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April 2009

Exposure Draft ED/2009/3

Derecognition

Proposed amendments to IAS 39 and IFRS 7

Comments to be received by 31 July 2009

International
Accounting Standards
Board®

Exposure Draft

DERECOGNITION

(proposed amendments to IAS 39 and IFRS 7)

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ED/2009/3

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Introduction

Background

IN1 In April 2005 the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) added a project to their respective research agendas to improve and potentially bring to convergence the derecognition requirements in IAS 39 *Financial Instruments: Recognition and Measurement* and FASB Statement No. 140 *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (SFAS 140). The boards made this decision because of the perceived complexity of the current requirements and the resulting difficulty in applying them in practice.

IN2 One reason for the complexity of IAS 39 is that it is internally inconsistent: it combines elements of various derecognition concepts (risks and rewards, control and continuing involvement) and requires them to be applied in a specified order to determine whether all or part of a previously recognised financial asset should be derecognised. In summary:

(a) IAS 39 permits a financial asset to be separated into parts only in defined circumstances. Otherwise it requires the derecognition tests to be applied to the entire asset.

(b) An entity must consider whether it has 'transferred' the asset to another party and, if so, whether it has also transferred substantially all the risks and rewards of the asset. If so, the entity derecognises the asset.

(c) Otherwise the entity determines whether it has retained control of the asset. If it has retained control of the asset, the entity recognises the asset only to the extent of its 'continuing involvement' in the asset. If it has not retained control of the asset, the entity derecognises the asset.

IN3 Another example of the complexity of IAS 39 is that it provides little guidance about how the 'substantially all the risks and rewards' test should be applied. Questions have arisen in practice about:

(a) whether each identified risk and reward should be substantially surrendered to allow for derecognition

(b) whether all risks should be aggregated separately from all rewards

(c) whether risks and rewards should be offset and then combined for evaluation

(d) how 'substantially all' should be interpreted in the evaluation of those risks and rewards.

IN4 In February 2006 the IASB and FASB published a Memorandum of Understanding (MoU). The MoU set out the relative priorities within the boards' joint work programme in the form of milestones to be reached by 2008. The MoU included the derecognition project and aimed for a due process document relating to the staff's research on this subject to be published by 2008.

IN5 At their joint meeting in April 2008 the boards affirmed their commitment to developing common, high quality standards and agreed on a pathway to completing the MoU projects. For the derecognition project, the boards set as targets:

(a) the publication of IASB and FASB exposure drafts in 2008 or early 2009;

(b) the issue of final standards in 2009 or 2010; and

(c) a decision in 2008 on a strategy to develop a common standard.

IN6 The IASB's decision to proceed directly to the publication of an exposure draft was in response to the global financial crisis and the recommendations of the Financial Stability Forum. Following that decision, the Board moved the project from its research agenda to its active agenda.

IN7 Similarly, the FASB's decision to publish an exposure draft was as a result of the financial crisis and requests by the US Securities and Exchange Commission to address urgently inconsistencies in how some concepts in SFAS 140 are applied in practice. In September 2008 the FASB published the exposure draft proposing amendments to SFAS 140. In the exposure draft, the FASB explained that (consistently with the MoU) it viewed the proposed amendments as a short-term solution and that it intended to join the IASB in producing a single standard on derecognition.

IN8 At their joint meeting in March 2009, the boards agreed that:

(a) the FASB would complete its short-term project of amending SFAS 140 by issuing a final statement in 2009;

(b) they would jointly deliberate (with the objective of reaching common conclusions) the comments the IASB receives on this exposure draft; and

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(c) at the conclusion of those deliberations, the IASB would issue a standard amending the derecognition requirements in IAS 39, and the FASB would expose the IASB's amendment of IAS 39 to its constituents for public comment.

IN9 In developing the proposed approach to derecognition of financial assets, the Board considered various factors, including the following:

(a) *Complexity*—The derecognition requirements in IAS 39 are difficult to understand and apply in practice.

(b) *Convergence*—The derecognition project presents an opportunity to improve IFRSs and US GAAP requirements on this topic, and achieve convergence.

(c) *Market environment*—Regulators and others have called for an improvement to, and convergence of, derecognition requirements.

(d) *Users' requests*—Users have repeatedly asked for more transparency in the accounting and reporting of transfer transactions, particularly those that involve securitisation vehicles.

(e) *Divergent views*—Constituents and Board members alike have divergent views on the substance of a transfer of a financial asset if the transferring entity maintains some involvement in the asset. Is the transfer a sale of the asset or is it a borrowing secured by the 'transferred' asset? To a large extent, the divergence in views on the substance of a transfer is caused by a lack of agreement on 'the asset that is the subject of a transfer'. In particular, can a financial asset be divided into smaller and smaller parts that are assets in their own right that may then qualify for derecognition? If so, can those parts be rights to any cash flows of the previously recognised financial asset, or rights to only particular types of cash flows?

Summary of the proposals

IN10 The proposed amendments would replace the approach to derecognition of financial assets in IAS 39 with an approach that is similar in that

(a) it uses the same criteria for when a transferred part of a financial asset qualifies to be assessed for derecognition (with some additional guidance to address known application issues);

(b) it uses a test of control (although unlike IAS 39 that test has primacy); and

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(c) many of the derecognition outcomes will be similar (the notable exceptions being transfers, such as repurchase agreements, involving readily obtainable financial assets).

IN11 However, the proposed approach is different from IAS 39 in that it does not combine elements of several derecognition concepts but rather focuses on a single element (control). As a result, unlike IAS 39, the proposed approach does not have:

(a) a test to evaluate the extent of risks and rewards retained;

(b) specific pass-through requirements; or

(c) a requirement for a transferor (in a transfer that fails derecognition) to recognise and measure a financial asset to the extent of its continuing involvement.

IN12 As noted in paragraph IN9(e), the Board was divided on the appropriate approach to derecognition of financial assets. A majority of the Board favoured (and decided on) the derecognition approach proposed in this exposure draft. However, five Board members preferred an alternative approach. Like the proposed approach, the alternative approach bases the decision of whether an entity should derecognise a transferred financial asset on whether the entity has surrendered control of the asset. However, unlike the proposed approach, the alternative approach assesses control differently, and with that, has a different perspective of what the asset that is the subject of the transfer is. The alternative approach is described in more detail as part of the five Board members' alternative views.

IN13 The proposed amendments also would revise the approach to derecognition of financial liabilities in IAS 39 to be more consistent with the definition of a liability in the IASB *Framework*.

IN14 The proposed amendments to IFRS 7 *Financial Instruments: Disclosures* would enhance the disclosures in that IFRS to improve the evaluation of risk exposures and performance in respect of an entity's transferred financial assets.

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Invitation to comment

The Board invites comments on all matters in this exposure draft, in particular on the questions set out in the paragraphs below. Comments are most helpful if they:

(a) respond to the questions as stated

(b) indicate the specific paragraph(s) to which they relate

(c) contain a clear rationale

(d) if applicable, provide a suggestion for alternative wording the Board should consider.

The Board is not seeking comments on other aspects of IAS 39 or IFRS 7.

Comments should be submitted in writing so as to be received no later than **31 July 2009**.

Question 1—Assessment of 'the Asset' and 'continuing involvement' at reporting entity level

Do you agree that the determination of the item (ie the Asset) to be evaluated for derecognition and the assessment of continuing involvement should be made at the level of the reporting entity (see paragraphs 15A, AG37A and AG47A)? If not, why? What would you propose instead, and why?

Question 2—Determination of 'the Asset' to be assessed for derecognition

Do you agree with the criteria proposed in paragraph 16A for what qualifies as the item (ie the Asset) to be assessed for derecognition? If not, why? What criteria would you propose instead, and why?

(Note: The criteria proposed in paragraph 16A are the same as those in IAS 39.)

Question 3—Definition of 'transfer'

Do you agree with the definition of a transfer proposed in paragraph 9? If not, why? How would you propose to amend the definition instead, and why?

Question 4—Determination of 'continuing involvement'

Do you agree with the 'continuing involvement' filter proposed in paragraph 17A(b), and also the exceptions made to 'continuing involvement' in paragraph 18A? If not, why? What would you propose instead, and why?

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Question 5—'Practical ability to transfer for own benefit' test

Do you agree with the proposed 'practical ability to transfer' derecognition test in paragraph 17A(c)? If not, why? What would you propose instead, and why?

(Note: Other than the 'for the transferee's own benefit' supplement, the 'practical ability to transfer' test proposed in paragraph 17A(c) is the same as the control test in IAS 39.)

Do you agree with the 'for the transferee's own benefit' test proposed as part of the 'practical ability to transfer' test in paragraph 17A(c)? If not, why? What would you propose instead, and why?

Question 6—Accounting for retained interests

Do you agree with the proposed accounting (both recognition and measurement) for an interest retained in a financial asset or a group of financial assets in a transfer that qualifies for derecognition (for a retained interest in a financial asset or group of financial assets, see paragraph 21A; for an interest in a financial asset or group of financial assets retained indirectly through an entity, see paragraph 22A)? If not, why? What would you propose instead, and why?

(Note: The accounting for a retained interest in a financial asset or group of financial assets that is proposed in paragraph 21A is not a change from IAS 39. However, the guidance for an interest in a financial asset or group of financial assets retained indirectly through an entity as proposed in paragraph 22A is new.)

Question 7—Approach to derecognition of financial assets

Having gone through the steps/tests of the proposed approach to derecognition of financial assets (Questions 1–6), do you agree that the proposed approach as a whole should be established as the new approach for determining the derecognition of financial assets? If not, why? Do you believe that the alternative approach set out in the alternative views should be established as the new derecognition approach instead, and, if so, why? If not, why? What alternative approach would you propose instead, and why?

Question 8—Interaction between consolidation and derecognition

In December 2008, the Board issued an exposure draft ED 10 *Consolidated Financial Statements*. As noted in paragraphs BC28 and BC29, the Board believes that its proposed approach to derecognition of financial assets in this exposure draft is similar to the approach proposed in ED 10 (albeit derecognition is applied at the level of assets and liabilities, whereas consolidation is assessed at the entity level). Do you agree that the proposed derecognition and consolidation approaches are

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compatible? If not, why? Should the Board consider any other aspects of the proposed approaches to derecognition and consolidation before it finalises the exposure drafts? If so, which ones, and why? If the Board were to consider adopting the alternative approach, do you believe that that approach would be compatible with the proposed consolidation approach?

Question 9—Derecognition of financial liabilities

Do you agree with the proposed amendments to the principle for derecognition of financial liabilities in paragraph 39A? If not, why? How would you propose to amend that principle instead, and why?

Question 10—Transition

Do you agree with the proposed amendments to the transition guidance in paragraphs 106 and 107? If not, why? How would you propose to amend that guidance instead, and why?

Question 11—Disclosures

Do you agree with the proposed amendments to IFRS 7? If not, why? How would you propose to amend those requirements instead, and why?

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Proposed amendments to IAS 39 *Financial Instruments: Recognition and Measurement*

Scope

Paragraphs 2(b) and (h) are amended (new text is underlined and deleted text is struck through).

2 **This Standard shall be applied by all entities to all types of financial instruments except:**

(a) ...

(b) **rights and obligations under leases to which IAS 17** *Leases* **applies. However:**

(i) **lease receivables recognised by a lessor are subject to the derecognition and impairment provisions of this Standard (see paragraphs 15A~~–37~~24A, 58, 59~~,~~ and 63–65 ~~and Appendix A paragraphs AG36–AG52 and AG84–AG93~~);**

(ii) **finance lease payables recognised by a lessee are subject to the derecognition provisions of this Standard (see paragraphs 39A–42B ~~and Appendix A paragraphs AG57–AG63~~); and**

(c)–(g) …

(h) **loan commitments other than those loan commitments described in paragraph 4. An issuer of loan commitments shall apply IAS 37** *Provisions, Contingent Liabilities and Contingent Assets* **to loan commitments that are not within the scope of this Standard. However, all loan commitments are subject to the derecognition provisions of this Standard (see paragraphs 15A–42B ~~and Appendix A paragraphs AG36–AG63~~).**

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Definitions

Paragraph 9 is amended (new text is underlined and deleted text is struck through).

Definitions relating to recognition and measurement

...

Derecognition **~~is the removal of a previously recognised financial asset or financial liability from~~ of a financial asset or liability is ceasing to recognise that asset or liability in an entity's statement of financial position.**

...

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.)

Recognition and derecognition

Paragraphs 15–24 are deleted and replaced by paragraphs 15A–24A. Paragraphs 25–37 are deleted (as a result, the next paragraph after paragraph 24A is paragraph 38).

Derecognition of a financial asset

15A An entity determines the item to be assessed for derecognition in paragraph 16A, and assesses continuing involvement in paragraphs 17A and 18A, at the level of the reporting entity. Hence, if the reporting entity is the group, an entity first consolidates all subsidiaries in accordance with IAS 27 and SIC-12 *Consolidation—Special Purpose Entities* and then applies those paragraphs to the resulting group.

16A An entity applies paragraphs 17A and 18A to a part of a financial asset (or a part of a group of financial assets) only if that part comprises specifically identified cash flows or a proportionate share of the cash flows from that financial asset (or that group of financial assets) (ie the performance of the part retained does not depend on the performance of the part transferred, and vice versa). If there are two or more transferees,

no transferee is required to have a proportionate share of the cash flows from the asset (or the group of financial assets) provided that the transferring entity has a proportionate share. In all other cases, paragraphs 17A and 18A are to be applied to the financial asset (or group of financial assets) in its entirety. In paragraphs 17A and 18A, the term 'the Asset' refers to either a part of a financial asset (or a part of a group of financial assets) as identified in this paragraph or, otherwise, a financial asset (or a group of financial assets) in its entirety.

17A An entity shall derecognise the Asset if:

(a) the contractual rights to the cash flows from the Asset expire;

(b) the entity transfers the Asset and has no continuing involvement in it; or

(c) the entity transfers the Asset and retains a continuing involvement in it but the transferee has the practical ability to transfer the Asset for the transferee's own benefit.

18A A transferor has no continuing involvement in the Asset if, as part of the transfer, it neither retains any of the contractual rights or obligations inherent in the Asset nor obtains any new contractual rights or obligations relating to the Asset. None of the following constitutes continuing involvement:

(a) normal representations and warranties relating to fraudulent transfer and concepts of reasonableness, good faith and fair dealings that could invalidate a transfer as a result of legal action;

(b) the retention of the right to service the Asset in a fiduciary or agency relationship; or

(c) forward, option and other contracts associated with reacquiring the Asset for which the contract (or exercise) price is the fair value of the transferred Asset.

Transfers that qualify for derecognition (see paragraph 17A(b) and (c))

19A For a transfer of all or part of a financial asset that meets the derecognition criteria in paragraph 17A(b) and (c), the transferor shall recognise any new assets obtained or new liabilities assumed in the transfer and initially measure them at fair value.

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20A For a transfer of an entire financial asset that meets the derecognition criteria in paragraph 17A(b) and (c), the transferor shall recognise in profit or loss the difference between:

(a) the carrying amount of the asset transferred (and derecognised) and

(b) the sum of

(i) the consideration received (including any new assets obtained less any new liabilities assumed) and

(ii) any cumulative gain or loss that the entity had recognised in other comprehensive income (see paragraph 55(b)).

21A For a transfer of a part of a financial asset that meets the derecognition criteria in paragraph 17A(b) and (c), the transferor shall account for the part retained as part of the financial asset recognised before the transfer. As a result, the entity shall allocate the carrying amount of the financial asset previously recognised between the part retained and the part transferred (and derecognised) on the basis of the relative fair values of those parts on the date of transfer. The entity shall recognise in profit or loss the difference between:

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

(b) the sum of

(i) the consideration received for the part transferred (and derecognised) (including any new assets obtained less any new liabilities assumed) and

(ii) any cumulative gain or loss that the entity had recognised in other comprehensive income (see paragraph 55(b)) and allocated to the part transferred.

The entity allocates a cumulative gain or loss that it had recognised in other comprehensive income between the part retained and the part transferred (and derecognised) on the basis of the relative fair values of those parts on the date of transfer.

22A If an entity transfers an entire financial asset or a group of financial assets to another entity in a transfer that qualifies for derecognition and, as part of the transfer, purchases an interest in that entity (which gives it the right to some of the cash flows from that asset or group of assets), it shall treat such interest as a retained part of the asset or group of assets

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previously recognised. If the transferee has other financial assets or liabilities in addition to those received from the transferring entity, the transferring entity shall split the interest purchased following the guidance in paragraph 21A between

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

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

Transfers that do not qualify for derecognition (see paragraph 17A(b) and (c))

23A For a transfer of all or part of a financial asset that fails the derecognition criteria in paragraph 17A(b) and (c), the entity shall continue to recognise the financial asset in its entirety and shall recognise a financial liability for the consideration received (the entity shall not offset the asset and the liability). In subsequent periods, the entity shall recognise any income on the transferred asset and any expense incurred on the financial liability (the entity shall not offset the income and expense). (See IAS 32 paragraph 42.)

24A If an entity measures at amortised cost a financial asset that it continues to recognise following a transfer, it shall not apply to the associated liability the option in this Standard to designate a financial liability as at fair value through profit or loss.

Paragraphs 39–42 are deleted and replaced with paragraphs 39A–42B.

Derecognition of a financial liability

39A 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.

40A If an entity exchanges one debt instrument with the creditor for another debt instrument, it derecognises the financial liability associated with the previous debt instrument and recognises a new financial liability if the terms of the debt instruments are substantially different. Similarly, if 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), the entity derecognises the associated financial liability and

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recognises a new financial liability. (This paragraph applies only if the exchange or modification is not a transfer of a financial asset, as that term is defined in paragraph 9. If the exchange or modification is a transfer of a financial asset, that asset shall be assessed for derecognition following the criteria in paragraphs 15–18A. To the extent the asset qualifies for derecognition, the entity derecognises it, and also derecognises the financial liability associated with the previous debt instrument.)

41A If an entity derecognises a financial liability, it shall recognise in profit or loss the difference between:

(a) the carrying amount of the liability derecognised and

(b) the consideration paid (including any non-cash assets transferred or liabilities assumed).

42A 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) for the part derecognised.

42B If an entity derecognises a financial liability as a result of an exchange of debt instruments or modification of terms, it includes any costs or fees incurred in the gain or loss recognised. 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.

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Measurement

Paragraph 47(b) is amended (new text is underlined and deleted text is struck through).

Subsequent measurement of financial liabilities

47 After initial recognition, an entity shall measure all financial liabilities at amortised cost using the effective interest method except for:

(a) ...

(b) financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition ~~or when the continuing involvement approach applies~~. Paragraphs ~~29 and 31~~ 23A and 24A apply to the measurement of such financial liabilities.

Paragraphs 106 and 107 are amended (new text is underlined and deleted text is struck through).

Effective date and transition

106 *Derecognition* (Amendments to IAS 39 and IFRS 7), issued in [month and year], amended paragraphs 2, 9 and 47(b), and deleted paragraphs 15–37 and 39–42 and replaced them with paragraphs 15A–24A and 39A–42B. Except as permitted by paragraph 107, an entity shall apply ~~the derecognition requirements in paragraphs 15–37 and Appendix A paragraphs AG36–AG52~~ those amendments prospectively to transactions entered into after [date]. Accordingly~~,~~:

(a) ~~i~~If an entity derecognised financial assets or financial liabilities ~~under~~ in accordance with IAS 39 (revised 200~~0~~3) as a result of a transaction ~~that occurred~~ entered into before ~~1 January 2004~~ [date specified above] or, if applicable, the earlier date from which the entity elected to apply the amendments and those assets or liabilities would not have been derecognised ~~under~~ in accordance with ~~this Standard~~ IAS 39 [as proposed to be amended], it shall not recognise those assets or liabilities (unless they qualify for recognition as a result of a later transaction or event).

(b) If, in accordance with IAS 39 (revised 2003), an entity did not derecognise financial assets or financial liabilities as a result of a transaction entered into before [date specified above] or, if

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applicable, the earlier date from which the entity elected to apply the amendments and those assets or liabilities would have been derecognised in accordance with IAS 39 [as proposed to be amended], it shall not derecognise those assets or liabilities (unless they qualify for derecognition as a result of a later transaction or event).

107 Notwithstanding paragraph 106, an entity may apply the ~~derecognition requirements in paragraphs 15–37 and Appendix A paragraphs AG36–AG52~~ amendments resulting from *Derecognition* (Amendments to IAS 39 and IFRS 7), issued in [month and year], ~~retrospectively~~ prospectively to transactions entered into before the ~~from a~~ date ~~of the entity's choosing~~ specified in paragraph 106, provided that the entity obtained the information needed to apply IAS 39 [as proposed to be amended] to assets and liabilities derecognised as a result of past transactions ~~was obtained~~ at the time ~~of~~ it initially accoun~~ting~~ed for those transactions. If an entity elects to apply the amendments prospectively to transactions entered into before the date specified in paragraph 106, it shall disclose that fact, and it shall apply the amendments to *all* transactions from that date.

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Appendix A
Application guidance

Scope (paragraphs 2–7)

Paragraph AG4(a) is amended (new text is underlined and deleted text is struck through).

AG4 Financial guarantee contracts may have various legal forms, such as a guarantee, some types of letter of credit, a credit default contract or an insurance contract. Their accounting treatment does not depend on their legal form. The following are examples of the appropriate treatment (see paragraph 2(e)):

(a) Although a financial guarantee contract meets the definition of an insurance contract in IFRS 4 if the risk transferred is significant, the issuer applies this Standard. Nevertheless, if the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts, the issuer may elect to apply either this Standard or IFRS 4 to such financial guarantee contracts. If this Standard applies, paragraph 43 requires the issuer to recognise a financial guarantee contract initially at fair value. If the financial guarantee contract was issued to an unrelated party in a stand-alone arm's length transaction, its fair value at inception is likely to equal the premium received, unless there is evidence to the contrary. Subsequently, unless the financial guarantee contract was designated at inception as at fair value through profit or loss or unless paragraphs ~~29–37~~ 23A and 24A ~~and AG47–AG52~~ apply (when a transfer of a financial asset does not qualify for derecognition ~~or the continuing involvement approach applies~~), the issuer measures it at the higher of:

(i) the amount determined in accordance with IAS 37; and

(ii) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18 (see paragraph 47(c)).

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The heading after paragraph AG33B, and paragraph AG34, are amended (new text is underlined and deleted text is struck through).

Recognition and derecognition (paragraphs 14–42<u>B</u>)

Initial recognition (paragraph 14)

AG34 ~~As a consequence of t~~<u>T</u>he principle in paragraph 14~~,~~ <u>results in</u> an entity recognis~~es~~<u>ing as assets and liabilities in its statement of financial position</u> all of its contractual rights and obligations ~~under~~ <u>associated with</u> derivatives ~~in its statement of financial position as assets and liabilities~~, respectively, except for derivatives that prevent a transfer of financial assets from being accounted for as a sale (see paragraph AG~~49~~<u>52J</u>). If a transfer of a financial asset does not qualify for derecognition <u>by the transferor</u>, the transferee does not recognise the transferred asset as its asset (see paragraph AG~~50~~<u>52K</u>).

The heading before paragraph AG36 is amended (new text is underlined and deleted text is struck through). Paragraphs AG36–AG52 are deleted and replaced with paragraphs AG36A–AG52A. Paragraphs AG52B–AG52L are added.

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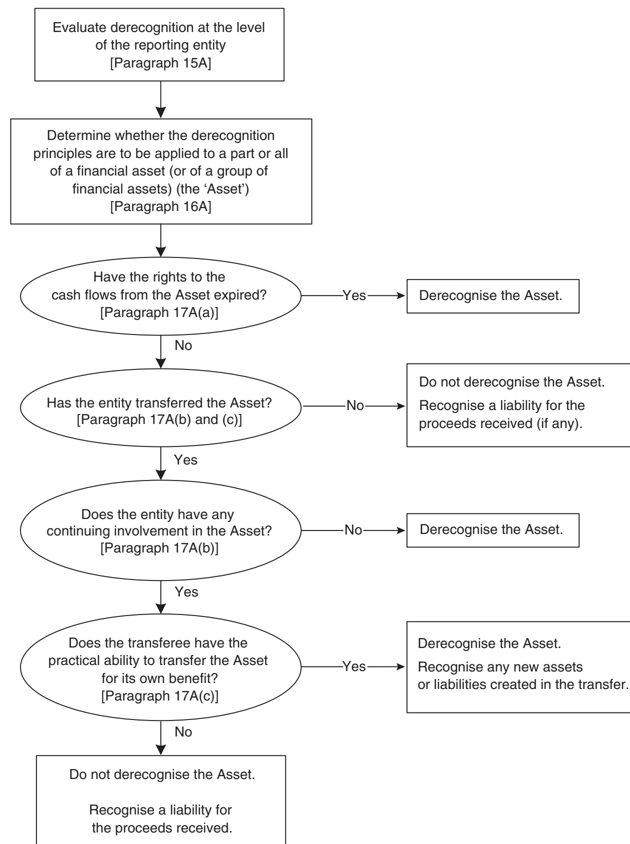
Derecognition of a financial asset (paragraphs 15A–~~37~~24A)

AG36A The following flow chart illustrates the evaluation of whether and to what extent a financial asset (or a group of financial assets) is derecognised.



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The 'Asset' to be assessed for derecognition (paragraph 16A)

AG37A The determination of the item (ie the Asset) to be assessed for derecognition is made at the level of the reporting entity on the basis of that entity's remaining interest in the financial asset that was the subject of the transfer. For example, if an entity transfers to another entity:

(a) a proportionate 80 per cent interest in a loan portfolio or

(b) 100 per cent of a loan portfolio in exchange for cash and a proportionate 20 per cent interest in that portfolio,

the Asset to be assessed for derecognition is a proportionate 80 per cent of the loan portfolio (irrespective of whether the transferring entity's retained proportionate 20 per cent share is an interest in the portfolio or an interest in the entity to which it transferred the portfolio).

Transfer of an entire financial asset

AG38A For a transfer of an entire financial asset or the right to all the cash flows or other economic benefits of a financial asset, the Asset to be evaluated for derecognition is the entire financial asset. Transferring the right to the cash flows of an entire financial asset is akin to transferring the asset itself. For example, for a transfer of the right to all cash flows of a loan, the Asset to be assessed for derecognition is the loan, irrespective of the fact that the transferring entity did not transfer to the transferee (via a legal assignment or otherwise) the loan contract it has with the borrower.

Transfer of a part of a financial asset

AG39A If the part of a financial asset transferred does not meet the conditions in paragraph 16A (ie the part does not comprise specifically identified cash flows or a proportionate share of the cash flows from the asset—the performance of the part transferred does not depend on the performance of the part retained, and vice versa), the Asset to be assessed for derecognition is the entire financial asset, regardless of the fact that only a part of the financial asset was the subject of the transfer. For example, for a transfer of the right to the *first* 90 per cent of the cash flows of a loan, the Asset to be assessed for derecognition is the entire loan.

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AG40A Similarly, transferring the right to the cash flows of a part of a financial asset that meets the conditions in paragraph 16A is akin to transferring the part itself. For example, for a transfer of the right to a proportionate 80 per cent share of the cash flows of a loan, the Asset is 80 per cent of the loan. (Hence, '20 per cent of the loan' would be considered a retained part of the previously recognised loan if the transfer qualified for derecognition, and the guidance in paragraph 21A would apply).

AG41A For a transfer of a part of a financial instrument that can be an asset or a liability over its life, the Asset is the entire instrument. For example, for a transfer of the 'receive' leg of an interest rate swap, the Asset is the swap. (Because the swap can be an asset or a liability over its term, the swap would have to meet *both* the derecognition criteria for financial assets in paragraph 17A and those for financial liabilities in paragraph 39A for it to be derecognised. As a result, a transfer of only the 'receive' leg of an interest rate swap, for example, does not qualify for derecognition.)

Transfer of a group of financial assets

AG42A For a transfer of a group of financial assets, the assets shall be evaluated for derecognition as a group (ie the Asset is the group of assets) to the extent that none of the assets in the group is an instrument that can be an asset or a liability over its life. Otherwise, the assets shall be evaluated for derecognition individually. For example, for a transfer of a portfolio of a floating rate loan and an interest rate swap, the loan and swap would be assessed for derecognition individually and the requirements in paragraph 17A(b) and (c) would apply to them separately.

AG43A Similarly, for a transfer of a part of a group of financial assets, the Asset is the part transferred only if

(a) the part meets the conditions in paragraph 16A and

(b) none of the assets in the group is an instrument that can be an asset or a liability over its life.

Meaning of 'transfer' (paragraph 17A(b) and (c))

AG44A An entity shall treat a transaction involving a financial asset as a transfer (and, as such, assess it for derecognition) if as part of the transaction it passes or agrees to pass to another party some or all of the cash flows or other economic benefits underlying that asset. Hence, irrespective of its legal form, a transaction shall be assessed for derecognition if it meets the definition of a transfer. For example, an entity might obtain a loan that

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it must repay (both principal and interest) only from proceeds generated by a specified asset in which the lender has a security interest (or by the transfer of the asset itself) and then only to the extent that the asset generates sufficient funds. In that case, the entity shall assess for derecognition the loan as a transfer of the securing financial asset. (The fact that a transaction meets the definition of a transfer does not necessarily mean that it will qualify for derecognition).

AG45A Similarly, an entity treats the issue of debt or equity instruments (beneficial interests) as a transfer of specific financial assets of that entity if, according to the terms of the instruments, the entity has agreed to remit to the holders some or all of the cash flows of those assets (this guidance applies irrespective of whether the certificates provide the holders with an interest in the entity or in the assets of that entity).

Transferor's continuing involvement (paragraphs 17A(b) and (c) and 18A)

AG46A In paragraphs AG47A–AG52G, 'the Asset' refers to either a part of a financial asset (or a part of a group of financial assets) as identified in paragraph 16A or a financial asset (or a group of financial assets) in its entirety.

AG47A The assessment of continuing involvement in the Asset is made at the level of the reporting entity. For example, if a subsidiary transfers to an unrelated third party a financial asset in which the parent of the subsidiary has continuing involvement, the subsidiary does not include the parent's involvement in the assessment of whether the asset qualifies for derecognition in its stand-alone financial statements (ie when the subsidiary is the reporting entity). However, a parent would include its continuing involvement (or that of another member of the group) in a financial asset transferred by its subsidiary in the derecognition assessment in its consolidated financial statements (ie when the reporting entity is the group).

AG48A An entity does not have a continuing involvement in the Asset if, as part of the transfer, it neither retains any of the contractual rights or obligations inherent in the Asset nor acquires any new contractual rights or obligations relating to the Asset. For example, an entity does not have continuing involvement in the Asset if it has neither an interest in the future performance of the Asset nor a responsibility under any circumstances to make payments in respect of the Asset in the future.

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AG49A Paragraph 18A(b) excludes from the assessment of continuing involvement the retention by a transferor of the right to service the Asset in a fiduciary or agency relationship. Such a relationship would be present if:

(a) the fees paid to the transferor are compensation for services provided and are commensurate with the level of effort required to provide those services (eg the service arrangement does not include terms, conditions or amounts that are not customarily present in arrangements for similar services negotiated at arm's length);

(b) the fees are senior in priority to any payment to the transferee from the serviced Asset; and

(c) the transferee has the right to terminate the servicing contract with the transferor.

AG50A Continuing involvement in the Asset may result from contractual provisions in the transfer agreement or in a separate agreement with the transferee or a third party entered into in connection with the transfer.

Transferee's practical ability to transfer for its own benefit (paragraph 17A(c))

AG51A For a transferee to have the practical ability to transfer the Asset for its own benefit, it must be in a position immediately after the transfer from the transferor to transfer, for its own benefit, the Asset to an unrelated third party *unilaterally* and *without having to impose additional restrictions* on that transfer.

Meaning of 'unilaterally'

AG52A To be in a position to transfer the Asset to an unrelated third party unilaterally, a transferee must have the ability to dispose of the Asset independently of the actions of others (except for the actions of the potential third-party buyer). For example, a transferee may have to obtain the consent of the transferor before it can transfer the Asset to a third party. In that case, if the transferor can withhold its consent without reason, the transferee does not have the ability to transfer the Asset unilaterally. On the other hand, if the transferor cannot unreasonably withhold its consent, the transferee has the ability to transfer the Asset unilaterally (provided the transferee can realise the full economic benefits of the Asset upon the transfer).

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Meaning of 'without additional restrictions'

AG52B To be in a position to transfer the Asset to an unrelated third party without having to impose additional restrictions, a transferee must be able to dispose of the Asset in isolation, ie without having to add restrictive conditions to the transfer of the Asset to that party. For example, if a transferor imposed obligations on the transferee concerning the servicing of the Asset, the transferee would have to impose those obligations on any entity to which it transfers the Asset. Hence, the transferee would not have the ability to transfer the Asset to a third party 'without additional restrictions'. The 'additional restrictions' may be in a contract separate from the contract for the transfer of the Asset, or the transfer contract and the 'additional restrictions' may be in a single contract.

AG52C An additional restriction is not a feature inherent in the Asset (ie it must be a feature that was not part of the Asset before the transfer). For example, a convertible bond contains a conversion option, which is already part of the bond. In a transfer of such a bond, the conversion option is not an additional restriction that would prevent the transferee from having the practical ability to transfer the convertible bond to a third party. On the other hand, in a transfer of a not readily obtainable convertible bond with a separate call option written by the transferee at the time of the transfer enabling the transferor to repurchase the convertible bond, the call option is an additional contract that may cause the transferee not to have the ability to transfer the convertible bond 'without any additional restrictions'. For example, the transferee might have to attach to the convertible bond a similar option in a subsequent transfer to avoid default if the transferor were to exercise the call option.

Meaning of 'for its own benefit'

AG52D To have the practical ability to transfer the Asset to an unrelated third party 'for its own benefit', a transferee must be in a position to keep for itself the consideration it would receive from an unrelated third party if it were to transfer the Asset to that party. Hence, if the transferee had an obligation to pass any such consideration from the third party on to the transferor, it would not meet the 'for its own benefit' requirement in the 'practical ability to transfer' test.

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Factors to consider in assessing 'practical ability to transfer'

AG52E Determining whether a transferee has the practical ability to transfer the Asset requires judgement, after considering all the relevant facts and circumstances. Some factors to consider in making that determination are:

(a) *the terms of the transfer (contractual) arrangement, including other contracts or arrangements entered into in relation to the transfer*

In assessing a particular transfer, it is necessary to consider any related arrangements, including any side agreements or sets of agreements entered into contemporaneously with, or in contemplation of, the transfer of the Asset.

(b) *the nature of the Asset (fungibility and obtainability)*

A contractual prohibition on disposing of the Asset (or the absence of an explicit contractual right to dispose of it) may not prevent the transferee from having the practical ability to transfer the Asset to a third party if the transferee can readily obtain a replacement asset. Replacement assets are deemed to be readily obtainable if the Asset is actively traded on an accessible market (at the date of transfer).

(c) *the market for the Asset*

A restriction or limitation that is effective on the number or identity of the parties to whom the transferee can transfer the Asset will have no practical effect if enough other potential buyers exist to create a market for the transfer of the Asset. Although the Asset involved in a transfer may not be readily replaceable, because of market convention, other established practice or an express or implied term of the transaction, the transferor may consider an asset that is not identical to the Asset an acceptable replacement for the Asset. If so, the other arrangements entered into by the parties to the transfer (as part of the transfer) would not prevent the transferee from having the ability to transfer the Asset.

(d) *the transferee's ability to obtain the full economic benefits of the Asset*

Any rights retained by a transferor that do not prevent the transferee from obtaining the full economic benefits of the Asset do not have any effect on the 'practical ability to transfer' test. For example, a transferor's right to match a bona fide offer received by the transferee from a third party does not prevent the transferee from having the ability to transfer the Asset to a third party. In such a

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case, if the repurchase were to be made in accordance with the contract, the transferee's position would be no better or worse than if it had sold that asset in the market on that day. The same analysis applies to a transfer for which the transferor retains a first right of refusal on the Asset or a repurchase right at the prevailing market value of the Asset.

(e) *economic constraints*

If a transferee stands to incur losses on the transfer of the Asset to a third party, it may be economically impeded from transferring the Asset to a third party, and therefore judged not to be practically free and able to do so. For example, a put option or a guarantee may constrain a transferee's ability to dispose of the Asset unless replacement assets are readily obtainable. This is because the transferee may be unlikely to forfeit the benefit of the option or guarantee (eg if the option or guarantee is sufficiently valuable to the transferee) without attaching a similar option, guarantee or other restrictive conditions on the transfer of that asset to a third party.

Reassessment of the 'practical ability to transfer' test

AG52F A transfer that does not qualify for derecognition because the transferee is deemed not to have the practical ability to transfer the Asset to a third party for its own benefit would subsequently qualify for derecognition if conditions changed so as to give the transferee that ability (for example, the Asset, which was not readily obtainable at the date of transfer, subsequently becomes readily obtainable). Subsequent events that change the probability of an option being exercised (other than the exercise or expiration of the option itself) would not trigger (nor would they be factored into) any reassessment.

AG52G Once a transferor derecognises the Asset because it judges that the transferee has the practical ability to transfer that asset to a third party for the transferee's own benefit, it does not re-recognise the Asset if conditions subsequently change resulting in the transferee no longer having that practical ability.

Transfers that qualify for derecognition

AG52H If an entity transfers an entire financial asset in a transfer that qualifies for derecognition and retains the right to service that asset for a fee, it recognises:

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(a) a servicing asset if the fee to be received is expected to compensate the entity more than adequately for the level of effort required to provide those services, and

(b) a servicing liability if the fee is expected not to compensate the entity adequately.

An entity initially measures a servicing asset at an amount determined on the basis of an allocation of the carrying amount of the previously recognised financial asset in accordance with paragraph 21A. An entity initially measures a servicing liability at fair value.

AG52I An entity may retain the right to a part of the interest payments on transferred assets as compensation for servicing those assets. The part of the interest payments that the entity would give up on termination or transfer of the servicing contract is allocated to the servicing asset or servicing liability. The part of the interest payments that the entity would not give up is an interest-only strip receivable. For example, if the entity would not give up any interest upon termination or transfer of the servicing contract, the entire interest spread is an interest-only strip receivable. For the purposes of applying paragraph 21A, the fair values of the servicing asset and interest-only strip receivable are used to allocate the carrying amount of the receivable between the part of the asset that is derecognised and the part that continues to be recognised. If no servicing fee is specified or the fee to be received is not expected to compensate the entity adequately for the level of effort required to provide those services, the entity recognises a liability for the servicing obligation and initially measures it at fair value.

Transfers that do not qualify for derecognition

AG52J To the extent that a transfer of a financial asset does not qualify for derecognition, the transferor's contractual rights or obligations related to the transferred asset are not accounted for separately as derivatives if recognising both the derivatives and either the transferred asset or the liability arising from the transfer would result in recognising the same rights or obligations twice. For example, a call option retained by the transferor may prevent a transfer of financial assets from being accounted for as a sale. In that case, the call option is not separately recognised as a derivative asset.

AG52K To the extent that a transfer of a financial asset 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.

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Examples

AG52L The following examples illustrate the application of the derecognition requirements in paragraph AG36A.

(a) *Transfer of a readily obtainable financial asset with a derivative*. If a transferor transfers a readily obtainable financial asset (eg an instrument publicly traded in an active market) and as part of the transfer enters into a derivative (eg repurchase agreement, call option, put option or total return swap) with the transferee, 'the Asset' is the financial asset sold and the derivative represents continuing involvement by the transferor in the Asset. This is because the derivative is a new asset or liability obtained by the transferor in connection with the transfer and through the derivative the transferor has an interest in the future performance of the Asset or a responsibility under defined circumstances to make payments in respect of the Asset in the future. Because the Asset is readily obtainable, the transferee has the practical ability to transfer the Asset to an unrelated third party for its own benefit. The transferee does not have to combine the Asset with the derivative in order to transfer it. Also, the transferee has the ability to obtain a replacement asset readily when the derivative is settled (if settlement of the derivative were to require physical delivery). Furthermore, the transferee has the practical ability to transfer the Asset 'for its own benefit' because it can use the full proceeds from any such subsequent transfer as it pleases (ie the transferee does not have an obligation to return those proceeds to the transferor). In summary, the transfer of the Asset results in the transferor passing control of the Asset to the transferee. The transferor derecognises, and the transferee recognises, the Asset, and both parties recognise the derivative.

(b) *Transfer of a not readily obtainable financial asset with a derivative.* If a transferor transfers a financial asset that is not readily obtainable (eg an originated loan or an ordinary share that is not publicly traded in an active market), and as part of the transfer enters into a derivative (eg repurchase agreement, call option, put option or total return swap) with the transferee, 'the Asset' is the financial asset sold. The derivative represents continuing involvement by the transferor in the Asset, because the derivative is a new asset or liability obtained by the transferor in connection with the transfer and through the derivative the transferor has an interest in the future performance of the Asset or a responsibility under defined circumstances to make payments in respect of the Asset in the

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future. Because the Asset is not readily obtainable, the transferee is unlikely to have the practical ability to transfer the Asset to an unrelated third party for its own benefit provided the derivative is to be physically settled. If the derivative is to be net settled, the transferee generally has the practical ability to transfer the Asset to an unrelated third party for its own benefit (but see the net-settled total return swap scenario in paragraph AG52L(h)). If the derivative is to be physically settled, the transferee would have to default if it were to transfer the Asset and the transferor were to exercise the call option, or when the repurchase agreement or the total return swap settles. Alternatively, the transferee could transfer the Asset but arguably only by attaching the derivative to the Asset (ie the transferee would not be able to transfer the Asset in isolation). If the derivative is a put option, the transferee appears to have the ability to transfer the Asset; however, the transferee may be unwilling to give up the value of the put option and thus economically be constrained from transferring the Asset in isolation (eg the put option might be sufficiently valuable to the transferee—whether that is the case will require judgement). As a result, the transferee is unlikely to have obtained control of the Asset (again, assuming that the derivative is not net settled). Accordingly, the transferor recognises a liability for the proceeds received and continues to recognise the Asset; the transferee recognises a receivable for the cash paid to the transferor.

(c) *Transfer of a financial asset with a subordinated interest in the asset*. As part of a transfer of a financial asset, a transferor may provide the transferee with credit enhancement by subordinating some or all of its interest retained in a transferred asset. For such transfers, 'the Asset' is the entire financial asset because the performance of the interest retained depends on that of the interest transferred. Through the interest retained and the subordination of that interest, the transferor has an interest in the future performance of the entire financial asset and thus has continuing involvement in the Asset. Also, because of the transferor's retained interest, the transferee will not have the practical ability to transfer the Asset to an unrelated third party for its own benefit. As a result, control of the Asset has not passed to the transferee. The transferor recognises a liability for the proceeds received and continues to recognise the Asset; the transferee recognises a receivable for the cash paid to the transferor.

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(d) *Transfer of a financial asset with a subordinated interest in the entity to which the asset is transferred*. As part of a transfer of a financial asset, a transferor may provide the transferee with credit enhancement by purchasing a subordinated (residual) interest in the transferee. For such transfers, 'the Asset' is the entire financial asset because the transferor's remaining interest in the transferred financial asset (considering its interest in the transferee) is subordinated and, as a result, the performance of that subordinated interest is dependent on the net interest transferred. Through the interest retained and the subordination of that interest, the transferor has an interest in the future performance of the entire financial asset and thus continuing involvement in the Asset. Also, because of the transferor's retained interest, the transferee does not have the practical ability to transfer the Asset to an unrelated third party for its own benefit. As a result, control of the Asset has not passed to the transferee. The transferor recognises a liability for the proceeds received and continues to recognise the Asset; the transferee recognises a receivable for the cash paid to the transferor.

(e) *Transfer of a financial asset with a credit guarantee*. As part of a transfer of a financial asset, a transferor may provide the transferee with credit enhancement in the form of a credit guarantee that could be unlimited or limited to a specified amount. For such transfers, 'the Asset' is the entire financial asset. The guarantee represents continuing involvement by the transferor in the Asset because the guarantee is a new liability assumed by the transferor in connection with the transfer, and through the guarantee the transferor has a responsibility to make payments in respect of the Asset if the debtor underlying the Asset were to default. Whether the transferee has the practical ability to transfer the Asset to an unrelated third party for its own benefit (and hence whether the transferee has obtained control of the Asset) depends on whether the Asset is readily obtainable and, if it is not, on whether the guarantee economically constrains the transferee. If the Asset is readily obtainable, the transfer qualifies for derecognition (in which case the transferor derecognises, and the transferee recognises, the Asset and both recognise a credit guarantee). If the Asset is not readily obtainable and the guarantee economically constrains the transferee, the transfer does not qualify for derecognition (in which case the transferor recognises a liability for the proceeds received and continues to recognise the Asset; the transferee recognises a receivable for the cash paid to the transferor).

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Issue of equity-linked note

(f) *Scenario A—Note not contractually linked to shares*. Entity A issues to Entity C a note for which the returns are linked to the performance of 10 per cent of Entity B's outstanding ordinary shares (ie Entity A will pay to Entity C 10 per cent of all interim and final distributions made by Entity B on Entity B's outstanding shares). According to the terms of the note, Entity A is not obliged to hold a 10 per cent investment in Entity B. However, although it is not obliged, Entity A invests in 10 per cent of Entity B's outstanding shares.

The issue by Entity A of the equity-linked note to Entity C does not qualify as a *transfer* of Entity A's 10 per cent investment in Entity B because Entity A is not obliged to remit to Entity C the economic benefits of its investment in Entity B. If Entity A were to sell its investment in Entity B to a third party, it would not be required to pass to Entity C the proceeds from the sale. Furthermore, the third party would receive all of the economic benefits of the investment in Entity B (ie distributions from Entity B would flow to the third party) and, as a result, there would be nothing for Entity A to remit to Entity C. In essence, Entity A has issued a note with an embedded derivative referenced to 10 per cent of the outstanding ordinary shares of Entity B. As a result, the issue of the note is not a transfer that is assessed for derecognition.

(g) *Scenario B—Note contractually linked to shares*. The facts are the same as in Scenario A except that:

(i) Entity C has a security interest in the shares that Entity A holds in Entity B;

(ii) Entity C agrees to look to only the cash flows from those shares for repayment of the note (ie Entity C has no recourse against Entity A);

(iii) Entity A is obliged to pass to Entity C all cash flows it receives from its 10 per cent investment in Entity B; and

(iv) Entity A is prohibited from selling the shares without the approval of Entity C.

In contrast to Scenario A, the issue by Entity A of the equity-linked note to Entity C qualifies as a *transfer* of Entity A's 10 per cent investment in Entity B because Entity A is obliged to pass to Entity C the economic benefits of its investment in Entity B. Entity A is prohibited from transferring the shares in Entity B and is required to forward to Entity C

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all distributions that it receives on those shares. Because it cannot transfer the shares, unlike Scenario A, those distributions could never flow to an entity other than Entity A (which then would have an obligation to pass them to Entity B). Entity C also has access to the economic benefits of the shares through its security interest.

'The Asset' is Entity A's 10 per cent investment in Entity B because even though Entity A did not transfer the shares to Entity C, it transferred the right to all the economic benefits that those shares generate (which is akin to transferring the shares themselves). The fact that Entity A has agreed to pass all economic benefits of the Asset to Entity C means that Entity A does not have an interest in the future performance of the Asset. Accordingly, Entity A has no continuing involvement in the Asset. As a result, Entity A has passed control of the Asset to Entity C. Entity A derecognises, and Entity C recognises, the Asset.

Transfer of a financial asset with a net-settled total return swap

(h) An entity transfers for CU100 a financial asset that has a five-year maturity and pays interest of CU10 on t0, t1...t5 and principal of CU100 at t5. After the transfer the transferee has physical custody of the asset. In connection with the transfer, the entity enters into a net-settled total return swap with the transferee.

(i) *Scenario A—Swap with interim return payments*. On t1 and t2, the transferor pays to the transferee a return (say, LIBOR plus a credit spread) on the initial CU100 it received from the transferee. The transferee pays to the transferor the CU10 that the financial asset generates. Also on t2 (in addition to the cash flows relating to the transferee's CU10 payment and the transferor's LIBOR-based payment), the parties exchange cash equal to the difference between the fair value of the financial asset and CU100. If the fair value of the financial asset exceeds CU100, the transferee pays that excess to the transferor. Alternatively, if the fair value of the financial asset is less than CU100, the transferor pays that difference to the transferee.

The transfer qualifies for derecognition because even though the transferor has continuing involvement in the financial asset ('the Asset') after the transfer as a result of the derivative (swap), the transferee has the practical ability to transfer the Asset for its own benefit. This is because the transferee can transfer the Asset to a third party unilaterally and without

having to impose any additional restrictions. Because the swap is net settled, the transferee does not have an obligation to deliver the Asset to the transferor upon settlement. The transferee has the ability to transfer the Asset 'for its own benefit' because it can use the full proceeds from any such subsequent transfer as it pleases (eg the transferee could transfer the Asset before the swap settles without having an obligation to return the proceeds to the transferor). The transferor derecognises, and the transferee recognises, the Asset and both recognise the total return swap as a derivative.

(ii) *Scenario B—Swap with interim return payments included in the settlement of the swap*. Same facts as in Scenario A, except that the interim return payments on the transferee's initial CU100 investment are included in the settlement price of the swap. On t1 and t2, the transferee pays to the transferor the CU10 that the financial asset generates. Also on t2, the parties exchange cash equal to the difference between the fair value of the financial asset and CU130 (different from the CU100 in Scenario A—the CU130 includes the interim return payments that the transferor made on t1 and t2 in Scenario A). Thus, if the fair value of the financial asset exceeds CU130, the transferee pays that excess to the transferor. Alternatively, if the fair value of the financial asset is less than CU130, the transferor pays that difference to the transferee.

The analysis and accounting outcome are the same as in Scenario A.

(iii) *Scenario C—Fully prepaid swap*. On t0, the transferor pays to the transferee CU100 (so on a net basis, the parties do not exchange cash on t0). On t1 and t2, the transferee pays to the transferor the CU10 that the financial asset generates. Also, on t2 the transferee pays to the transferor the fair value of the asset. The transferor does not have a security interest in the asset that the transferee has in its custody. Also, the transferee is not restricted from selling the asset to a third party.

The analysis and accounting outcome are the same as in Scenario A except that (in addition to derecognising the Asset) the transferor recognises as a financial asset its right to receive cash flows from the transferee on t1 and t2 (those

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cash flows are (a) the cash flows that the transferred (and derecognised) Asset generates on t1 and t2 and (b) the fair value of the Asset on t2)). The transferee would recognise a corresponding financial liability (in addition to recognising the Asset).

(iv) *Scenario D—Fully prepaid swap with asset 'ring-fenced' (reverse pass-through).* Same facts as in Scenario C except that the transferor has a security interest in the asset transferred to the transferee on t0 (as a result, the transferee is prohibited from transferring the asset to a third party). The transferor has no rights to the transferee's other assets if the asset does not generate any cash flows. Also, the transferee could decide to settle its obligation to pass on any cash flows from the assets on t1 and t2 or pay the fair value of the asset on t2 by transferring the asset to the transferor.

The transfer fails derecognition. Through the swap, the transferor has continuing involvement in the financial asset transferred (the Asset) and the transferee is restricted from transferring the Asset for its own benefit. As a result, the transferor continues to recognise the Asset. (The transferor would not recognise a financial liability as a result of the failed sale because it would derecognise that liability in light of its CU100 payment to the transferee on t0. Similarly, the transferee would not recognise a financial asset because it would immediately derecognise that asset as a result of the receipt of CU100 from the transferor on t0.)

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The heading before paragraph AG57 and paragraphs AG57–AG63 are amended (new text is underlined and deleted text is struck through). Paragraph AG62A is added.

Derecognition of a financial liability (paragraphs 39A–42B)

AG57 An entity shall derecognise a financial liability (or part of it) ~~is extinguished when the~~ if the present obligation is eliminated and the entity is no longer required to transfer economic resources in respect of that obligation. For example, a debtor would derecognise a financial liability (or part of it) if it either:

(a) discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or

(b) ~~is~~ obtains a legal~~ly~~ release~~d~~ from primary responsibility for the liability (or part of it) either by process of law or ~~by~~ from the creditor~~.~~ (even ~~I~~if the debtor ~~has given a~~ guarantees the third party's obligation to the creditor ~~this condition may still be met.~~).

AG58 If an issuer of a debt instrument repurchases that instrument, ~~the debt is extinguished~~ it derecognises that liability (because it no longer has a present obligation to transfer economic resources to a third party) even if ~~the issuer~~ it is a market maker in that instrument ~~or intends to resell it in the near term~~.

AG59 Payment to a third party, including a trust (sometimes called 'in-substance defeasance'), does not, by itself, relieve the debtor of its ~~primary~~ obligation to the creditor, in the absence of a legal release.

AG60 If a debtor pays a third party to assume ~~an~~ its debt obligation and notifies its creditor that the third party has assumed ~~its debt~~ the obligation, the debtor does not derecognise the ~~debt obligation~~ associated liability unless the ~~condition in paragraph AG57(b) is met~~ creditor legally releases the debtor from the responsibility for the liability. If the debtor pays a third party to assume ~~an~~ its debt obligation and obtains a legal release from its creditor, the debtor ~~has extinguished the debt~~ no longer has a present obligation to transfer economic resources to the creditor and derecognises the associated liability. However, if the debtor also agrees to make payments on the debt to the third party or direct to its original creditor, the debtor recognises a new debt obligation to the third party.

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AG61 ~~Although~~ Even though a legal release, whether judicially or by the creditor, results in derecognition of a liability, the entity may recognise a new liability if the derecognition criteria in paragraphs 15A~~–37~~18A are not met for the financial assets transferred. If those criteria are not met, the transferred assets are not derecognised, and the entity recognises a new liability relating to the transferred assets.

AG62 For the purpose of paragraph 40A, the original and renegotiated terms of a debt instrument are substantially different if the discounted present value of the cash flows under the ~~new~~ renegotiated terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the ~~original~~ financial liability under the original terms. ~~If an exchange of debt instruments or modification of terms is accounted for as an extinguishment, any costs or fees incurred are recognised as part of the gain or loss on the extinguishment. If the exchange or modification is not accounted for as an extinguishment, any costs or fees incurred adjust the carrying amount of the liability and are amortised over the remaining term of the modified liability.~~

AG62A The guidance in paragraph AG62 applies only to the extent the exchange or modification is not a transfer of a financial asset, as that term is defined in paragraph 9. For example, an entity might exchange a debt instrument with the creditor for a debt instrument that is similar in nature to the loan described in paragraph AG44A (ie the new debt instrument requires the entity to repay the loan (both principal and interest) only from proceeds generated by a specified financial asset in which the creditor has a security interest (or by the transfer of the asset itself) and then only to the extent that the asset generates sufficient funds). In that case, the entity analyses the new debt instrument as a transfer of the financial asset following the criteria in paragraphs 15A–18A. If the asset qualifies for derecognition, the entity derecognises it, and also derecognises the financial liability relating to the previous debt instrument.

AG63 In some cases, 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 defaults. In th~~i~~ese circumstances the debtor:

(a) recognises a new financial liability based on the fair value of its obligation for the guarantee; and

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(b) recognises a gain or loss based on the difference between (i) any proceeds paid and (ii) the carrying amount of the ~~original~~ previously recognised financial liability less the fair value of the ~~new financial liability~~ guarantee.

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Proposed amendments to IFRS 7 *Financial Instruments: Disclosures*

Paragraph 13 and the heading before paragraph 13 are deleted. After paragraph 42, headings and paragraphs 42A–42F are added.

Derecognition

42A The disclosure requirements in paragraphs 42B–42F relating to transferred financial assets supplement the other disclosure requirements of this IFRS. An entity shall present the disclosures in paragraphs 42B and 42D–42F in a single note in its financial statements.

Derecognition—Transferred financial assets that are not derecognised

42B An entity may have transferred financial assets in such a way that part or all of the financial assets do not qualify for derecognition (see paragraphs 15A–18A of IAS 39). The entity shall disclose information that enables users of its financial statements to understand the relationship between those assets and associated liabilities after the transfer. The entity shall disclose for each class of such financial assets:

(a) the nature of the assets.

(b) the nature of the risks to which the entity remains exposed.

(c) the carrying amounts of the assets and of the associated liabilities.

(d) a description of the nature of the relationship between the assets and the associated liabilities, including any restrictions on the entity's use of the assets.

(e) when the counterparty (or counterparties) to the associated liabilities has (have) recourse only to the assets, a schedule that sets out the fair value of the assets, the fair value of the associated liabilities and the net position.

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Derecognition—Transferred financial assets that are derecognised

42C When an entity derecognises financial assets but has continuing involvement in them (see paragraphs 15A–18A of IAS 39), the entity shall disclose information that enables users of its financial statements to evaluate the nature of and risks associated with the entity's continuing involvement in those derecognised financial assets.

42D To meet the objective in paragraph 42C, an entity shall disclose, as a minimum, for each category of continuing involvement at the reporting date:

(a) the carrying amount of the assets and liabilities recognised in the entity's statement of financial position representing the entity's continuing involvement, and the line items in which those assets and liabilities are recognised.

(b) the fair value of the assets and liabilities representing the entity's continuing involvement.

(c) the amount that best represents the entity's maximum exposure to loss from its continuing involvement, including how the maximum exposure to loss is determined.

(d) the fair value of derecognised financial assets in which the entity has continuing involvement, including a description of the methods and assumptions applied in determining the fair value (see paragraphs 27A and 27B).

(e) the undiscounted cash outflows to repurchase derecognised financial assets (eg the strike price in an option agreement or the repurchase price in a repurchase agreement).

(f) a maturity analysis of the undiscounted cash outflows to repurchase the derecognised financial assets that shows the remaining contractual maturities of the entity's continuing involvement.

(g) a sensitivity analysis showing the possible effect on the fair value of the continuing involvement of changes in the relevant risk variables that were reasonably possible at the reporting date. The entity shall describe the methods and assumptions used in preparing the sensitivity analysis (see relevant sections of paragraphs B17–B21).

(h) qualitative information that explains and supports the quantitative disclosures in (a)–(g).

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42E In addition, an entity shall disclose for each category of continuing involvement:

(a) the gain or loss recognised at the date of transfer of the assets.

(b) income and expenses recognised from the entity's continuing involvement (eg servicing fees and fair value changes in derivative instruments).

(c) if the total amount of transfer activity (that qualifies for derecognition) in a reporting period is not evenly distributed throughout the reporting period (eg if a substantial proportion of the total amount of transfer activity takes place in the closing days of a reporting period), the total amount of the transfer activity and the related gains or losses recognised in the period within the reporting period that has the greatest transfer activity. The entity shall also disclose when (within a reporting period) the greatest transfer activity took place (eg the last five days before the end of the reporting period).

An entity shall provide this information for each of the periods for which a statement of comprehensive income is presented.

42F An entity shall disclose any additional information that it considers necessary to meet the disclosure objective in paragraph 42C.

Effective date and transition

Paragraph 44H is added.

44H *Derecognition* (Amendments to IAS 39 and IFRS 7), issued in [month and year], deleted paragraph 13 and added paragraphs 42A–42F. An entity shall provide the disclosures required by those paragraphs for transactions entered into after [date, which is the effective date of the amendments to IAS 39 resulting from *Derecognition* (Amendments to IAS 39 and IFRS 7), issued in [month and year]]. However, if the entity elects to apply those amendments to IAS 39 before [date specified above], it shall provide the added disclosure requirements for all transactions from that earlier date. If an entity derecognised financial assets or financial liabilities in accordance with IAS 39 (revised 2003) as a result of a transaction entered into before [date specified above] or, if applicable, the earlier date from which the entity elected to apply the amendments to IAS 39 resulting from *Derecognition* (Amendments to IAS 39 and IFRS 7),

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issued in [month and year], and those assets or liabilities would not have been derecognised in accordance with IAS 39 [as proposed to be amended], it shall provide the disclosures required by paragraphs 42C–42F. If, in accordance with IAS 39 (revised 2003), an entity did not derecognise financial assets or financial liabilities as a result of a transaction entered into before [date specified above] or, if applicable, the earlier date from which the entity elected to apply the amendments to IAS 39 resulting from *Derecognition* (Amendments to IAS 39 and IFRS 7), issued in [month and year], and those assets or liabilities would have been derecognised in accordance with IAS 39 [as proposed to be amended], it shall provide the disclosures required by paragraph 42B.

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Appendix B
Application guidance

After paragraph B28, headings and paragraphs B29–B34 are added.

Derecognition (paragraphs 42A–42F)

Categories of continuing involvement (paragraphs 42D and 42E)

B29 Paragraphs 42D and 42E require qualitative and quantitative disclosures for each category of continuing involvement. An entity classifies its continuing involvement into categories that are representative of the entity's exposure to risks. For example, an entity may categorise its continuing involvement by type of continuing involvement (eg repurchase agreements, guarantees, call options and servicing) or by type of transfer (eg factoring, receivables securitisations and securities lending).

Maturity analysis for undiscounted cash outflows to repurchase transferred assets (paragraph 42D(f))

B30 Paragraph 42D(f) requires an entity to disclose a maturity analysis of the undiscounted cash outflows to repurchase derecognised financial assets, which shows the remaining contractual maturities of the entity's continuing involvement (eg the strike price in an option agreement or the repurchase price in a repurchase agreement). This analysis distinguishes cash flows that are required to be paid (eg forward contracts), cash flows that the entity may be required to pay (eg written put options) and cash flows that the entity might choose to pay (eg purchased call options).

B31 An entity uses its judgement to determine an appropriate number of time bands in preparing the maturity analysis required by paragraph 42D(f). For example, an entity might determine that the following time bands are appropriate:

(a) not later than one month;

(b) later than one month and not later than three months;

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(c) later than three months and not later than one year; and

(d) later than one year and not later than five years.

B32 If there is a range of possible maturities, the cash flows are included on the basis of the earliest date on which the entity can be required or permitted to pay.

Qualitative information (paragraph 42D(h))

B33 The qualitative information required by paragraph 42D(h) includes a description of the derecognised financial assets, and the nature and purpose of the continuing involvement retained after transferring those assets. It also includes a description of the risks to which an entity is exposed, including:

(a) a description of how the entity manages the risk inherent in its continuing involvement.

(b) whether the entity is required to bear losses before other parties, and the ranking and amounts of losses borne by each category of party involved.

(c) a description of triggers associated with obligations to provide financial support or to repurchase a transferred financial asset.

Gain or loss on derecognition (paragraph 42E(a))

B34 Paragraph 42E(a) requires an entity to disclose the gain or loss on derecognition relating to financial assets in which the entity has continuing involvement. The entity shall indicate if a gain or loss on derecognition arose because the fair values of the components of the previously recognised asset (ie the interest in the asset derecognised and the interest retained by the entity) were different from the fair value of the previously recognised asset as a whole. In that situation, the entity also discloses the extent to which the fair value calculations were dependent on Level 3 inputs in paragraph 27A of IFRS 7 (as amended in March 2009).

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Amendments to other IFRSs

The amendments below shall be applied to transactions entered into after [date]. If an entity applies [draft] Derecognition *to transactions entered into earlier than [date], these amendments shall be applied from that earlier date. Amended paragraphs are shown with new text underlined and deleted text struck through.*

Proposed amendments to IFRS 1 *First-time Adoption of International Financial Reporting Standards* (as revised in 2008)

Presentation and disclosure

Paragraph 20A is added.

20A An entity shall provide the disclosures required by paragraphs 42A–42F of IFRS 7 *Financial Instruments: Disclosures* for transactions entered into after [date] or, if applicable, the earlier date from which the entity elected to apply the derecognition requirements of IAS 39, as permitted by paragraph B2 of this IFRS. If an entity derecognised financial assets or financial liabilities in accordance with its previous GAAP as a result of a transaction entered into before [date] or, if applicable, the earlier date from which the entity elected to apply the requirements, and those assets or liabilities would not have been derecognised in accordance with IAS 39, it shall provide the disclosures required by paragraphs 42C–42F of IFRS 7. If, in accordance with its previous GAAP, an entity did not derecognise financial assets or financial liabilities in accordance with its previous GAAP as a result of a transaction entered into before [date] or, if applicable, the earlier date from which the entity elected to apply the requirements, and those assets or liabilities would have been derecognised in accordance with IAS 39, it shall provide the disclosures required by paragraph 42B of IFRS 7.

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Appendix B
Exceptions to retrospective application of other IFRSs

Paragraphs B2 and B3 are amended (new text is underlined and deleted text is struck through).

Derecognition of financial assets and financial liabilities

B2 Except as permitted by paragraph B3, a first-time adopter shall apply the derecognition requirements in IAS 39 *Financial Instruments: Recognition and Measurement* prospectively ~~for~~ to transactions ~~occurring~~ entered into on or after ~~1 January 2004~~ [date]. ~~In other words,~~ Accordingly:

(a) if a first-time adopter derecognised non-derivative financial assets or non-derivative financial liabilities in accordance with its previous GAAP as a result of a transaction ~~that occurred~~ entered into before ~~1 January 2004~~ [date specified above] or, if applicable, the date from which the entity elected to apply the requirements, it shall not recognise those assets and liabilities in accordance with IFRSs (unless they qualify for recognition as a result of a later transaction or event).

(b) if, in accordance with its previous GAAP, a first-time adopter did not derecognise financial assets or financial liabilities as a result of a transaction entered into before [date specified above] or, if applicable, the earlier date from which the entity elected to apply the requirements, it shall not derecognise those assets or liabilities in accordance with IFRSs (unless they qualify for derecognition as a result of a later transaction or event).

B3 Notwithstanding paragraph B2, an entity may apply the derecognition requirements in IAS 39 ~~retrospectively~~ prospectively to transactions entered into ~~from a~~ before the date ~~of the entity's choosing~~ specified in paragraph B2, provided that the entity obtained the information needed to apply IAS 39 to financial assets and financial liabilities derecognised as a result of past transactions ~~was obtained~~ at the time ~~of~~ it initially account~~ing~~ed for those transactions. If an entity elects to apply the derecognition requirements in IAS 39 prospectively to transactions entered into before the date specified in paragraph B2, it shall disclose that fact, and it shall apply the requirements to *all* transactions from that date.

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Proposed amendment to IFRS 4 *Insurance Contracts*

Recognition and measurement

Temporary exemption from some other IFRSs

Paragraph 14(c) is amended (new text is underlined and deleted text is struck through).

14 Nevertheless, this IFRS does not exempt an insurer from some implications of the criteria in paragraphs 10–12 of IAS 8. Specifically, an insurer:

(a)–(b) ...

(c) shall ~~remove~~ derecognise an insurance liability (or a part of ~~an insurance liability~~ it) ~~from its statement of financial position when, and only when, it is extinguished—ie when the obligation specified in the contract is discharged or cancelled or expires~~ (or the part) no longer qualifies as a liability of the insurer. An insurance liability ceases to qualify as a liability of the insurer if the present obligation is eliminated and the insurer is no longer required to transfer economic resources in respect of that obligation.

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Proposed amendment to IAS 32 *Financial Instruments: Presentation*

Presentation

Offsetting a financial asset and a financial liability (see also paragraphs AG38 and AG39)

Paragraph 42 is amended (new text is underlined and deleted text is struck through).

42 ...

In accounting for a transfer of a financial asset that does not qualify for derecognition, the entity shall not offset the transferred asset and the associated liability (see IAS 39 paragraph ~~36~~23A).

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Proposed amendments to guidance on implementing IFRSs

Proposed amendments to guidance on implementing IAS 39 *Financial Instruments: Recognition and Measurement*

Section B Definitions

The answer to Question B.32 is amended (new text is underlined and deleted text is struck through).

B.32 Recognition and derecognition of financial liabilities using trade date or settlement date accounting

IAS 39 has special rules about recognition and derecognition of financial assets using trade date or settlement date accounting. Do these rules apply to transactions in financial instruments that are classified as financial liabilities, such as transactions in deposit liabilities and trading liabilities?

No. IAS 39 does not contain any specific requirements about trade date accounting and settlement date accounting in the case of transactions in financial instruments that are classified as financial liabilities. Therefore, the general recognition and derecognition requirements in IAS 39.14 and IAS 39.39A apply. IAS 39.14 states that financial liabilities are recognised on the date the entity 'becomes a party to the contractual provisions of the instrument'. Such contracts generally are not recognised unless one of the parties has performed or the contract is a derivative contract not exempted from the scope of IAS 39. IAS 39.39A specifies that financial liabilities are derecognised only when they ~~are extinguished, ie when the obligation specified in the contract is discharged or cancelled or expires~~ no longer qualify as a liability of the entity, ie when the present obligation is eliminated and the entity is no longer required to transfer economic resources in respect of that obligation.

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Proposed amendments to guidance on implementing IFRS 1 *First-time Adoption of International Financial Reporting Standards*

IAS 39 *Financial Instruments: Recognition and Measurement*

Paragraph IG52 is reproduced for ease of reference. Paragraphs IG53 and IG54 are amended (new text is underlined and deleted text is struck through).

IG52 An entity recognises and measures all financial assets and financial liabilities in its opening IFRS statement of financial position in accordance with IAS 39, except as specified in paragraphs B2–B6 of the IFRS, which address derecognition and hedge accounting.

Recognition

IG53 An entity recognises all financial assets and financial liabilities (including all derivatives) that qualify for recognition under IAS 39 and have not yet qualified for derecognition in accordance with IAS 39, except non-derivative financial assets and non-derivative financial liabilities derecognised in accordance with previous GAAP as a result of a transaction entered into before ~~1 January 2004~~ [date], to which the entity does not choose to apply paragraph B3 (see paragraphs B2 and B3 of the IFRS). For example, an entity that does not apply paragraph B3 does not recognise non-derivative financial assets transferred in a securitisation, transfer or other derecognition transaction entered into ~~that occurred~~ before ~~1 January 2004~~ [date] if those transactions qualified for derecognition in accordance with previous GAAP. However, if the entity uses the same securitisation arrangement or other derecognition arrangement for further transfers after ~~1 January 2004~~ [date], those further transfers qualify for derecognition only if they meet the derecognition criteria of IAS 39.

IG54 An entity does not recognise financial assets and financial liabilities that do not qualify for recognition in accordance with IAS 39, or have already qualified for derecognition in accordance with IAS 39 (unless they are derivative assets or liabilities that qualify for recognition in accordance with IAS 39).

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Proposed amendments to guidance on implementing IFRS 7 *Financial Instruments: Disclosures*

After paragraph IG40 a heading and paragraph IG40A are added.

Derecognition (paragraph 42A–42F)

IG40A The following examples illustrate some possible ways to meet the quantitative disclosure requirements relating to derecognition in IFRS 7.

Transferred financial assets that are not derecognised

Illustrating the application of paragraph 42B(c) and (e)

	Class of financial asset				
	Financial assets at fair value through profit or loss		**Loans and receivables**		**Available-for-sale financial assets**
CU million	Trading securities	Trading derivatives	Mortgages	Consumer loans	Equity investments
Carrying amount of assets	X	X	X	X	X
Carrying amount of associated liabilities	(X)	(X)	(X)	(X)	(X)
For those liabilities that have recourse only to specific assets:					
Fair value of assets	X	X	X	X	X
Fair value of associated liabilities	(X)	(X)	(X)	(X)	(X)
Net position	X	X	X	X	X

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Transferred financial assets that are derecognised

Illustrating the application of paragraph 42D(a)–(e)

Continuing involvement with transferred financial assets that have been derecognised						
CU million	Fair value of transferred (derecognised assets)	Cash outflows to repurchase transferred (derecognised assets)	Carrying amount of continuing involvement in statement of financial position		Fair value of continuing involvement	Maximum exposure to loss
Type of continuing involvement			Assets	Liabilities		
Repurchase agreements	X	(X)	X	(X)	X	X
Written put options	X	(X)		(X)	X	X
Purchased call options	X	(X)	X		X	X
Securities lending	X	(X)	X	(X)	X	X
Servicing	X		X	(X)	X	X
Total			X	(X)	X	X

Carrying amount of continuing involvement in the statement of financial position		
CU million	Total	
Class of asset or liability	Assets	Liabilities
Held for trading	X	
Available-for-sale financial assets	X	
Financial liabilities at fair value through profit or loss		(X)
Total	X	(X)

Illustrating the application of paragraph 42D(f)

Undiscounted cash flows to repurchase transferred assets							
CU million	Maturity of continuing involvement						
Type of continuing involvement	Total	<1 month	<3 month	<6 month	<1 years	1–2 years	>2 years
Repurchase agreements	X	X	X	X	X	X	
Written put options	X		X	X	X	X	
Purchased call options	X			X	X	X	X
Securities lending	X	X	X				

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Approval by the Board of exposure draft *Derecognition* (proposed amendments to IAS 39 and IFRS 7) published in March 2009

The exposure draft *Derecognition* (proposed amendments to IAS 39 and IFRS 7) was approved for publication by nine of the fourteen members of the International Accounting Standards Board. Professor Barth and Messrs Gélard, Leisenring, McGregor and Yamada voted against publication of the exposure draft. Their alternative views on the exposure draft are set out after the Basis for Conclusions. Those Board members prefer an alternative approach to derecognition of financial assets, which is described in detail as part of their alternative views.

Sir David Tweedie	Chairman
Thomas E Jones	Vice-Chairman
Mary E Barth	
Stephen Cooper	
Philippe Danjou	
Jan Engström	
Robert P Garnett	
Gilbert Gélard	
Prabhakar Kalavacherla	
James J Leisenring	
Warren J McGregor	
John T Smith	
Tatsumi Yamada	
Wei-Guo Zhang	

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Basis for Conclusions

This Basis for Conclusions accompanies, but is not part of, the proposed amendments to IAS 39 and IFRS 7.

Introduction

BC1 This Basis for Conclusions summarises the International Accounting Standards Board's considerations in proposing amendments to IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 7 *Financial Instruments: Disclosures*. Individual Board members gave greater weight to some factors than others.

The proposed amendments

Principle underlying the approach to the derecognition of financial assets

Definition of an asset

BC2 The approach that the Board selected for derecognition of financial assets has the underlying principle that 'an entity should derecognise a financial asset or a part of it when the asset or the part of it ceases to qualify as an asset of the entity'.

BC3 The Board believes that the definitions of the elements of financial statements are a significant first step in determining the content of financial statements. The definitions screen out items that lack one or more characteristics of assets or other elements of financial statements. Consequently, the definitions of the elements impose limits or restraints on the recognised assets and liabilities of an entity.

BC4 Therefore, when an item fails to qualify as an asset of an entity (as defined in the IASB's *Framework for the Preparation and Presentation of Financial Statements*), an entity should not continue to recognise the item in its statement of financial position.

BC5 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'.

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BC6 The definition of an asset in the *Framework* highlights that an asset has two essential characteristics, and an item does not qualify as an asset of an entity if it lacks one or both of them. The two essential characteristics of an asset are:

(a) an asset represents 'future economic benefits' that 'are expected to flow to the entity'; and

(b) the right to the expected future economic benefits is 'controlled by the entity'.

BC7 Accordingly, in determining whether it should recognise a particular item as its asset, an entity must consider whether the item embodies future economic benefits, and, if so, whether it controls those future benefits.

Future economic benefits

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.

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.

BC10 Thus, if the future economic benefits underlying a financial asset cease to exist or are extinguished, the entity that has recognised that asset should remove it from its financial statements. Also, if an entity has relinquished control over the future economic benefits of an asset, it has sold the asset and should derecognise it. Similarly, if it has not surrendered control over the future economic benefits, the entity has not sold the asset and should not derecognise it.

Control

BC11 'Control' is the means by which an entity ensures that the future economic benefits embodied in an item accrue to it and not to others. Hence, to have an asset, an entity must have access to the future economic benefits embodied in that asset and generally must be able to deny or regulate others' access to those benefits.

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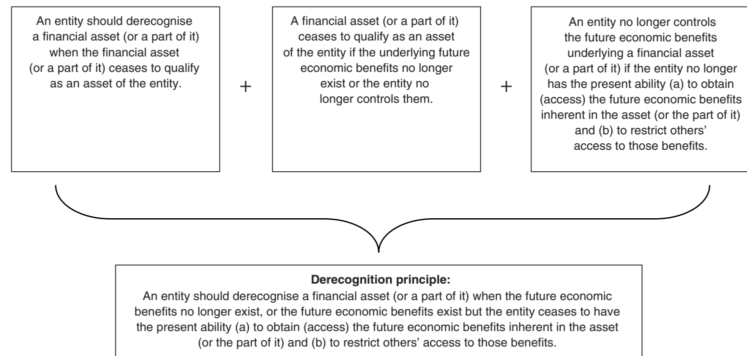
BC12 Because the future economic benefits embodied in a *financial* asset are the right to future cash inflows, 'control' in context of a financial asset means, in general terms, the ability to obtain (access) the future cash inflows of the asset and the ability to restrict others' access to those future cash inflows.

Present control

BC13 Under the definition of an asset in the *Framework*, only *present* rights to obtain future economic benefits are assets and not items that may in the future become an entity's assets. Hence, an entity has no asset for particular future economic benefits (and as such should not recognise that asset in its statement of financial position) if it might gain access to the benefits in the future. On the other hand, an entity has an asset (and should recognise it or should continue to recognise it in its statement of financial position) if its present access to the economic benefits of that asset could be removed, but the event that would remove its access to the economic benefits has not yet happened.

Definition of an asset, future economic benefits and present control

BC14 The principle that serves as the basis for the Board's approach to derecognition of financial assets can be graphically summarised as follows:



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Approach to derecognition of financial assets

Focus of the derecognition approach

BC15 To develop an approach that would make the derecognition principle operational, the Board concluded that the focus of such an approach should be on whether the counterparty to a transfer of a financial asset (ie the transferee) has obtained control of the economic benefits of the asset so received (ie derecognition is assessed from the perspective of the transferee).

BC16 The Board acknowledges that control of a financial asset's economic benefits could be assessed from the transferor's perspective. However, the Board believes that, because a financial asset is assessed for derecognition after a transfer has taken place, it is more appropriate to assess control at that point from the perspective of the transferee.

BC17 Assessing control from the transferee's perspective makes the transferor's accounting a function of the rights of the transferee. However, the Board notes that the right of the transferee to do as it pleases with an asset constitutes the ultimate evidence that the transferor has given up control.

Symmetry of accounting

BC18 If a transferee is judged to have obtained control of the economic benefits of a financial asset, it must mean that the transferor has relinquished such control. Two parties cannot control the same asset simultaneously. Consequently, the Board believes that the transferee's accounting should be the mirror image of the transferor's accounting. In other words, if a transferor is required to derecognise a particular financial asset (or a part of it), the transferee should be required to recognise that asset (or that part). Similarly, if the transferor is required to continue to recognise a particular financial asset (or a part of it), the transferee should not be required to recognise that asset (or that part).

Criteria for the derecognition approach

BC19 The Board believes that the main way by which an entity can obtain the economic benefits of a financial asset (or a part of it) is via *transfer* of that asset (or the part of it) to another entity in exchange for other assets, in settlement of a liability or as a distribution to the entity's owners. Therefore, the Board proposes a derecognition test that assesses whether the transferee has the practical ability to transfer to an unrelated third

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party the asset that is the subject of the transfer ('the Asset'). This test is in IAS 39 at present. Unlike IAS 39, the test has primacy in this exposure draft. (Also unlike the test in IAS 39, the test in this exposure draft is supplemented by a separate requirement that any of the proceeds a transferee would receive from a subsequent transfer of the Asset to an unrelated third party must remain with the transferee).

BC20 Some Board members (those who prefer an alternative approach to derecognition of financial assets—see Alternative views on exposure draft) believe that a transferee can obtain (access) the economic benefits of a financial asset in ways other than through a transfer of the asset to a third party. For example, an entity that purchased a portfolio of loans may be restricted (as part of the arrangement with the seller) from selling the portfolio to a third party. However, that restriction does not preclude the entity from holding the portfolio and receiving (and keeping for itself) all of the cash flows that the underlying loans generate. Those Board members view the ability by a transferee to obtain a financial asset's economic benefits for the transferee's own benefit as control over those benefits.

BC21 However, the Board disagreed with that view. The Board believes that the transactions in which a transferee does not obtain the practical ability to transfer to a third party the financial asset that is the subject of the transfer are typically those that involve non-readily obtainable financial assets for which the transferor continues to be exposed to the performance of the asset in some way after the transfer. For example, the transferor might have transferred some or all of the upside potential, but retained some or all of the downside risk (or vice versa), or it might have transferred some of the risks and rewards, but not all.

BC22 For those transfers, the Board believes that it is difficult to assess which entity controls the financial asset. The Board considered whether it should require a test that would base the derecognition outcome on whether the transferor remained exposed to substantially all of the risks and rewards of the transferred financial asset (or perhaps a test that would focus on the transferor's exposure to only those risks and rewards that are specific to the asset). However, the Board was concerned that such a test would import the issues encountered currently in practice with the 'risks and rewards' tests in IAS 39 in assessing what constitutes substantially all of the risks and rewards. As a result, the Board decided that if the transferee did not have the practical ability to transfer the financial asset for its own benefit and the transferor retained a continuing involvement in the asset, the transferor has not passed control to the transferee.

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BC23 Under this approach, the Board recognises that a transferor might be required to continue to recognise the 'transferred' asset in its entirety (as if it controlled the entire asset), even though it might be exposed to only some of the risks and rewards associated with that asset after the transfer. This outcome is different from that of applying the 'continuing involvement' step in the current version of IAS 39 (the application of that step would result in the transferor recognising the asset to the extent of its continuing involvement in the asset). However, the Board believes that this approach arguably provides fewer opportunities for structuring. Furthermore, the Board believes that the approach is less complex to understand and apply than the current requirements in IAS 39 and thus is an improvement to financial reporting.

BC24 Overall the Board is of the view that the proposed approach is consistent with and addresses the issues set out in paragraph IN9:

(a) *Complexity*—The approach can be seen as an evolution of IAS 39 that is an improvement to the current derecognition model. The approach is similar to IAS 39 in that:

(i) the same definition of a part of an asset is used, with some additional guidance to address known application issues;

(ii) the test of control is still used, although unlike the IAS 39 model that test has primacy (also unlike IAS 39, the test is complemented by a 'for the transferee's own benefit' test);

(iii) many of the derecognition outcomes will be similar under the approach as compared to IAS 39 (the notable exceptions being transfers, such as repurchase agreements, involving readily obtainable assets).

Unlike IAS 39, the approach does not combine elements of several derecognition concepts (risks and rewards, control and continuing involvement) but rather focuses on a single element (control). The lack of

(i) a test to evaluate the extent of risks and rewards retained,

(ii) pass-through requirements and

(iii) a requirement for a transferor (in a transfer that fails derecognition) to recognise and measure a financial asset to the extent of its continuing involvement,

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which have caused a number of application issues in practice, should result in the approach being easier to understand and apply and hence improve financial reporting.

(b) *Convergence*—The approach is similar in some respects to the proposed amendment to SFAS 140. Like the proposed amendment to SFAS 140, the proposed approach assesses derecognition on the basis of control, and evaluates control, to some extent, in a similar manner. Also, like the proposed amendment to SFAS 140, the approach proposed in this exposure draft provides criteria for the item to be assessed for derecognition (overall, these criteria are similar, albeit less restrictive, than those proposed by the SFAS 140 amendment). A major difference between the proposed amendment to SFAS 140 and the proposed approach in the exposure draft is that the former requires that transferred financial assets have been isolated from the transferor, any of its consolidated affiliates and its creditors, even in bankruptcy. The approach proposed in this exposure draft does not require such a test. The Board believes that this test, which might make it necessary for the transferor to obtain a legal opinion specific to US bankruptcy laws, would be difficult to apply in jurisdictions outside the US.

(c) *Market environment and user's requests*—The Board believes that the approach will be less complex to understand and apply than the existing requirements in IAS 39 (see 'Complexity' above) and is a step towards convergence of IFRSs and US GAAP on this topic (see 'Convergence' above). For those reasons and considering the proposed expanded disclosure requirements, the Board believes that the proposed approach is responsive to the requests by users, regulators and others for improvements to the requirements in IAS 39, convergence with US GAAP and increased transparency in the accounting and reporting of transfer transactions (in particular those that involve securitisation vehicles).

(d) *Divergent views*—By focusing on control of the asset by the transferee (ie the 'practical ability to transfer for its own benefit' test) and drawing a line if it is unclear which entity has control, the proposed approach reflects the divergent views on the substance of transfer transactions, especially transfers involving financial assets that are not readily obtainable and in which the transferor has continuing involvement after the transferor.

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Interaction between derecognition and consolidation

BC25 Some transfers of financial assets can give rise to both derecognition issues and consolidation issues. For example, an entity might transfer a financial asset to an entity that is part of the transferor's group for financial reporting purposes. Alternatively, an entity might transfer financial assets to a securitisation vehicle and purchase some of the beneficial interests issued by the vehicle or have some other interest in, or involvement with, that vehicle.

BC26 The Board concluded that derecognition should be evaluated at the level of the reporting entity. Thus, in its consolidated financial statements, an entity that transfers financial assets must first consider the consolidation requirements in IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation—Special Purpose Entities* and then the derecognition requirements in the Standard (as proposed to be amended). The Board's conclusion is consistent with the current requirements in IAS 39, which require consolidation to be assessed first: an entity sets the boundaries of the reporting entity and then determines whether transfers outside the reporting entity meet the derecognition criteria.

BC27 A logical consequence of the Board's conclusion of assessing derecognition at the level of the reporting entity is that to the extent the transferor's parent or other entities within the group (eg a sister company) have 'continuing involvement' in the transferred financial assets, the transferor would not consider that involvement when assessing the transfer for derecognition in its stand-alone financial statements (ie when the transferor is the reporting entity). However, the parent of the transferor would include in the derecognition analysis at its level (ie in its consolidated financial statements) its involvement in the financial assets transferred by its subsidiary.

BC28 The proposed derecognition approach for financial assets is similar to the approach proposed by the Board in the recently published exposure draft ED 10 *Consolidated Financial Statements* (albeit derecognition is applied at the level of assets and liabilities, whereas consolidation is assessed at the entity level). ED 10 focuses on control of an entity and defines 'control' as follows: 'A reporting entity controls another entity when the reporting entity has the *power* to direct the activities of that other entity to generate returns *for the reporting entity*.'

BC29 The Board's proposed approach to derecognition of financial assets and its underlying principle is also based on control. 'Control' in the context of financial assets is (a) the ability to obtain (access) the underlying future economic benefits and (b) the ability to restrict others' access to those

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benefits (ie the ability to access the benefits for one's own benefit). Thus parts (a) and (b) in the control definition in this exposure draft are similar to the 'power to direct activities of another entity to generate returns' and 'for the reporting entity' parts, respectively, in the control definition in ED 10.

Determination of 'the Asset' to be assessed for derecognition

BC30 The Board concluded that the item to be assessed for derecognition is determined at the level of the reporting entity and on the basis of that entity's remaining interest in the financial asset that was the subject of the transfer. This assessment will ensure that the asset to be assessed for derecognition will be the same, irrespective of whether:

(a) an entity transfers an entire financial asset to another entity in exchange for cash and an interest in the transferred asset (or an interest in the entity, such as a beneficial interest in a securitisation vehicle, that entitles the entity to some of the cash flows from that asset), or

(b) transfers a part of or an interest in that financial asset.

Transfer of an entire financial asset

BC31 The Board concluded that transferring the right to all cash flows of a financial asset is akin to transferring the asset (contract) itself. In such a transfer, none of the cash flows underlying the contract remain with the transferor. The transferor does not benefit from any of the cash flows it receives from the financial asset. The transferor is in an identical economic position, whether it transfers the right to all cash flows of the asset or whether it transfers the asset (contract) itself.

Transfer of a part of a financial asset

BC32 The Board concluded that a part of a financial asset (or a part of a group of financial assets) qualifies as 'the Asset' to be assessed for derecognition only if it represents a right to specifically identified cash flows or a proportionate share of the cash flows from that asset (or group of assets).

BC33 In choosing these criteria, the Board noted that

(a) financial instruments are made up of contractual rights or contractual obligations that might be financial assets or financial liabilities in their own right,

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(b) many transfer transactions separate those rights and obligations and then combine them in different ways, usually for a commercial reason, and

(c) if financial statements are to give a faithful representation of transactions and events, the derecognition approach (and hence 'the Asset' criteria) adopted needs to reflect the separation and packaging of those rights and obligations.

BC34 In its purest form, a part of an asset may be defined as the 'rights and obligations (ie assets and liabilities) embedded in that asset'. This would mean that the right to receive any of the cash flows of a financial asset would in itself qualify as an asset that should qualify for derecognition if the derecognition criteria are met.

BC35 However, the Board was concerned that if it had defined 'the Asset' that can be assessed for derecognition as a right to *any* cash flows of a financial asset, it would have allowed an entity to achieve derecognition of a transferred part of a financial asset even though the part transferred included some or all of the risks or rewards of the part retained or even though the performance of one part was dependent on that of the other part (ie the parts were interdependent). As a result, the Board decided to restrict the types of interests in a financial asset that might qualify for derecognition to those parts that meet the 'parts' definition in paragraph 16 of the current version of IAS 39.

BC36 For a transfer of a part of a financial instrument that can be an asset or a liability over its life (eg the 'receive' leg of an interest rate swap), the Board concluded that 'the Asset' to be assessed for derecognition is the entire instrument. This is because the cash flows relating to the asset part of the instrument are likely to be netted with the cash flows relating to the liability part. Accordingly, the 'specifically identified cash flows' from the instrument that would be observable would be net flows, and thus they would be different from, and less than, the cash flows relating to the asset part only.

Transfer of a part of a group of financial assets

BC37 The Board concluded that for a transfer of a part of a group of financial assets, none of the assets can be instruments that can be an asset or a liability over their life. The Board reached this conclusion to prevent entities from circumventing the prohibition discussed in paragraph BC36 by including those types of instruments in a group of non-derivative or other financial assets and then transferring a proportionate interest in the group of assets.

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Meaning of 'transfer'

BC38 The Board decided to define 'transfer' broadly. The Board's intention was that the scope of transactions that are considered for derecognition should be consistent with the underlying objective that all transactions that are economically transfers of financial assets should be assessed for derecognition. The Board believes that the proposed definition ensures that irrespective of their form, qualifying transactions will be assessed for derecognition. For example, a non-recourse loan in which an entity repays the principal and interest of the loan only from proceeds generated by the specific asset it finances (or by the transfer of the item itself) and then only to the extent that the asset generates sufficient funds is in effect a transfer of the securing financial asset that has to be evaluated for whether it qualifies for derecognition.

BC39 Similarly, the Board believed that in some instances, the issue of debt or equity instruments (beneficial interests) by a securitisation vehicle is effectively a transfer of all of the cash flows of the financial assets in that vehicle. This would be the case, for example, when the vehicle has agreed to pass to the transferee all of the cash flows of its financial assets. The Board believes that consistent with its conclusion in paragraph BC31 that a transfer of the right to all of the cash flows of a financial asset is akin to a transfer of that asset itself, those types of transactions should be evaluated as transfers of the assets themselves.

'Continuing involvement' step

BC40 The Board decided that if following a transfer an entity is not involved in the transferred financial asset in any way, it no longer controls the economic benefits of that asset (ie after the transfer, the transferee's ability to obtain and restrict others' access to those benefits is not constrained). This will be the case for many simple transactions, in which one entity transfers all its rights and obligations relating to a financial asset to another entity and acquires no new rights or obligations relating to that asset. Hence, the Board decided that once an entity identifies the asset to be assessed for derecognition, if the entity does not have any continuing involvement in that asset, the entity derecognises the asset.

BC41 The Board considered some types of involvement in transferred financial assets after the transfer to be commonplace and consistent with its 'control of an asset's economic benefits' principle. Hence, the Board decided to exclude them from the 'continuing involvement' definition (even though technically they would meet that definition). The exceptions are:

(a) normal representations and warranties

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(b) fiduciary (or agency) servicing

(c) forwards, options or other contracts with a contract (or exercise) price of fair value.

Normal representations and warranties

BC42 Most transfer agreements include representations and warranties relating to the accuracy of the information provided about the assets that are the subject of the transfer (eg the underwriting procedures performed). Accordingly, the consequence of not providing an exception for normal representations and warranties could have been that many transfers would not have qualified for derecognition (because they might have failed the subsequent 'practical ability to transfer' test), even though the only involvement a transferor would have after the transfer would be those representations and warranties.

Fiduciary (or agency) servicing

BC43 On the basis of the definition of continuing involvement, servicing rights retained by a transferor would have constituted continuing involvement in the transferred asset. The Board decided to make an exception for servicing contracts that qualify as fiduciary or agency relationships. If the Board had not made such an exception, many transfers of financial assets to securitisation vehicles would have failed derecognition (because those vehicles are often prohibited from selling the assets or are required to remit the cash flows generated by the assets to the investors in the vehicles, and thus the transfers would not have met the 'practical ability to transfer' test), even though the only role of the transferor after the transfer would be that of an agent that acts on behalf of the vehicles or the investors in the vehicles.

BC44 The Board decided to provide some criteria for when a servicer stands in a fiduciary (or agency) position. First, the role of a fiduciary (or agency) servicer is that of a service provider that is contractually obliged to perform its duties (at market rates for such services) in the best interest of the transferee (ie the entity that owns the assets). Additionally, typically a fiduciary's or agent's fees are senior in priority to any payment to the transferee from the serviced assets. If not, the Board concluded that the fiduciary or agent holds an interest in the serviced assets similar to that of the transferee. Finally, the Board noted that in a fiduciary's (or agency's) relationship, the entity that receives (and pays for) services is usually able to terminate the service contract.

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Forwards, options or other contracts with a contract price of fair value

BC45 The Board concluded that even though a fair value forward or option that a transferor obtains in connection with a transfer of a previously recognised financial asset is a new right relating to the asset transferred and thus would be continuing involvement in accordance with the proposed definition, the transferor in repurchasing the asset under the forward or option is in the same economic position as a third party that purchases the asset from the transferee. As a result, the transferee is able to obtain the full economic benefits of the asset (albeit from the transferor and not a third party), thus meeting the Board's derecognition principle.

'Practical ability to transfer for its own benefit' test

BC46 Paragraph BC14 states that the principle the Board applies to derecognition of financial assets is whether an entity has the present ability (a) to obtain (access) the future economic benefits inherent in the asset (or a part of it) and (b) to restrict others' access to those benefits.

BC47 The future economic benefits embodied in an asset may flow to an entity in a number of ways. For example, an entity can obtain the economic benefits of a financial asset by exchanging it for other assets, by using it to settle a liability or by distributing it to the owners of the entity.

BC48 If the transferee is free and able to transfer a financial asset in any of these ways, the transferee can obtain the economic benefits. To the extent that the transferee can restrict others' access to those benefits (ie if it is entitled to receive and keep for itself the proceeds from any such potential subsequent transfer), the transferee controls the economic benefits of the asset. This interpretation is consistent with the notion that the entity with an asset is the one that, within the limits set by the nature of the benefit or the entity's right to it, can use it as it wishes. An entity is able to give control of an asset to a third party only if the entity itself has that control.

BC49 The Board believes that the assessment of whether the transferee has the practical ability to transfer the asset that is the subject of a transfer—unilaterally and without having to impose additional restrictions—and whether the transferee has that ability for its own benefit (ie whether it can obtain the full economic benefits of that asset) will require judgement and can be made only after considering all the relevant facts and circumstances.

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Unilateral ability to transfer without attaching restrictions

BC50 The Board decided that the important issue regarding the ability to transfer an asset is what the transferee is able to do in practice, rather than what contractual rights or contractual prohibitions the transferee has regarding the asset.

BC51 The Board noted that contractual restrictions on the transferee's right to transfer a financial asset to a third party will not necessarily prevent the transferee from having the practical ability to make such a transfer. For example, a contractual prohibition on transfers to third parties (including a limitation on the number or identity of those third parties) may have no practical effect (and therefore may not prevent the transferee from having the practical ability to transfer the asset to a third party) if replacement assets are readily obtainable, because the transferee may be able to transfer the asset and satisfy the prohibition by obtaining a replacement asset. For this purpose, the Board judged replacement assets to be readily obtainable only if the asset is actively traded on an accessible market.

BC52 Similarly, if a transferee must obtain the consent of the transferor to the transfer of a financial asset to a third party, the Board concluded that the transferee may have the practical ability to transfer the asset, provided that the transferor cannot unreasonably withhold its consent. However, if the transferor can withhold its consent without reason, the Board did not believe that the transferee has the practical ability to transfer a financial asset to a third party.

BC53 As part of the transfer arrangement with the transferor, a transferee may not be contractually prohibited from transferring a financial asset to a third party. However, the Board decided that the transferee's ability to dispose of the asset might be of little use if the transferee has to attach restrictive conditions or 'strings' to the transfer to protect itself from losses that it would otherwise incur on the transfer. For example, if a transferee writes a call option enabling the transferor to insist on the return of a transferred financial asset that is not readily obtainable, the transferee risks defaulting on its obligation to the transferor if it transfers the asset to a third party without attaching a call option or forward purchase contract. If the transferee transfers the asset and the transferor exercises the call option, the transferee may be unable to get back the asset for delivery to the transferor. The Board noted that, therefore, the existence of the call option may mean that the transferee is not free to transfer the asset without restrictions.

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BC54 However, the Board noted that a call option of the type described in the preceding paragraph will not prevent the transferee from transferring the asset (even though the asset is not capable of being readily replaced) if because of market convention, other established practice or an express or implied term of the transaction, it is reasonably certain that the transferor will consider a similar asset an acceptable replacement for the transferred asset, or if, according to the terms of the option contract, the call option is to be settled net.

BC55 In the case of a transfer of a not readily obtainable financial asset in which the transferee obtains a put option over the asset, the Board concluded that the transferee might be economically impeded from transferring the asset unencumbered by an option or a right to reacquire because the transferee would not be able to exercise its put option. Although a transferee is, in theory, always free not to exercise a put option, the Board regards a put option as conveying benefits to the transferee that it may not be prepared to give up lightly, so its existence may constrain the transferee.

BC56 The proposed approach requires assessment by the transferor of whether an option (or any other 'additional' contract entered into with the transferor as part of the transfer arrangement) constrains a transferee to be made once only, at the date of transfer. That requirement reflects the Board's view that it would be impractical to require the transferor to re-evaluate the option and, if necessary, change the accounting treatment of the transfer on an ongoing basis throughout the life of the option. However, the proposed approach would treat the expiry or non-exercise of an option previously considered to be constraining as a recognition/derecognition event.

For the transferee's own benefit

BC57 If the transferee has the practical ability to transfer to an unrelated third party the financial asset that is the subject of the transfer with the transferor, it has the ability to obtain the asset's economic benefits. Having that ability in isolation, however, is not evidence of the transferee having control of the asset. As noted in paragraph BC48, the transferee also must be able to restrict others' access to those benefits. The transferee controls the asset only if it is in a position to keep for itself the consideration it would receive from a third party if it were to transfer the asset to that party. Accordingly, if the transferee has an obligation to pass the consideration from the third party to the transferor, it will not have the practical ability to transfer the asset 'for its own benefit'.

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Practice implications of the 'practical ability to transfer' test

BC58 Paragraph BC48 notes that the Board concluded that if a transferee is free and able to transfer the financial asset that is the subject of the transfer (ie the Asset) (and receive and keep all of the benefits of the Asset without having to remit them to the transferor), the transferor must have passed control of the economic benefits to the transferee. Therefore, a major implication of the 'practical ability to transfer for its own benefit' test is that if that test is met, the transferor will derecognise the Asset, irrespective of the nature of the transferor's continuing involvement in the Asset.

BC59 Because most sale and repurchase agreements involving financial assets (repo transactions) concern the transfer of one readily obtainable security in exchange for another readily obtainable security, an implication of this test is that most repo transactions will be treated as a sale of the transferred assets.

BC60 That means that each party to the transaction will derecognise the security it had recognised before the transaction, and each will recognise the security received in return. In most jurisdictions, this will represent a fundamental change in accounting treatment because, to date, sale and repurchase agreements generally have been treated as secured borrowings, and stock lending transactions generally have not affected the assets and liabilities recognised in the statement of financial position.

BC61 The Board recognises that this change will have a major impact on the reported financial position of many entities. Nevertheless, for the reasons set out above the Board believes its proposal will improve financial reporting.

Transfers that qualify for derecognition

BC62 The Board decided to carry forward from the current version of IAS 39 the recognition and measurement guidance for a transfer of a part of a financial asset that qualifies for derecognition (see paragraph 21A). The Board clarified that this guidance also applies to a transfer of an entire financial asset that qualifies for derecognition in which, as part of the transfer, the transferor obtains an interest in the transferee that entitles it to some of the cash flows from that asset (see paragraph 22A). For such transfers, the Board views the part that the transferor retains as part of the financial asset that the transferor previously recognised. As such, the Board does not believe that the transferor should apply a measurement attribute to the part retained that is different from the measurement attribute that the transferor applied to the whole asset

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recognised before the transfer. Furthermore, the Board reasoned that if it required that a transferor use a different measurement attribute for the part retained, it would provide for selective application of fair value and an opportunity for earnings management. (See also the discussion about the appropriate unit of account with respect to the part retained in a transfer of a financial asset in paragraphs BC64–BC82.)

Transfers that do not qualify for derecognition

BC63 The Board also decided to carry forward from the current version of IAS 39 the prohibition to measure as at fair value through profit or loss the financial liability that is created in a transfer that does not qualify for derecognition, if the transferor measures at amortised cost the financial asset that it is required to continue to recognise after the transfer. The Board noted had it permitted the fair value option in that circumstance, the outcome would have been inconsistent with one of the objectives of the fair value option, which is to eliminate or significantly reduce a measurement inconsistency that would otherwise arise from measuring assets or liabilities on different bases. (See the requirements for when an entity can use the fair value option in the definition of a *financial asset or financial liability at fair value through profit or loss* in paragraph 9 of IAS 39.)

Reasons for why the Board did not choose the alternative approach

BC64 A minority of the Board preferred an alternative approach to derecognition of financial assets (that alternative approach is described in more detail in the alternative views). The Board did not choose the alternative approach for the following reasons.

BC65 If an entity transfers a financial asset or a part of it and retains risks relating to that asset or part, there is disagreement about the substance of the transaction. Some believe the transaction is a borrowing because the transferor retained risks related to the asset. Others believe that the transaction is a sale because the transferee is entitled to receive the cash flows (the benefits) from the asset or part of it acquired.

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BC66 The accounting for these transactions is controversial because no accounting principle can adequately represent both views. Accordingly, any accounting method chosen will be criticised for not reflecting the substance of the transaction. Another difficulty adding to the controversy is the disagreement about how the *Framework* should be applied to a transfer transaction to determine whether the asset qualifies for derecognition.

BC67 The Board was divided and Board members supported one of two alternatives: the approach described in the alternative views and the approach proposed in the exposure draft. Under the alternative approach, an entity derecognises a financial asset if it no longer controls all the economic benefits of the asset. An implication of that approach is that if an entity transfers part of a financial asset, it generally will derecognise the previously recognised asset and will recognise as a new asset the economic benefits retained. The retained economic benefits are treated as a new asset because their characteristics typically differ from those embodied in the previously recognised asset. Consistently with the other requirements in IAS 39, the new asset would be measured at fair value and any gain or loss resulting from the transfer would be recognised in profit or loss.

BC68 Under the approach proposed in the exposure draft, an entity derecognises a financial asset or a part of it if it relinquishes control of the asset or the part (provided the part is of a type that the proposed approach permits to be derecognised). The entity assesses control after it determines that it has continuing involvement in the transferred asset or the part after the transfer. To the extent that the entity has relinquished control of (and derecognises) the part transferred, it allocates the carrying amount of the underlying asset between the part transferred and the part retained on the basis of the relative fair value of those parts. The entity accounts for the part retained as a part of the asset recognised before the transfer. Thus, it applies to the part the same measurement attribute that it previously used for the entire asset.

BC69 The Board agrees with the Board members supporting the alternative approach that if an entity surrenders control of a financial asset, it should derecognise the asset. However, the Board disagrees over the asset that is the subject of the transfer. It believes that because the alternative approach typically would allow derecognition of a financial asset in its entirety if an entity transferred a part of the asset, that approach effectively allows the transfer of a right to any cash flows of a financial

asset to be derecognised, and the retention of the rights to the remaining cash flows of that asset to be treated as a new asset. The Board disagrees with this outcome, and as a result, disagrees with the unit of account for derecognition in the alternative approach.

BC70 The Board believes that a financial asset cannot be subdivided into smaller and smaller assets and accounted for as if it consisted of separate assets when the cash flows of the original asset recognised are interdependent. As noted in paragraph BC35, the Board believes that the relevant unit of account for the purpose of assessing derecognition is the financial asset in its entirety, or specifically identified or proportionate cash flows of the asset.

BC71 If a transfer does not qualify for derecognition under the proposed approach, the asset that was the subject of the transfer remains an asset of the transferor, and the obligation to remit cash flows from the asset is recognised by the transferor as a liability. The Board members favouring the alternative approach believe that the asset that remains in the transferor's statement of financial position and the related liability do not satisfy the definitions of assets and liabilities in the *Framework*, in part because the transferor's only obligation is to pass to the transferee the cash flows from the asset that was the subject of the transfer to the extent that the transferor collects any such cash flows from the debtor underlying the asset.

BC72 The Board believes that the alternative approach overlays a unit of account onto the definition of an asset. The *Framework* currently does not provide guidance about unit of account issues. The ongoing project to improve the *Framework* will address this issue. The Board has decided that the unit of account for the purpose of assessing derecognition is the entire asset, or specifically identified or proportionate cash flows of the asset. It also concluded that a transferee's right to part of the cash flow of an asset in a transfer that does not qualify for derecognition does not constitute a right to the asset itself.

BC73 The Board believes that an obligation to remit cash flows from an asset of an entity meets the definition of a liability in the *Framework*. Even under the alternative approach, a transfer of a financial asset that does not qualify for derecognition is a borrowing and the transferor recognises a liability for its obligation to remit cash flows to the transferee. The Board believes that the point of disagreement is about what the asset is and whether it qualifies for derecognition. The liability exists only as a function of whether the asset that is the subject of a transfer qualifies for

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derecognition. The Board believes that the transferee's asset in the case of a transaction that does not qualify for derecognition is a right to part of an underlying asset of the transferor and not the underlying asset itself.

BC74 The Board members who support the alternative view believe that the proposed approach is also inferior because the order of transactions affects the accounting (ie two entities with identical rights and obligations may report different assets and liabilities depending on the order in which they acquired or incurred those rights and obligations, because—once recognised—assets are 'sticky'). However, the Board believes that much of the issue in practice will be eliminated because the concern in practice relates primarily to assets that are readily obtainable in the marketplace. For those types of assets, the proposed approach will lead to accounting outcomes that are consistent with those of applying an approach for which the order of transactions does not matter.

BC75 However, the Board acknowledges that an unresolved difference remains for transactions in which the transferee has not acquired the practical ability to transfer, for its own benefit, to a third party the asset that is the subject of the transfer, and that asset is not readily obtainable in the marketplace. The issue for those transactions primarily is that an entity that retains a subordinated position in a transferred financial asset is required to continue to recognise the asset and also to recognise a liability for the obligation to remit cash flows from the asset to a transferee. However, if the entity acquired the subordinated position in the marketplace, it would recognise only a net position. The Board believes that this is not a problem in practice because in many instances the subordinated interest is retained by the transferor. The transferor keeps the subordinated position because of its inability to sell it and realise what it believes to be its value. Accordingly, the Board believes that the continued recognition by the transferor of the financial asset underlying the subordinated interest appropriately reflects the substance of the transaction.

BC76 The Board believes that the issue that for the proposed approach the order of transactions might affect the accounting is also an issue about unit of account and its resolution is beyond the scope of the derecognition project. Unless a transferee acquires an entity, practice is to account for the asset acquired as a single unit. This is the case for a derivative and an executory contract. However, there is an open question about when or whether some contracts and investments should be recognised on a gross basis, showing an asset and a liability instead of a net position. An argument could be made that the unit of account is the entire asset

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resulting in a gross presentation for the transferee if the transferee has a subordinated interest in underlying assets that it can manage for its own benefit. Such an approach, however, is beyond the scope of the derecognition project.

BC77 Another approach might be to consider whether assets and beneficial interests in them should be viewed as an entity in its own right having a circumscribed area of business activity provided through contractual rights. In the *Framework* project, the Board's preliminary view is that a reporting entity does not necessarily need to be a legal entity. Again, such an approach is beyond the scope of the derecognition project.

BC78 The Board concluded that it must specify the unit of account that constitutes the part of a financial asset that is the subject of a transfer transaction. As noted in paragraphs BC69 and BC70, the Board believes that it would be inappropriate to specify that any subdivision of an asset (no matter how small that subdivision is)—indeed any provision inserted into a contract that does not produce a separate cash flow under the contract—is an asset in its own right that may qualify for derecognition. Until the *Framework* project is completed, the Board recognises that at the standards level it will be necessary to specify a unit of account.

BC79 The Board believes the proposed approach faithfully represents the position of an entity by clearly depicting an entity's leverage and risk relating to that leverage in the statement of financial position. Indeed, if an entity transferred a part of a financial asset and retained the most subordinated interest in it, it would have a leveraged position in the underlying asset. The proposed approach would not obscure that leverage by showing only the net position in the statement of financial position.

BC80 The Board believes that users generally support an approach that would not permit derecognition of a part of a financial asset when the transferor retains substantial risks of ownership of the underlying asset. The Board is of the view that the approach chosen permits users to better understand leverage and risk and does not permit gain or loss on sale accounting when the transferor has continuing involvement in the asset that is the subject of the transfer and the transferee does not control it.

BC81 The Board also believes that the proposed approach complements the proposal on consolidation. Many transfers of financial assets are made to special purpose entities (SPEs) that in turn issue beneficial interests in those assets. If an entity controls the SPE, it is required to consolidate it. The proposed consolidation standard (ED 10) specifies that an entity that has significant risks and rewards of an SPE is likely to control it to be in a

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position to protect itself, for example, by having the ability to manage loan defaults. If an SPE could derecognise assets when it issues disproportionate beneficial interests in them, the requirement to consolidate would be meaningless because there would be no assets in the SPE to consolidate. Under the proposed derecognition approach, an SPE could not derecognise assets by issuing disproportionate beneficial interests in them unless the SPE had no continuing involvement with the assets, or the transferees (beneficial interest holders) had a right to sell the underlying assets and would realise the full economic benefit of those assets.

BC82 In many instances, a transferor carries at amortised cost in its statement of financial position a financial asset that is the subject of a transfer. The Board considered whether a transfer transaction should result in the remeasurement at fair value of any retained part of the asset. The Board concluded that a requirement to change the measurement attribute from amortised cost to fair value would lead to the selective recognition of fair value and an opportunity for earnings management. For example, a sale of a one per cent proportionate interest in a loan would require the 99 per cent retained interest to be measured at fair value. The Board concluded that in a transfer of a part of a financial asset that qualifies for derecognition, the part retained should be subsequently measured using the same measurement attribute as that previously used for the underlying asset. The Board noted that it has an active project, being conducted jointly with the FASB, to address the broader question of how to measure financial instruments.

Approach to the derecognition of financial liabilities

BC83 The Board decided to amend the derecognition approach in IAS 39 to more closely align it with the definition of a liability in the *Framework*. It does not expect that compared with today's requirements in IAS 39 the amendments will significantly change practice for the derecognition of financial liabilities.

Current requirements

BC84 IAS 39 primarily uses a legal release approach to derecognition of financial liabilities. A settlement approach is used in support of that legal release approach.

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BC85 The legal release approach focuses largely on legal status—whether the debtor has been released entirely from, is only secondarily liable for or remains primarily liable for the contractual obligation. Thus, under the legal release approach, derecognition is deemed inappropriate in the absence of a full release by the creditor's agreement or legal cancellation.

BC86 Under the legal release approach, derecognition is appropriate when the contractual obligation that gives rise to the financial liability has been discharged fully by performance or exercise, has expired, has been forgiven by the creditor, has been assumed by a third party, or has been nullified or cancelled by law, and, by implication, the debtor has no further obligations to the creditor.

BC87 The settlement approach is used mainly as application guidance, to illustrate some of the means by which a liability could be settled and hence how a debtor may be assessed as no longer obliged under a liability previously recognised by the debtor. For example, IAS 39 provides the following examples as methods for settlement of a present obligation:

(a) payment of cash

(b) transfer of other assets

(c) performance of services

(d) termination of a performance obligation by risk release (eg expiration of a financial guarantee contract)

(e) replacement of the obligation with another obligation (if the terms of the new obligation are substantially different from those of the old obligation)

(f) transfer of the obligation to another party

(g) conversion of the obligation to equity.

Proposed amendment

BC88 The *Framework* defines a liability as ‘a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits’.

BC89 On the basis of that definition, the Board noted that a liability has two primary characteristics:

(a) it represents an expected future ‘outflow from the entity of resources embodying economic benefits’; and

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(b) it is a present ('existing') obligation of the entity (ie the entity has a 'duty or responsibility to act or perform in a certain way' which 'leaves the entity with little, if any, discretion to avoid the outflow of resources to another party').

BC90 Hence, whether a particular item is a liability of an entity at a particular time requires the following considerations:

(a) whether the item represents a present obligation of the entity (ie the entity has a 'duty or responsibility to act or perform in a certain way'); and

(b) whether it represents an expected future outflow from the entity of resources embodying economic benefits.

BC91 The Board noted that the approach in the current version of IAS 39 focuses on the legal extinguishment of an individual obligation that is based on the terms of the underlying contract or arrangement. However, for a liability to exist (in accordance with the *Framework*) an entity must *have a present obligation that represents an expected future outflow from the entity of resources embodying economic benefits.*

BC92 Therefore, the Board decided that the amended approach should assess derecognition of financial liabilities on the basis of:

(a) continuing existence of a present obligation; and

(b) the requirement that this may result in a future outflow from the entity of an asset.

BC93 Using such a principle, a liability could cease to exist because of:

(a) specific actions of the entity (eg payment, performance); or

(b) changes in the entity's circumstances (eg bankruptcy).

BC94 The proposed approach has the benefit of mirroring the proposed derecognition principle for financial assets, in that the approach:

(a) focuses first on economic resources, and then

(b) considers how the entity is linked to those economic resources.

BC95 The Board also believes that another benefit is that this derecognition principle makes liability derecognition more symmetrical with liability recognition.

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Amendments to IFRS 7—disclosures relating to derecognition

BC96 The Board proposes requiring disclosures that enable users of financial statements:

(a) to understand the relationship between transferred financial assets that are not derecognised and associated liabilities; and

(b) to evaluate the nature of and risks associated with the entity's continuing involvement in derecognised financial assets.

Transferred financial assets that are not derecognised

BC97 When financial assets are transferred but not derecognised, there has been a contractual event that may not be captured fully by the accounting that treats any cash received as a secured borrowing. In those situations, the Board concluded that it is useful to understand the relationship between those financial assets and the associated liabilities that an entity recognises. Understanding the relationship between the assets and associated liabilities helps users of financial statements in assessing both an entity's cash flow needs and the cash flows available to the entity from its assets.

BC98 IFRS 7 requires disclosures about transferred financial assets that are not derecognised. The Board decided to carry over those disclosures because they provide some information useful in understanding the relationship between transferred financial assets that are not derecognised and associated liabilities.

BC99 However, in addition to those disclosures, the Board proposes:

(a) disclosure of a qualitative description of the nature of the relationship between transferred assets and associated liabilities, to include any restrictions on the transferred assets; and

(b) linked presentation of transferred financial assets and associated liabilities when the counterparty to the associated liabilities has recourse only to the transferred assets.

BC100 The Board noted that the disclosures proposed would provide information useful in assessing the extent to which the economic benefits generated from assets of an entity cannot be used in an unrestricted manner, as is implied when assets are controlled and recognised in an entity's statement of financial position. In addition, it would also provide information about liabilities that will be settled

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entirely from the proceeds received from specific assets, and thus identifies liabilities for which the counterparties do not have claims on the assets of the entity in general. For those assets for which the underlying cash flows are committed to be used to satisfy related liabilities, the linked presentation disclosure (in addition to showing the cash flow relationship between those assets and liabilities) also provides a means of understanding the net exposure of an entity following a transfer transaction that fails derecognition.

Transferred financial assets that are derecognised

BC101 IFRS 7 does not require disclosures about transferred assets that have been derecognised. The Board was asked by the Financial Stability Forum and others to review the disclosure requirements for what are often described as 'off balance sheet' activities; derecognised financial assets form part of such activities.

BC102 When an entity retains continuing involvement in financial assets that it has derecognised, the Board concluded that users of financial statements would benefit from information about the risks to which the entity remains exposed. Information about the risks associated with an entity's continuing involvement provides users with information relevant in assessing the amount, timing and uncertainty of the entity's future cash flows.

BC103 The Board observed that IFRS 7 already requires some of the proposed disclosures by class of financial instrument or by type of risk. However, IFRS 7 asks for the information at an aggregated level, so information specific to derecognition transactions is often not available. In response to requests from users and others the Board is now proposing disclosures specific to derecognition transactions.

BC104 The proposed disclosures focus on the risk exposure of an entity, and would provide information about the timing of return and the value of financial assets that may or will return to an entity's statement of financial position in the future. The Board reasoned that a combination of disclosures about the fair value of the derecognised assets, the strike price or repurchase price to repurchase assets, the fair value of its continuing involvement, the maximum exposure to loss and qualitative information about an entity's obligations to provide financial support are relevant in understanding the risks retained by an entity.

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BC105 In addition, information about an entity's gain or loss on derecognition and the timing of recognition of that gain or loss provides information about the proportion of an entity's profit or loss that arises from transferring financial assets in which the entity also retains continuing involvement. Such information is useful in assessing the extent to which an entity generates profits from transferring financial assets while retaining some form of continuing involvement and thus exposure to risk.

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Alternative views on exposure draft

Alternative views of Mary E Barth, Gilbert Gélard, James J Leisenring, Warren McGregor and Tatsumi Yamada

AV1 Professor Barth and Messrs Gélard, Leisenring, McGregor and Yamada voted against publication of the proposed amendments to IAS 39 contained in the exposure draft *Derecognition*, for the reasons set out below.

AV2 These Board members agree that the derecognition requirements of IAS 39 *Financial Instruments: Recognition and Measurement* are internally inconsistent and should be replaced. The Standard combines the requirements of a control approach with those of a risks and rewards approach. However, they object to the approach proposed in the exposure draft. In particular they disagree with the proposed approach's assessment of what does (or does not) meet the definition of an asset or a liability, and criteria for determining the entity that controls an asset.

AV3 These Board members also believe that although the approach proposed in the exposure draft purports to be based on control, it is primarily driven by a risk and rewards rationale and overlaid with a control notion. Therefore it combines two approaches to derecognition and would lead to the same inconsistencies and application difficulties encountered in the guidance it is intended to replace. For example, if a transferor transfers the first 90 per cent of the cash it collects on a loan receivable (a disproportionate interest) derecognition is denied and the proceeds from the transfer are recognised as a liability. Assuming that the transferee has the right to dispose of the acquired interest and thus meets the control criterion, derecognition is still denied under the proposed approach because the transferor has continuing risk and rewards in the transferred asset.

AV4 These Board members concluded that the proposed approach is not supported by the IASB's *Framework for the Preparation and Presentation of Financial Statements*. They believe that the proposed approach would result in recognising assets and liabilities that do not meet the definitions of those elements in the *Framework*. In addition, they believe that application of the proposed approach does not faithfully represent the transferor and transfersees contractual rights and obligations. The *Framework*'s definition of an asset refers to the control of a resource from which future economic benefits are expected to flow to the entity. These Board members believe

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that a right to receive a cash flow does not represent a future economic benefit to the holder of that right when the holder of that right also has an obligation to pay the amount it will receive to a third party and cannot otherwise use the cash received for its benefit.

AV5 Consequently, for the example of a transfer of the first 90 per cent of the cash flow from a loan receivable (in paragraph AV3), the transferor does not control all of the economic benefits that constitute the asset previously recognised by the transferor. The transferor has no right to the first 90 per cent of the cash flows from the loan; it is merely acting as servicer. The transferee controls access to that cash and the right to the cash if collected.

AV6 These Board members also emphasise that the *Framework* definition of a liability refers to a present obligation that is expected to result in an outflow of resources embodying economic benefits. Retention of a subordinated interest in an asset previously recognised does not constitute a liability of the transferor because doing so does not create an obligation for the transferor. If the asset fails to generate returns, the transferor has no obligation to the transferee. The transfer of the first 90 per cent of the cash flows of the previously recognised asset results in the transferor retaining a disproportionate share of any risks associated with the asset, but does not result in incurring a liability (because there is no present obligation to transfer economic benefits). Rather, the value of the excess risks retained (ie the risks in excess of a pro rata sharing) reduces the value of the retained interest in the transferred asset. These Board members believe that the proposed approach necessitates the recognition of 'non-existent' liabilities because a transfer has failed the derecognition criteria.

AV7 These Board members also believe that there are unacceptable consequences arising from the proposed approach. For example, they believe that the proposed approach will result in very different accounting by two entities with identical contractual rights and obligations only because one of those entities once owned part or all of the transferred financial asset. Under IAS 39, a derivative such as a fixed price option that entitles the holder to acquire an asset it has never owned would be accounted for simply as a call option (asset). Yet under the proposed approach, if that option pertains to an asset previously recognised by the transferor, the transferor and transferee would be required to determine whether the asset is fungible or readily obtainable to determine whether the transferred asset should or should not be

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derecognised by the transferor and recognised by the transferee. Only if the transferred asset is derecognised would the call option derivative be recognised. As a result, ownership history affects the accounting. These Board members do not believe this is appropriate.

AV8 Under the approach proposed in the exposure draft, 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 based on 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 the derecognition criteria and hence the transferor would continue to recognise the asset. These Board members agree that the proposed approach for financial liabilities is conceptually sound, but question why the same approach is not applied to financial assets. They emphasise that the derecognition model in revised IAS 39 will be internally inconsistent if the approach proposed in the exposure draft is adopted. In their view, the proposed approach would replace one set of conceptual inconsistencies with another and might have significant unanticipated consequences.

AV9 These Board members do not believe it is necessary or desirable to create the rules described in paragraph BC70 (of the exposure draft) to determine whether the transferor has surrendered control over the economic benefits underlying an asset. They contend that 'bright-line' tests are inherently contrary to any principled objective. These Board members also believe that the proposed approach is rule-based. They emphasise that a slight shift in the form or structure of a transaction can cause it to move across the threshold, resulting in profoundly different accounting for transactions that are economically similar.

AV10 Under the approach proposed in the exposure draft, a part of a financial asset (or of a group of financial assets) qualifies as the asset to be assessed for derecognition only if it represents a right to specifically identifiable cash flows or a proportionate share (as defined in paragraph 16A of the exposure draft) of the cash flows from that asset (or group of assets). These Board members conclude that the Board drew an arbitrary line to identify the part of a financial asset that is eligible to be assessed for derecognition because the proposed guidance has no conceptual basis.

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AV11 As acknowledged by the Board in the exposure draft, most financial instruments comprise bundles of contractual rights and/or contractual obligations, and transfer transactions unbundle those rights and obligations and rebundle them in different ways. These Board members believe that if financial statements are to give a faithful representation of transactions and events, the recognition and derecognition approach adopted needs to reflect fully this unbundling and rebundling. Thus, these Board members believe that a derecognition approach should focus on rights and obligations acquired or assumed as part of the transfer, including those relating to the asset transferred. Such an approach would be consistent with the way participants in financial markets structure financial instruments to manage risk and hence will best reflect the economics of the market place.

AV12 Furthermore, these Board members believe that disproportionate cash flows of a financial asset are identifiable cash flows. They believe that contracting parties know which cash flows they have relinquished and acquired and that agreement is not arbitrary. The fact that the values of the retained interest and the part transferred are interdependent should be reflected in the valuation of the retained interest, but should not preclude derecognition. These Board members also believe that the proposed approach in the exposure draft is not consistent with how financial instruments are accounted for in accordance with IAS 39 today. For example, if an entity writes a guarantee on a receivable, even though the value of the guarantee is dependent on the value of the receivable, the guarantor does not recognise the receivable as its assets.

AV13 One of the reasons underlying the approach proposed in the exposure draft seems to be that removing an asset from the transferor's statement of financial position (even if the asset no longer qualifies as an asset of the entity) does not faithfully represent the risks or exposures of the entity if the transferor retains a continuing involvement in the asset. These Board members disagree with that view. They believe that the appropriate way to treat uncertainty and risk is to recognise all rights and obligations. Hence risks retained by the seller of a financial asset would be recognised and measured at appropriate amounts. Recognising the transferor's rights and obligations remaining after the transfer may entail recognising a derivative. This would be no different from any other derivative recognised today. Traditionally, the risks relating to derivatives are disclosed in the notes as opposed to recognising the underlying assets in the statement of financial position.

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AV14 These Board members also believe that the approach proposed in the exposure draft is not operational. Under the proposed approach, when an entity transfers an entire financial asset or a group of financial assets that meets the derecognition criteria and purchases an interest in the transferee, if the transferee has liabilities or other assets (in addition to that transferred to it), the transferor would be required to split the interest purchased between a portion representing its interest in the transferred asset and an interest in the other assets and/or liabilities of the transferee. These Board members believe that, in some cases, the transferor might not be aware of all the assets and liabilities held by the transferee.

AV15 Moreover, these Board members believe that the approach proposed in the exposure draft would render accounting for transfers within a group and stand-alone financial statements of transferees less useful. For example, if a parent transfers an asset to a subsidiary, but the parent continues to be involved in the asset the parent would continue to recognise the transferred asset in its stand-alone financial statements. This means that the subsidiary would not recognise the asset transferred but instead would recognise a receivable from the parent. This treatment is contrary to how a sale of goods between a parent and subsidiary (with a right of return) is accounted for at present. These Board members disagree with this dichotomy and question the rationale for the different accounting treatment.

AV16 These Board members support a different approach to derecognition of financial assets. That approach is set out and referred to in this document as the 'alternative approach'. That approach is described in the following section.

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Alternative view — Description of the alternative approach

Summary

Under the alternative approach, when the rights to identified cash flows are transferred, the transferor derecognises the previously recognised asset and recognises all the rights and obligations either retained or obtained in the transfer transaction. For example, forward contracts, puts, calls, guarantees or disproportionate involvement with respect to transferred cash flows would not result in failed sales or result in the recognition of a liability for the proceeds received. Any involvement would be recognised and measured at the date of transfer at fair value. The objective would be to recognise any rights and obligations associated with a transferred asset as if those rights and obligations related to an asset that had not previously been owned.

Under the alternative approach, a transferor could be required to apply the same disclosure guidance as proposed by the amendment to IFRS 7. The proposed amendment to IFRS 7 would provide adequate information to enable users to evaluate the nature of and risks associated with the transferor's continuing involvement in derecognised financial assets. The full exposure (including the nature, timing, ranking, amount and uncertainty of any obligations or cash outflows relating to the entity's continuing involvement in a transferred asset and the details about those assets) would be provided in one note (disclosure). Hence, the proposed disclosures would provide clear information both on the allocation of risks and on their potential impact on the financial condition of the transferor.

Derecognition criteria

AV17 The following paragraphs set out the alternative approach to derecognition of financial assets.

AV18 A transfer occurs when one party passes to or undertakes to pass to another party some or all of the cash flows or other 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, distribution and other exchange.

AV19 An entity shall derecognise a financial asset when 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.

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AV20 When an entity transfers an interest in a financial asset or a group of financial assets, the entity shall apply paragraph AV19 to the entire financial asset or group of financial assets (except for financial instruments that meet the conditions in paragraph AV22).

AV21 In applying paragraph AV19, an entity shall consider the whole transfer arrangement, including any side agreements or sets of simultaneous agreements entered into contemporaneously with or in contemplation of the transfer of the financial asset.

AV22 An entity shall not apply paragraph AV19 to:

(a) a transfer of an entire financial instrument or a part of 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.

(b) a transfer of either an entire portfolio or an interest in 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.

However, an entity shall apply paragraph AV19 to a transfer of the right to 'receive' future cash flows (the asset or 'receive' leg) of such an instrument.

Transfers that qualify for derecognition

AV23 When a transferor derecognises a financial asset in accordance with paragraph AV19, the transferor shall apply paragraphs AV24 and AV25 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.

AV24 If the financial asset or group of financial assets qualifies for derecognition (in accordance with paragraph AV19), the entity 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) transferred. Similarly, a transferor shall recognise as a new asset an investment in a transferee that the transferor purchases as part of the transfer.

AV25 The transferor shall measure at fair value, on initial recognition, all assets and liabilities resulting from the transfer of an entire, or an interest in, a financial asset (or group of financial assets).

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AV26 On derecognising a financial asset or group of financial assets, a transferor shall recognise in profit or loss the difference between:

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

(b) the sum of

(i) the consideration received (including any new asset obtained less any new liability assumed) and

(ii) any cumulative gain or loss that had been recognised in other comprehensive income.

Transfers that do not qualify for derecognition

AV27 If a transfer does not result in derecognition because the financial asset qualifies as an asset of the entity, 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.

AV28 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 AV19, the transferor shall continue to recognise the collateral as its asset.

Transferee's accounting

AV29 When accounting for a transfer involving a financial asset, the transferee applies the requirements of IAS 39 in recognising its obligations or rights assumed or acquired as part of the transfer.

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Application guidance

AV30 The following flow chart illustrates the evaluation of whether a financial asset is derecognised.