) a financial asset that an entity has recognised and (b) the arrangement into which the entity has entered and under which it has agreed to pass on cash flows from that asset to another entity must be for the transaction to qualify as a transfer.

7. The link between the financial asset and the transaction transferring the economic benefits is also important when applying the derecognition principle underlying the alternative approach (ie how strong must the link be to conclude that the transferor no longer has present access to the economic benefits of the asset or no longer can restrict others' access to those benefits?).

8. Rather than tinkering with the transfer definition, the staff believe that the Board can address the issues raised by respondents to the ED more easily and more efficiently as part of the application guidance for the alternative derecognition approach. (See Paper 3B).

9. The staff also believe that with the alternative derecognition approach a transfer definition is no longer needed. Unlike IAS 39 and the proposed approach in the ED, the derecognition principle underlying the alternative approach does not include the term 'transfer'.[1]

10. The staff acknowledges that some might be concerned that without a 'transfer' definition an entity might not know when it has to apply to the derecognition principle. However, the staff believes that an entity will know when it has entered into a transaction that involves one or more of its financial assets. Hence the entity will know that it must then assess the asset(s) for derecognition according to the derecognition principle in the financial instruments standard.

11. The staff also notes that the focus of the alternative derecognition approach is on an entity's appropriate recognition of its contractual rights and obligations. The fact that the entity obtained those rights and obligations as a result of a transfer is irrelevant. Thus having a 'transfer definition' may give 'transfer' more importance than it deserves.

12. In light of the foregoing, a majority of **the staff recommend that the Board not provide a transfer definition in the final standard on derecognition of financial instruments, but rather deal with the issues identified by respondents to the ED with respect to that definition by providing**

[1]Under the alternative derecognition approach, an entity must derecognise a financial asset when the economic benefits inherent in that asset no longer exist or when the benefits exist but the entity ceases to have the present ability (a) to obtain all of those benefits or (b) to restrict others' access to them.

additional guidance on the application of the derecognition principle underlying the alternative approach.

13. The staff note that since the proposed disclosures in the ED hinge on whether there was a transfer one might wonder what would happen to those proposed requirements if the Board were to decide to eliminate the transfer definition. If that were the Board's decision, the staff would recommend that the derecognition disclosure requirements come into effect when an entity enters into a transaction that results in derecognition, or that does not result in derecognition, applying the derecognition principle underlying the alternative approach.

14. Some staff prefer to keep the transfer definition and improve that definition by addressing the concerns raised by respondents to the ED. 'Transfer' is a term widely used in practice, especially when identifying, reviewing and analysing transactions. It is a term that many users and preparers are familiar with and comfortable with applying. Many preparers may feel that the term 'transfer' identifies when an economic transaction takes place. Deletion of this term may cause inconsistent application. If the Board were to decide to keep a transfer definition, the staff will present a paper with a revised definition that addresses the related concerns at a future Board meeting.

Question 1
Does the Board agree with the recommendation in paragraph 12? If not, why not, and instead does the Board want to keep the transfer definition and address the concerns raised by respondents to the ED in the transfer definition itself?

Staff analysis of, and recommendation for, other concerns (paragraph 5(i)-(k))

Paragraph 5(i)-(j): Do 'economic benefits' include voting or subscription rights?

15. **Note**: Respondents raised this concern in the context of the transfer definition. However, this concern equally applies to the derecognition principle underlying the alternative approach because that principle focuses on a transferor's present access to the *economic benefits* of the financial asset that the transferor

recognised before the transfer. Thus if the Board agreed with the staff recommendation in the foregoing section to eliminate the transfer definition, the Board should discuss the following paragraphs in the context of that derecognition principle.

16. Paragraphs 8, 9 and 12 of the Basis for Conclusions in the ED define and describe 'economic benefits'. These paragraphs, which are based on the definition of an asset in the IASB *Framework*[2], state (emphasis added):

> BC8 The future economic benefits embodied in an asset are the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents of an 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.
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> BC9 **The future economic benefits embodied in a financial asset generally are the contractual right to future cash flows**. For example, receivables are expected to generate cash, which is their main function.
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> […]
>
> BC12 **Because the future economic benefits embodied in a financial asset are the right to future cash inflows**, 'control' in context of a financial asset means, in general terms, the ability to obtain (access) the future cash inflows of the asset and the ability to restrict others' access to those future cash inflows.

17. Thus the definition of 'economic benefits' in the ED focuses on contractual rights that are *financial* in nature (ie the right to future cash flows). However, some financial assets might also include *nonfinancial* contractual rights and obligations, such as the right to vote or subscribe. Unless they are required to be separated (or 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.

18. 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

[2] See paragraphs 53-55 in the *Framework*.

unit of account in IAS 39 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.

19. If the unit of account were the individual rights and obligations within the contract, the solution to the issue of whether 'economic benefits' as that term is used in the alternative 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.[3]

20. However, recognising financial assets and liabilities on the basis of individual contractual rights and obligations rather than on the basis of the contract as a whole would be a change to the existing requirements that is beyond the scope of this project. IAS 39 provides that the unit of account is the contract. Thus it would appear that logic dictates that 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).

[3]The JWG of World Standard Setters already identified this unit of account issue. See the discussion in paragraphs 2.44-2.52 of the Basis for Conclusions of the Draft Standard *Financial Instruments and Similar Items* developed by that group.

21. 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 alternative 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).

22. In summary, the staff believe that defining 'economic benefits' to include nonfinancial benefits makes sense because it is consistent with how IAS 39 assesses contracts for the purpose of initial recognition of financial assets and liabilities, as the staff have noted in paragraph 20.

23. The staff also point out that 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.

24. In light of the foregoing discussion, **a majority of the staff recommend that in the derecognition project 'economic benefits' encompass both financial and nonfinancial economic benefits.** (This assumes that the nonfinancial benefits have not already been separated from the related financial asset at initial recognition).

25. Some staff believe that as the instrument (i.e. the actual stock certificate) has not legally changed, the original asset should not be derecognised. Rather, the transfer of a non-financial right (such as a voting right) should be treated as a re-measurement event. This is because there was no modification of the terms of the instrument between the original purchaser and the original issuer, and the underlying legal form of the instrument has not changed. The entity merely entered into a separate transaction with a third party, a transaction which should

be recorded as a separate liability since the parties do not have a legal right to offset the two instruments.

Question 2
Does the Board agree with the staff recommendation in paragraph 24? If not, why? What does the Board wish to do instead, and why?

Paragraph 5(k): Expanded disclosures as a result of broader transfer definition

26. The ED proposed to expand the disclosure requirements for transfer transactions (irrespective of the transfer definition). That is, under IFRS 7 *Financial Instruments: Disclosures*, an entity must provide disclosures for transfers only when these transfers do not result in derecognition. The ED proposed to introduce new disclosures for transfers of financial assets that are derecognised and in which the transferor continues to be involved after the transfer. The Board proposed these disclosures specifically to address users' concern about the lack of transparency in entities' financial statements for transfer transactions as a result of the current disclosure requirements in IFRS 7.

27. The staff will address the concern about the proposed expansion of the derecognition disclosure requirements in IFRS 7 in a separate paper that it intends to bring to the Board at the IASB meeting in March.