

IFRS news

Emerging issues and practical guidance*

Supplement – June 2009

Derecognition of financial instruments ED

The Board published an exposure draft proposing amendments to IAS 39 and IFRS 7 in March. Ian Farrar and Tracy YH Chen in PwC's Global Accounting Consulting Services in Hong Kong explain the key proposals.

IAS 39 and derecognition of financial assets

The ED includes two approaches to the derecognition of financial assets: the 'proposed model' based on control is favoured by the majority of the Board; the 'alternative view' is supported by the remaining five members. A failed sale results in the asset remaining on the balance sheet under both approaches, with the proceeds received recognised as a financial liability.

Proposed model

The existing model in IAS 39 is primarily 'risks and rewards', with a secondary 'control' test where risks and rewards have neither been substantially transferred nor retained. 'Control' takes centre-stage in the 'proposed model', with a risks and rewards overlay in the form of a test for continuing involvement in the transferred asset. Hopes are that this will reduce one element of the complexity in the current model.

Other complexities have also been removed, including those arising from:

- The strict 'pass-through' criteria; and
- Continuing involvement accounting.

The proposed approach derecognises transferred assets when the entity either:

- Has no continuing involvement in the asset; or
- Retains a continuing involvement but no longer controls the asset.

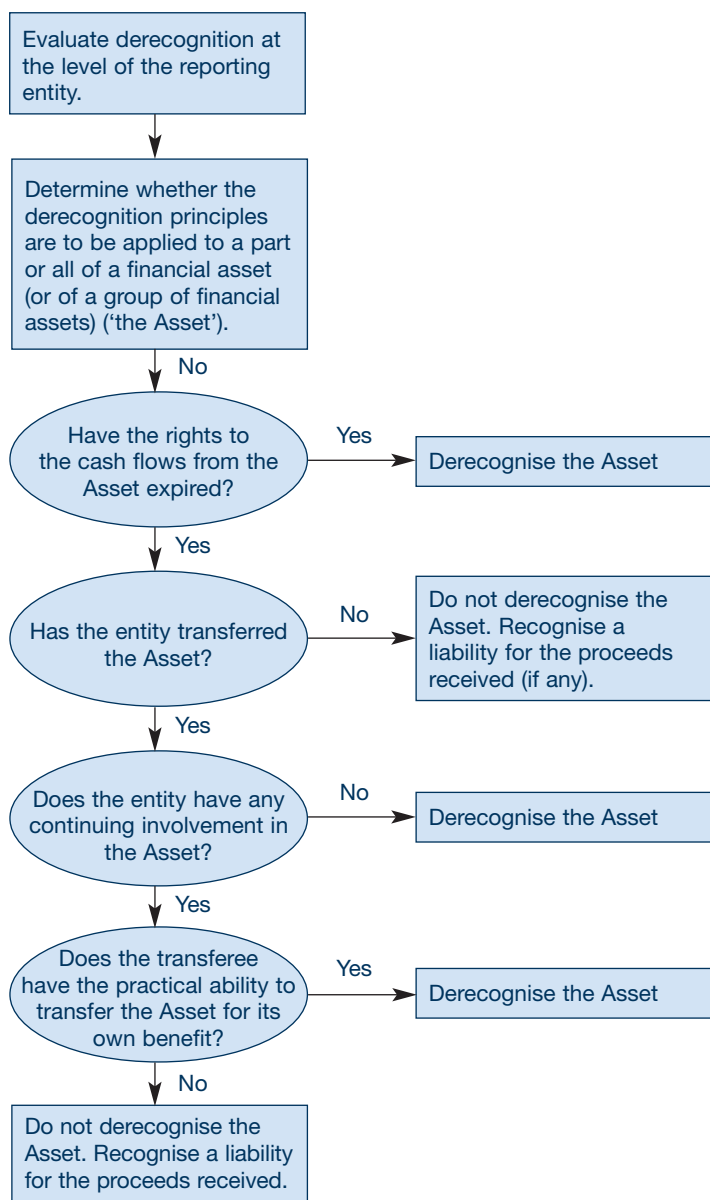
However, some of the existing requirements have been retained in a broadly similar guise in the proposed model. For example, the entity first consolidates all subsidiaries (including SPEs), determines what asset, part of an asset, or group of assets are being considered for derecognition, and derecognises all those financial assets for which the rights to cash flows have expired. See the flowchart on p2.

PwC observation

The requirement for assets to be 'similar' in order for them to be assessed together, as a package, for derecognition has been removed. However, they must meet the definition of a financial asset and cannot include interests that at various times during the instrument's life can be both an asset and a liability (for example, an interest rate swap).

Background

- 2005: Board adds derecognition project to research agenda following criticism that IAS 39 derecognition requirements are complex and can give rise to counter-intuitive accounting.
- July 2008: Board accelerates derecognition project to address recommendations made by the Financial Stability Forum, moving the project it to its active agenda .
- March 2009: ED published, with aim of improving and simplifying the requirements and to enhance disclosures relating to transferred financial assets in which the entity retains a continuity involvement.
- June 2009: roundtable discussions scheduled in Tokyo, London and Toronto to seek constituents' views on the proposals and to explain the interaction between the proposals in this ED and the recently issued ED 10, 'Consolidated financial statements'.
- 31 July 2009: deadline for comments.
- First half of 2010: final standard due.



- Continuing involvement: a transferor has retained a continuing involvement in the asset if, as part of the transfer, it retains any of the contractual rights or obligations inherent in the asset, or obtains any new contractual rights or obligations relating to the asset. Normal representations and warranties, servicing rights retained in a fiduciary or agency relationship, and contracts associated with re-acquiring the asset at fair value (for example, a put, call or forward) are not considered to be continuing involvement.

PwC observation

There is little that explains what represents a fiduciary or agency relationship. However, the ED appears to imply that the retention of servicing rights would be considered continuing involvement unless the transferor could be removed as servicer. Removal rights are not common in factoring agreements, which could result in significantly less derecognition for factoring arrangements under the proposed model.

- Control is the practical ability to transfer for its own benefit. The definition is similar to that in current IAS 39, as it looks to whether the transferee in the transaction has the practical ability to dispose of the asset for its own benefit. To have the practical ability to dispose of the asset, the transferee must be able to make a subsequent transfer to an unrelated third party unilaterally, without having to impose additional restrictions on that transfer.

PwC observation

The definition of control in the ED differs from that applied to an acquirer in the existing IAS 27, 'Consolidated and separate financial statements', and from that proposed in ED 10, 'Consolidated financial statements'. Both consider what the entity is able to do, rather than what third parties can do. ED 10 and the proposed derecognition model are intended to apply a control concept, but it is possible that arbitrage opportunities may arise through the use, or otherwise, of SPEs in derecognition transactions.

Contracts (for example, options and forwards) allowing or requiring the transferee to return an asset that is readily obtainable in the market to the transferor under specified conditions would not restrict the transferee's practical ability to sell the underlying asset. A sale and repurchase transaction ('repo') would therefore qualify for derecognition if the transferred asset is actively traded on an accessible market at the date of transfer.

PwC observation

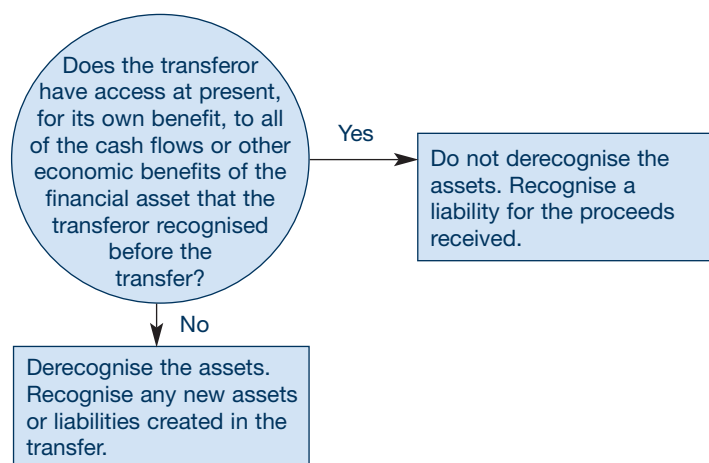
The proposed accounting for 'repo' transactions of readily obtainable financial assets would result in a significant reduction in the gross balance sheet of banks for transactions that traditionally have been viewed as financing arrangements. In addition, the requirement to repurchase the asset would be accounted for as a derivative (a forward contract) measured at fair value through profit or loss.

Alternative view

Derecognition under the alternative approach is also based on control. If the entity has given up control over any of the cash flows of the asset, it no longer controls that asset and hence the asset is derecognised in its entirety. The concept of partial derecognition does not exist in this model. A new asset/liability is recognised for any continuing involvement in the asset retained. See the flowchart on p3.

PwC observation

The alternative approach would result in greater derecognition than either the existing or proposed models, as the transfer of rights to any individual cash flows in the transferred asset would result in derecognition of the entire asset. Another consequence would be increased recognition of gains and losses on retained interests.



IAS 39 and derecognition of financial liabilities

The ED proposes that a financial liability is derecognised when it no longer qualifies as a liability of the entity – that is, when the present obligation is eliminated and a transfer of economic resources in respect of that obligation is no longer required.

PwC observation

The proposed model is similar to the current requirements in IAS 39, with much of the guidance carried forward. Current practice would not be expected to change significantly.

Disclosures under IFRS 7

The ED proposes significant new qualitative and quantitative disclosures for transferred assets that:

- Do not qualify for derecognition; or
- Are derecognised, but in which the entity has retained a continuing involvement.

These disclosures are intended to enable a user to understand the sensitivity of the entity's results and financial position to its continuing involvement in the transferred asset.

New disclosure requirements include:

- The fair value of derecognised financial assets.
- The maximum exposure to loss from the continuing involvement and how it is determined.
- Undiscounted cash outflows required to repurchase derecognised financial assets, and a contractual maturity analysis of such cash flows.
- A sensitivity analysis showing the possible effect on the fair value of the continuing involvement of reasonably possible changes in relevant risk variables.

Additionally, for each category of continuing involvement, the entity discloses:

- The gain or loss recognised at the date of transfer.
- Income and expenses recognised from its continuing involvement.
- Detailed information for unevenly distributed transfer activities during the reporting period.

PwC observation

The disclosure requirements appear to represent a 'shopping list', rather than setting out a principle requiring disclosure of decision-useful information. Preparers may not have the systems in place to capture all the data necessary to meet these disclosure requirements for assets they no longer control.

Effective date and transition

The ED proposes prospective application to transactions entered into after the effective date. Early adoption is permitted if the entity obtained the information necessary to apply the amended derecognition guidance at the point of initially accounting for those transactions.