INFORMATION FOR OBSERVERS
IASB/FASB Meeting: 23 October 2007, Norwalk
Project: Derecognition of financial instruments
Subject: Accounting Principles for Derecognising Financial Assets measured at fair value (Agenda Paper 6B)

Accounting Principles for Derecognising Financial Assets measured at fair value

Education session for the meeting of the joint Boards
on staff research on derecognition

Disclaimer

This education session reflects the view of the staff. In no ways should the views be seen as representing the views of either the International Accounting Standards Board or the Financial Accounting Standards Board.

Why research derecognition of financial instruments?

- Fundamentally different derecognition requirements in IFRS and US GAAP
- Ongoing need to repair and maintain existing guidance
- Excessive reliance on legal concepts such as ‘legal isolation’

Memorandum of Understanding

- MOU progress expected to be achieved by 2008
  - To have issued a due process document relating to the results of staff research efforts
- Staff research focused on derecognising financial instruments
  - most complicated derecognition questions across all assets and liabilities arise with financial instruments
  - financial instruments are divisible into individual rights and obligations

Objective of staff research report

The objective of the staff research report is

- to identify principles for derecognising financial assets measured at fair value
- starting with the existing definition of an asset
- and then extend those principles to financial liabilities and financial assets not measured at fair value

Definition of an asset

- Economic resource
  - *Contractual promise* that is capable of producing cash inflows or reducing cash outflows
- Control
  - The *right* in the contract gives the entity *power or ability* to insist that the contractual promise is honoured
- Economic benefits flow to the entity
  - The manner in which economic benefits are received as a result of holding the contractual right to the contractual promise should not cause the financial asset to be derecognised

Proposed Derecognition Principle

An entity shall derecognise a financial asset (or a part of a financial asset) when its right (or a part of its right) in the contract that gave rise to the financial asset ceases to exist

Symmetry

- Proposed Derecognition Principle results in symmetry
  - in initially recognising and derecognising financial assets
    - Financial assets initially recognised when the entity becomes party to the contract
  - in derecognising financial assets and derecognising financial liabilities
    - Financial liabilities are derecognised when the obligation in the contract is extinguished/ when the entity’s obligation ceases to exist

Applying Derecognition Principle (1)

Derecognise a financial asset if the rights in the contract cease to exist irrespective of whether the entity

- has a right and/ or obligation to re-acquire the contractual right to the financial asset
- has a right and/ or obligation to receive or pay economic benefits based on changes in the value of the financial asset (eg. non payment losses, slow payment losses and/ or changes in interest rates)

Applying Derecognition Principle (2)

Continue to recognise a financial asset if entity retains the contractual rights irrespective of promises by the entity:

- that it will not sell the financial asset or use the financial asset in a specific way
- that cash that the entity collects on the financial asset will be immediately passed to another party
- that another party is entitled to collect and use cash generated from the financial asset
- to unconsolidated limited purpose entities

Facts for Case Study 1

The entity sells a government bond on an active market. The entity also does one of the following:

- purchases a call option that entitles the entity to re-acquire the government bond in the future
- writes a put option that entitles another entity to force the entity to re-acquire the government bond in the future
- enters a forward purchase contract that creates a right and obligation to re-acquire the government bond in the future

Case Study 1

Derecognition Principle

- Derecognise government bond

Recognise

- Call option contract
- Put option contract
- Forward purchase contract

Facts for Case Study 2A

The entity

- Borrows from a creditor
- Shifts contractual rights of receivables to the trustee
- Receives excess cash

The trustee uses the funds collected on the receivables to pay monthly instalments on the borrowing to the creditor and to pay excess cash to the entity

Case Study 2A

Derecognition Principle

- Derecognise receivables

Recognise

- Right to receive excess cash

Proposed Linked Presentation Principle

An entity shall apply linked presentation when the entity unconditionally promises at the reporting date that economic benefits on the financial asset will be used to settle recognised present obligations

What is linked presentation?

- Linked presentation is a display mechanism to provide information about the flow of economic benefits from an asset to settle a liability
- The effects of the liability expected to be settled by the asset should be shown deducted from the effect of the asset on the face of the balance sheet, income statement and cash flow statement within a single caption

Why do we need linked presentation?

- Separate derecognition principles and linked presentation principles permits a ‘pure approach’ for recognition/ derecognition based on the definition of an asset:
    - Recognition/ derecognition should focus on rights to the asset
    - Linked presentation focuses on the manner in which economic benefits are expected to flow to the entity from the asset

What linked presentation is <u>not</u>

Linked presentation is **not**

1. A second derecognition test or ‘nifty netting’
   - Derecognition test focuses on rights to the asset
   - Linked presentation focuses on the flow of economic benefits
2. Offset
   - Each of the two parties do not owe the other determinable amounts
   - No right of offset

What is an ‘unconditional promise’?

Nothing else needs to occur for debt holders to have a claim to economic benefits generated by the financial asset

Facts for Case Study 2B

The entity

- Borrows from a creditor
- Retains contractual rights to receivables
- Unconditionally promises that payments on the receivables will be sent to an account maintained by the trustee
- Permits the trustee to use the funds collected on the receivables to pay monthly instalments on the borrowing to the creditor
- Receives excess cash

Case Study 2B

Derecognition Principle

- Do not derecognise receivables

Recognise

- Liability obligation to creditor

Linked Presentation Principle

- Apply linked presentation to receivables and liability to creditor

Facts for Case Study 3

- The entity owns a portfolio of mortgage loan assets
- A single investor acquires an unconditional promise that the entity will pass 90% of all cash flows received on the mortgage loan assets to the investor
- The entity retains contractual rights to the mortgage loan assets

Case Study 3

Derecognition Principle

- Do not derecognise mortgage loan assets

Recognise

- Liability obligation to investor

Linked Presentation Principle

- Apply linked presentation to mortgage loan assets and liability to investor

Facts for Case Study 4

The entity

- Has a downgrade in credit rating
- Amends the terms of existing debt by entering a pledge agreement -debt holders are entitled to a first claim on trade receivables in the event of failure to fulfil debt service on the new loan
- Retains contractual rights to the receivables and receives all cash flows

Case Study 4

Derecognition Principle

- Do not derecognise pledged receivables

Recognise

- Liability obligation to debt holder

Linked Presentation Principle

- Do **not** apply linked presentation because the promise to settle the liability from the receivables is conditional on failure to fulfil debt service on the new loan

Conclusion

- Staff conclusion
  - A financial asset should be recognised/ derecognised as a result of rights in the contract to the asset
  - The likelihood of there being a future flow of economic benefits arising from the financial asset, and the probable amount of those future inflows or outflows, is a matter affecting the measurement of its value, presentation and disclosure and is not a matter affecting whether it should be recognised

Pro’s and Con’s of proposed principles

- Pro’s
  - Consistent, symmetrical principles for derecognising financial assets and financial liabilities
  - Many assets transferred in securitisation transactions that currently qualify for derecognition in IFRS and US GAAP will be recognised in the financial statements (possibly using linked presentation)
- Con’s
  - Different accounting results if contracts are structured differently
  - Some people consider that sale and repurchase transactions should not qualify for derecognition

Next steps

- Discuss remaining chapters of staff research report with Board Advisers in October 2007
- Complete a final draft version of the staff research report and distribute to Boards in November
- What next?