Project **Derecognition**

Topic **Consideration of the IASB derecognition model**

Purpose

1. The purpose of this meeting is for the Board to discuss:

   a. Certain aspects of the IASB's proposed derecognition model (the alternative model or "pure" financial components approach), and

   b. Certain areas within ASC Topic 860 Transfers and Servicing (Topic 860, formerly FASB Statement No. 166, Accounting for Transfers of Financial Assets) that the Board may reconsider in conjunction with its efforts to reach a converged derecognition standard.

Background

2. In March 2009, the IASB published an exposure draft, Derecognition ED/2009/3 (proposed amendments to IAS 39 and IFRS 7) which proposed a derecognition model for financial assets and liabilities, as well as an Alternative View. Based on feedback received from comment letters, the IASB opted to end deliberations on the primary derecognition model as exposed and to begin further developing and deliberating the Alternative View. In April 2010, the IASB staff held an educational session for the FASB to summarize the decisions made by the IASB to date on the alternative derecognition model for financial assets and liabilities. The Boards then discussed some initial areas of clarification requested by FASB Board members on that model at the April 23, 2010 Joint Board Meeting. No decisions were made. During those meetings, the FASB Board raised concerns about the proposed alternative model as

presented. The FASB Board agreed to provide input on the model to be discussed jointly at the May Joint Board Meeting.

Items for the Board's consideration

3. Subsequent to those meetings, the FASB staff conducted a series of FASB small group meetings to understand FASB Board members' thoughts about the IASB's proposed alternative derecognition model. The staff has summarized below the comments made by Board members during those small group meetings.

Discussion on the IASB's proposed derecognition model

Continuing involvement/effective control

4. Four of five Board members discussed the lack of consideration of continuing involvement within the model. The model does not consider the nature and extent of the transferor's continuing involvement with the transferred assets, nor does it provide for an assessment of effective control. The IASB has provided an exception to the model to enable repo transactions to be reported as secured borrowings. However, the exception may result in accounting for similar transactions differently. For example, the model accounts for repo transactions as secured borrowings whereas the transfer of a financial asset with optionality such as a purchased call option or written put option would be reported as a sale (even when the options act like a forward purchase contract). The resulting disparity may not faithfully represent the underlying substance of the transactions.

5. Without further analysis of the nature and extent of the transferor's continuing involvement with transferred assets, the model would permit an entity to shrink its balance sheet. Aside from repo transactions, Board members also noted the following about the lack of consideration of continuing involvement:

   a. With the benefit of hindsight, history suggests in some instances that entities do not appropriately measure and report their continuing involvement (including implicit guarantees). The proposed approach relies on disclosures and may result in an entity not fully reporting the underlying risks related to transferred assets.

b. All preceding derecognition models consider continuing involvement when evaluating whether derecognition should occur.

c. When evaluating whether the transferor has control over transferred assets, the proposed model does not consider *future* obligations.

Sales of portions of financial assets

6. Four of five Board members discussed the accounting for sales of portions of financial assets. It was also noted that, under the Alternative Approach, the measurement attribute differs depending on whether the rights to some cash flows were proportionate (relative fair value) or disproportionate (fair value). A Board member noted that with servicing, the cash flows can never be fully proportionate. This concept of different measurement attributes based on proportionality does not appear to be consistent with the business model approach in IFRS 9.

7. A transferor would apply the proposed derecognition requirements to any transfer of cash flows (regardless of whether the cash flows are proportionate or disproportionate). The proposed model does not restrict the component to which the derecognition requirements are applied. [As a result, the derecognition model would expand the IASB's notion of financial asset established in its financial instruments model.] For example, if a transferor transfers the last dollar of a loan receivable and ceases to have present access for its own benefit to all economic benefits of that transfer of specified cash flows, the transferor would derecognize the loan receivable in its entirety and remeasure at fair value its continuing interests in the loan.

8. In contrast, Statement 166 defined the unit of account to which its derecognition criteria must be satisfied as an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset. The FASB concluded that, in practice, it is difficult to determine whether a transferor has surrendered control over a component of a financial asset, or a component of a

group of financial assets, if the transferor continues to maintain custody of the original financial asset(s). One Board member discussed that, under the IASB's proposed model, there is no definition of a transfer and therefore, a transaction can qualify for derecognition without ever transferring the underlying asset.

9. All FASB Board members discussed that the proposed components approach coupled with the proposed remeasurement requirement could enable earnings manipulation.

Use of an entity

10. The model does not consider the consolidation of an entity before derecognition. Additionally, the model views a special purpose entity (SPE) as the transferee rather than looking through the SPE to its third-party beneficial interest holders. Some FASB Board members discussed that the proposed derecognition approach may result in SPEs that, through the issuance of beneficial interests that distribute all the cash flows from their assets, become "empty SPEs". Thus, even in scenarios in which the transferor controls and consolidates the SPE transferee, the transferred assets may no longer be reported as assets of the SPE. Under the proposed approach, whether an SPE will be empty or not, depends on the nature of the beneficial interests issued (i.e., whether the beneficial interest entitles the holders of such instrument to the cash flows of an asset or a portfolio of assets, or to an interest in the entity).

11. Some FASB Board members would like additional analysis to better understand how the proposed approach would apply to transactions that typically involve SPEs or defeasance trusts.

Other Items

12. The FASB Board members generally identified those items noted above as high priority. Various Board members also provided the following comments about the proposed derecognition model:

a. Legal consequences of a transfer should not be ignored. Most Board members agree that Statement 166's legal isolation approach may not be portable to international accounting. However, they believe that a derecognition model should focus on the transferor's legal rights to have access to the economic benefits of the transferred assets.

b. Operational issues about determining who has the rights to the transferred assets should be further considered.

c. The proposed model focuses only on control, while existing derecognition models consider both control and risks and rewards.

d. Consideration of decisions made in other projects including leases and revenue recognition to identify any areas of inconsistent conclusions and understand if there is a supporting rationale for alternative conclusions.

13. The following table summarizes the discussion points the FASB Board members have identified about the IASB's proposed alternative derecognition model.

Discussion Point	Sub-points
Continuing Involvement/ Effective Control	• Repos and in-substance repos as secured borrowings should flow

	from model • How in the money calls and puts should impact the derecognition decision • Recognition and measurement of items representing an entity's continuing involvement, including implicit guarantees
Sales of portions of financial assets	• Different measurement attributes depending on whether your interest is proportionate and disproportionate; trigger gain recognition • Requires derecognition of an entire asset for any transfer of or partial interest in the cash flows of the asset • Lack of a definition of a transfer
Use of an entity	• Understand whether securitization transactions and defeasance trust become "empty SPEs"
Other concerns	• Legal consequences of a transfer should not be ignored • Operational issues about determining who has the rights to the transferred assets should be further considered • Proposed model focuses only on control • Consider further interaction with leases and revenue recognition

Principles of Topic 860 (formerly Statement 166) for possible redeliberation

Continuing involvement/effective control

14. Board members may consider redeliberating Topic 860's guidance to determine when a transferor has maintained effective control over transferred assets. Specifically, the Board may reconsider the accounting for repo transactions and consider what fact patterns might exist that would make a financial asset transfer an in-substance repo.

Pure components approach

15. The Board may consider redeliberating the unit of account guidance in Topic 860:

> To be eligible for sale accounting, an entire financial asset cannot be divided into components before a transfer unless all of the components meet the definition of a participating interest. The legal form of the asset and what the asset conveys to its holders shall be considered in determining what constitutes an entire financial asset. An entity shall not account for a transfer of an entire financial asset or a participating interest in an entire financial asset partially as a sale and partially as a secured borrowing. [860-10-40-4A]

16. Specifically, the Board may consider re-examining the notion of participating interest to determine if this method is the most appropriate way to account for the transfer of a portion of a financial asset, and reconsider whether this approach results in the most decision-useful information.

Legal isolation

17. The Board may consider re-examining the notion of legal isolation as a requirement for meeting the derecognition criteria. Board members noted that the concept of legal isolation may be interpreted and applied inconsistently across jurisdictions and therefore could result in different accounting for similar transactions. Board members expressed an interest in developing a principle that would eliminate the need for legal isolation and the current emphasis on what would happen in bankruptcy. However, Board members would like to

incorporate risk and rewards and continuing involvement analyses that generally are considered when assessing legal isolation into a revised derecognition model.

Use of an entity

18. Some Board members also may consider re-examining how the use of an entity affects the derecognition of a transfer of financial assets. Consistent with concerns noted above, those Board members believe that a transferor should not obtain a different accounting treatment depending on whether or not an entity has been involved in the transfer.