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New derecognition model proposed for financial instruments

On 31 March 2009, the International Accounting Standards Board (IASB) initiated its public consultation on a revised derecognition model for financial instruments with the publication of an exposure draft (ED) ED/2009/3 *Derecognition: Proposed amendments to IAS 39 and IFRS 7*. The ED proposes to replace the existing guidance on derecognition of financial assets and financial liabilities in IAS 39 *Financial Instruments: Recognition and Measurement* and the related disclosures required by IFRS 7 *Financial Instruments: Disclosures*. The ED also sets out an alternative derecognition model preferred by a minority of Board members.

Work on the derecognition project was accelerated in late 2008 in response to requests from constituents to progress work on this project as a matter of urgency.

The IASB has requested comments on the proposals by 31 July 2009. Public round-table discussions are planned over the coming months to seek constituents' input at an early stage and to explain the interaction between the proposals in the ED and the recent proposals on consolidation set out in ED 10 *Consolidated Financial Statements*.

The ED proposes different approaches to derecognition for financial assets and financial liabilities.

Financial assets

The approach proposed for financial assets focuses on the existence of control. This differs from the current guidance in IAS 39 which is primarily concerned with 'risks and rewards' (control being a secondary test). The ED illustrates the proposed approach in a flow chart, which is reproduced on the next page.

Step 1 – identifying the reporting entity

The first step would be to identify the reporting entity from which perspective derecognition is to be assessed. When preparing **consolidated financial statements**, the reporting entity is the **group** and, therefore, derecognition would be assessed for the consolidated entity, including all subsidiaries that are required to be consolidated in accordance with IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation – Special Purpose Entities*. If multiple entities within the consolidated group are part of the transfer arrangement, all contractual arrangements entered into by all entities would be considered in assessing derecognition (e.g. a parent providing a guarantee over the financial assets transferred from one of its subsidiaries to a third party). When preparing **separate financial statements**, the reporting entity is the **separate entity** and, therefore, the derecognition model would be applied at the separate entity level, even if the transferee is part of the same consolidated group.

Step 2 – identifying the "Asset"

The entity would next identify the "Asset" to which the derecognition principles are to be applied. This term is used to refer to either a part of a financial asset (or a part of a group of financial assets) that is assessed separately for derecognition or, otherwise, to a financial asset (or a group of financial assets) in its entirety.

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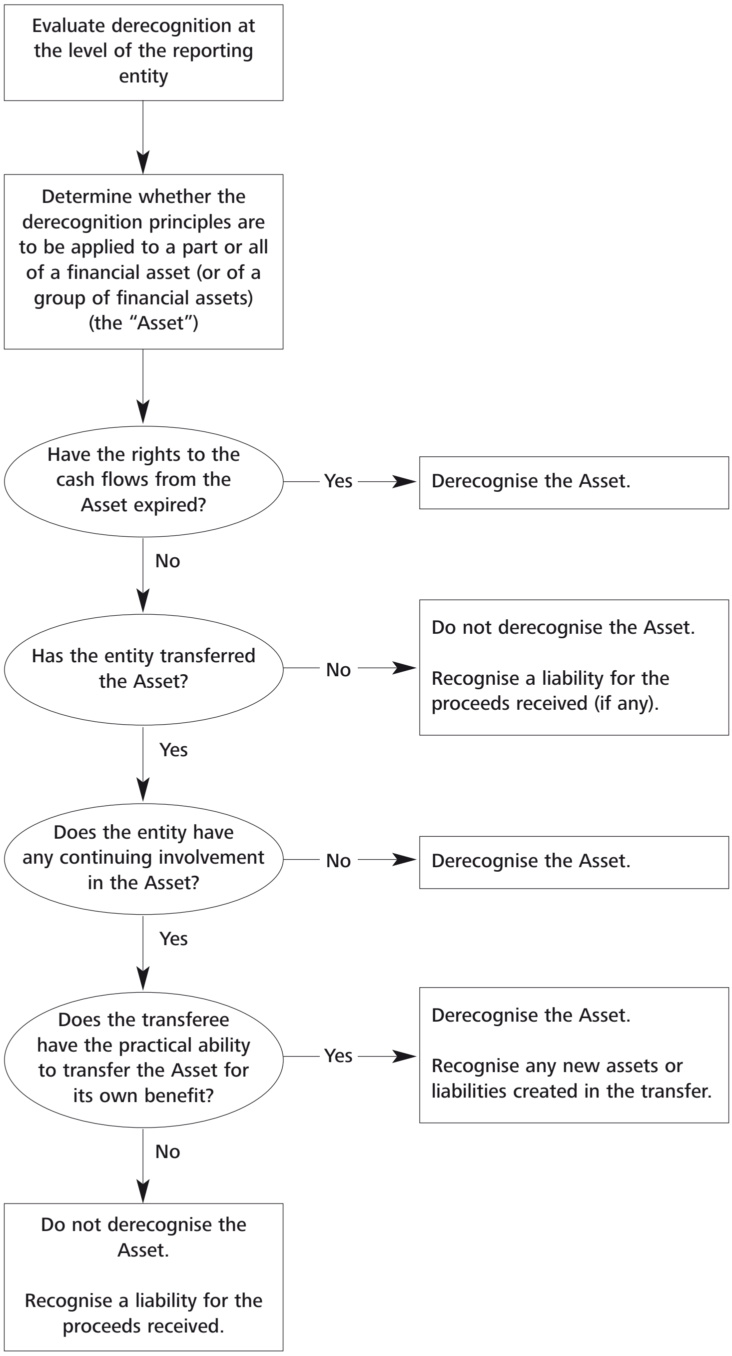
Proposed derecognition model – financial assets



Under the proposals, the derecognition principles would generally be applied to a financial asset in its entirety. Part of a financial asset would be assessed separately only if either:

- that part comprises **specifically identified cash flows**; or
- a **proportionate share** of the cash flows from the financial asset is transferred.

Where there is a transfer of a **disproportionate** part of a financial asset, that part would not be assessed for derecognition; instead, the entire financial asset would be assessed. One example of such a disproportionate transfer would be the transfer of a right to the first 70% per cent of the cash flows of a loan.

A transfer of part of a financial asset that could be an asset or a liability over its life (e.g. an interest rate swap or a forward contract) would not qualify for separate derecognition; instead, the transferred asset would be required to pass both the asset and liability derecognition tests. In the case of a group of assets, any asset that could be an asset or liability during its life would be assessed separately for derecognition (e.g. if a loan portfolio includes an interest rate swap, the swap derivative would be assessed separately for derecognition).

Step 3 – applying the derecognition criteria

For the purposes of applying the derecognition criteria (see below), the term 'transfer' is defined broadly in the ED as including all forms of sale, assignment, provision of collateral, sacrifice of benefits, distribution and other exchange. It includes transferring rights to the cash flows from a financial asset as the Board believes this is akin to transferring the actual cash flows.

The ED proposes that an entity should derecognise an Asset only in the following circumstances:

- the contractual rights to the cash flows from the Asset **expire**; or
- the entity transfers the Asset and has **no continuing involvement**; or
- 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.

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.

The following would not be considered continuing involvement under the proposals:

- **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;
- **servicing rights retained** in a fiduciary or agency relationship; and
- **forward, option and other contracts** associated with reacquiring the asset if the strike price is the fair value of the Asset on the exercise date.

To meet the **'practical ability to transfer'** criterion, the transferee should be in a position to transfer the Asset immediately and unilaterally to an unrelated third party without having to impose additional restrictions on the transfer. The proposed Application Guidance accompanying the ED lists a number of factors to consider when assessing the practical ability to transfer. A practical implication of the proposals would be that many sale and repurchase agreements would qualify for derecognition where such transfers involve readily obtainable financial instruments.

Step 4 – accounting for derecognition
If a transfer qualifies for derecognition, the Asset would be derecognised and any new assets or liabilities recognised and initially measured at fair value. The proposals do not prescribe specific accounting for those new assets and liabilities created (and would delete the current requirements in IAS 39 regarding so-called 'continuing involvement' assets and liabilities).

For transfers of an entire financial asset, any gain or loss arising would be calculated as the difference between (1) the carrying amount of the asset transferred and (2) the sum of the consideration received (including the effects of new assets/liabilities) and any cumulative gain or loss recognised in other comprehensive income (OCI). For transfers of a part of a financial asset, the carrying amount and the amount in OCI would be allocated between the parts transferred and retained using their relative fair values. The ED also addresses situations where the consideration received (in part) is an interest in the entity to which the Asset has been transferred.

If a transfer does not qualify for derecognition, the entity would continue to recognise the entire financial asset and recognise a financial liability for the consideration received (if any). IAS 32 *Financial Instruments: Presentation* would be amended to clarify that neither the asset and the associated liability nor any income or expense arising from them should be offset. Furthermore, the proposals would prohibit the use of the fair value option for the associated liability if the asset transferred (but not derecognised) is measured at amortised cost.

The proposed Application Guidance accompanying the ED includes comprehensive examples illustrating how the new guidance would be applied to specific fact patterns.

The alternative view for financial assets

The alternative model for derecognition of financial assets, supported by five Board members, is also based on control. The main difference when compared to the model discussed in the previous section is that, under the alternative model, an entity would derecognise a transferred financial asset if the transferor ceases to have the ability to (a) obtain all of the future economic benefits inherent in the asset and (b) restrict others' access to those benefits. Therefore, if the transferor's rights to cash flows after the transfer differ from its rights before the transfer, the asset would be derecognised (and, where appropriate, a new asset recognised). The alternative model does not distinguish between a fully proportionate share in cash flows transferred and a disproportionate share. The alternative model would result in a greater likelihood of derecognition of financial assets, and recognition of new assets and liabilities, compared with the model favoured by the majority of the Board.

Financial liabilities

The ED also proposes to amend the guidance on derecognition of financial liabilities to make it more consistent with the IASB's *Framework for the Preparation and Presentation of Financial Statements*. The ED would require derecognition of a financial liability if it **no longer qualifies as a liability** of the entity – i.e. if the present obligation is eliminated and the entity is no longer required to transfer economic resources in respect of that obligation. The ED also includes expanded guidance on debt renegotiations and in-substance defeasances.

The proposed model for derecognising financial liabilities is broadly similar to current requirements in IAS 39.

Disclosures

The ED would significantly increase the disclosures required for transfers of financial assets – whether or not they qualify for derecognition. The proposed disclosures (listed on the next page) are illustrated in the proposed amendments to the Implementation Guidance on IFRS 7 which accompany the ED. All disclosures would be required to be provided in a single note in the financial statements.

Disclosures for transfers of financial assets

Transfers of financial assets not derecognised

For transfers of financial assets that do not result in derecognition, the entity would be required to disclose information that enables users to understand the relationship between the assets still recognised and the associated liabilities. For each class (as determined in accordance with IFRS 7) of such financial assets, the entity would be required to disclose:

(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; and

(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.

Transfers of financial assets derecognised

For transfers of financial assets that result in derecognition, but the entity has continuing involvement, the entity would be required to disclose information that enables users to evaluate the nature of and associated risks with the entity's **continuing involvement** in those derecognised financial assets.

To meet the objective, the entity would be required to disclose the following at the reporting date for each **category**[1] of continuing involvement:

(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 m**aximum 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 IFRS 7.27A/B);

(e) the **undiscounted cash outflows** to repurchase derecognised financial assets (e.g. 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. This analysis would distinguish between cash flows required to be paid, cash flows that may be required to be paid and cash flows that the entity might choose to pay;

(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 would describe the methods and assumptions used in preparing the sensitivity analysis (see relevant sections of IFRS 7.B17–B21); and

(h) **qualitative information** that explains and supports the quantitative disclosures in (a)-(g). This would include information about the derecognised assets, the continuing involvement and the risk the entity is exposed to.

This information would be supplemented by disclosures about the gain or loss recognised at the date of transfer and any income and expense recognised resulting from the entity's continuing involvement. This would include disclosing whether gains or losses arose because the fair value of the components of a recognised financial asset is different to the fair value of the instrument as a whole.

Entities would be required to disclose additional information if the total amount of transfer activity is not evenly distributed over the reporting period. In such circumstances, the entity would be required to disclose the total amount of transfer activity and the related gain or loss in the period within the reporting period that has the greatest transfer activity including when it took place.

An entity would also be required to disclose any additional information to meet the disclosure objective for its continuing involvement in financial assets transferred.

1 In this context, a category is representative of the entity's exposure to risks. For example, the categories could be based on type of continuing involvement (e.g. repurchase agreements) or on type of transfer (e.g. factoring).

Effective date and transition

While not proposing an effective date, the ED explains how transition to the new guidance would work. The general principle for transition to the new guidance would be prospective application, i.e. application to transfers that occur after the effective date. Therefore:

- financial assets and financial liabilities derecognised under the previous guidance would remain derecognised; and

- financial assets and financial liabilities not derecognised under the previous guidance would not be derecognised.

However, earlier application to transactions before the effective date would be permitted if the entity obtained the information necessary to apply the amended guidance on derecognition at the point of initially accounting for those transactions. If an entity chooses to apply the guidance before the effective date, it would have to apply it to all transfers occurring after the early adoption date and disclose that fact.

Next steps

The current expectation is that a final IFRS on this subject will be issued in the first half of 2010.

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