

IAS 39 – Derecognition of financial assets in practice

October 2008



Preface



Companies have now experienced three full years of applying IAS 39, 'Financial instruments: Recognition and measurement'. During this time the standard has gone through a period of bedding down, and in the process we have worked with companies

to develop solutions to many issues. This is particularly so in the area of derecognition of financial assets. This is one of the most difficult aspects of IAS 39, itself one of the most challenging standards in IFRS.

The derecognition requirements for financial assets have come under heightened scrutiny as a result of the current credit crisis, which has highlighted the complexity of applying IAS 39 to structures designed to achieve derecognition. It has also caused some to question whether the current requirements result in accounting that faithfully represents certain structures. The IASB has recognised these concerns and has accelerated the timetable for its joint project with the FASB to do some 'blue sky thinking' about a possible future approach to derecognition. Nevertheless, it seems that the present model is likely to continue to apply for some time.

Although the markets for sales of financial assets have slowed considerably, transactions are still occurring. As more countries transition to IFRS, many different structures are being analysed to determine the implications of the current requirements on their accounting.

This publication helps explain the current requirements. Section 1 outlines the IAS 39 requirements for the derecognition of financial assets. Section 2 provides answers to some of the questions we are asked most often by companies applying these requirements in practice. Section 3 provides detailed illustrations of how to apply the IAS 39 requirements to some common structures – both 'traditional' structures and some of the more innovative structures that have emerged.

The transactions and solutions set out in this publication are not exhaustive. They do not illustrate all of the possible scenarios involving derecognition; nor do they answer all of the questions that arise in practice. But the pages that follow will answer many of your questions and illustrate how to apply the derecognition requirements to some of the transactions that are available.

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How to use this publication

This publication focuses on the derecognition of financial assets. It does not address derecognition of liabilities nor derecognition of non-financial items (for example, property and inventories). The issues addressed affect corporate entities as well as banks and other financial institutions and, in particular, the financial controllers that work in them. More generally, this publication will be of interest to anyone dealing with securitisation and factoring transactions.

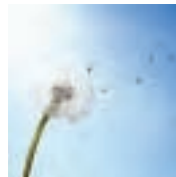
Section 1 contains an overview of the IAS 39 requirements. This sets the scene, particularly for those readers who are less familiar with the standard. It does not cover all matters of detail and should not be regarded as a substitute for referring to IAS 39.

Section 2 covers, in question and answer format, the issues that we are most frequently asked about. The questions and answers in this section are relatively brief. An index is provided as a quick reference guide.

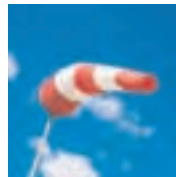
Section 3 provides detailed illustrations of how to apply the derecognition requirements to a range of common transactions. We present the mechanics of applying the IAS 39 requirements for derecognition of financial assets, starting with an analysis using a flowchart (see Appendix), and culminating with the accounting entries. The section starts with a summary of the issues addressed.

Please note that the IFRIC's agenda includes a number of issues in relation to derecognition. The views expressed in this publication are current at the date of publication but are subject to change pending any interpretation issued by the IFRIC. Please ensure that you seek up-to-date information and advice regarding the application of IAS 39 to the particular facts and circumstances involved in any transaction.

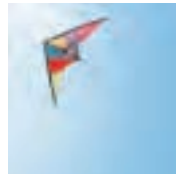
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Section 1

Derecognition theory



Derecognition theory

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Derecognition of financial assets at a glance

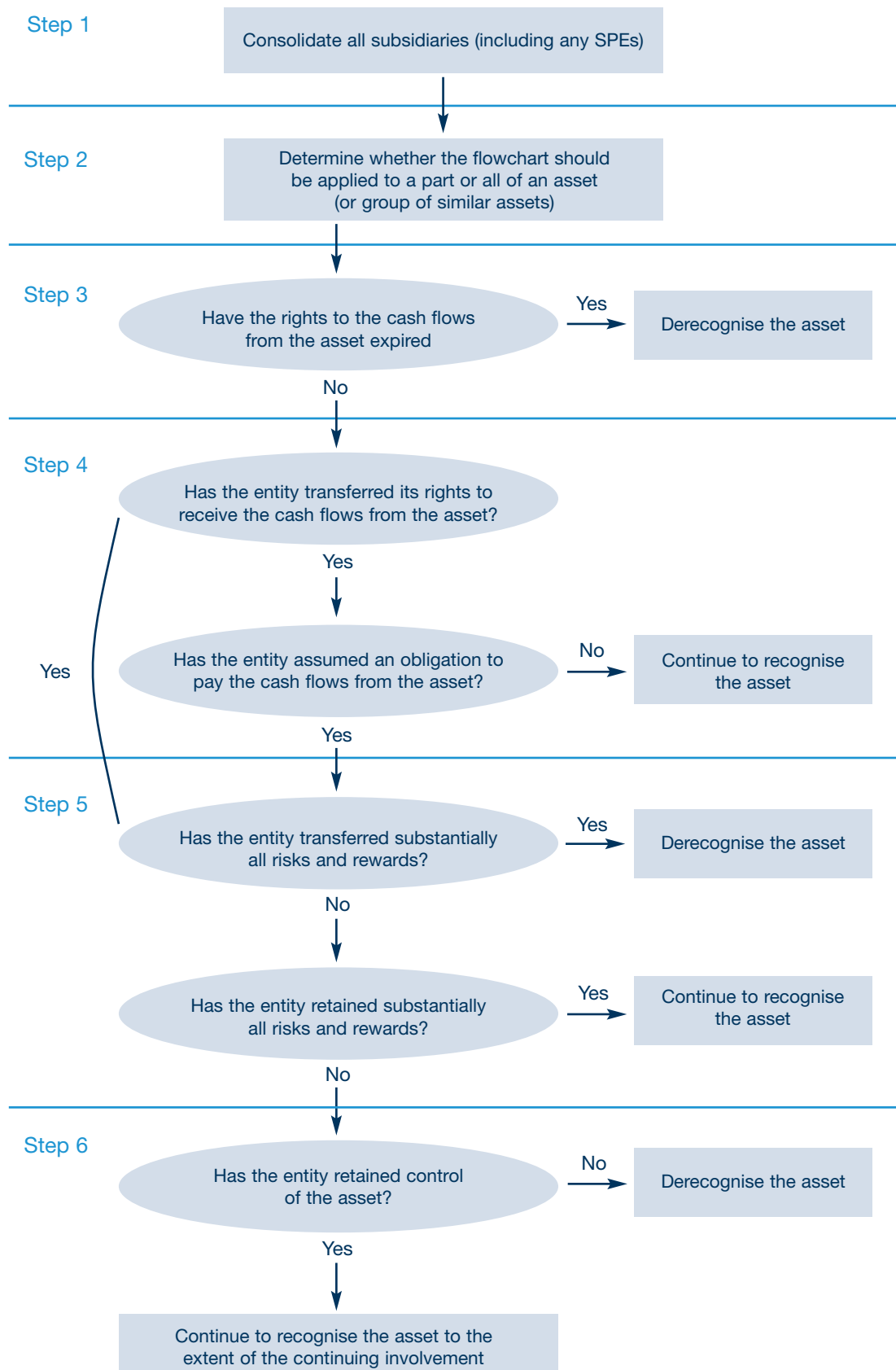
Introduction and background

It is not often difficult to decide whether a financial instrument should be derecognised. For example, if a manufacturer receives cash in settlement of a receivable, there are no longer any rights to receive cash from the asset, and the receivable is derecognised. But many transactions are more complex; as a result, the derecognition requirements in IAS 39, 'Financial instruments: Recognition and measurement', are complex.

IAS 39 contains one set of requirements that apply to the derecognition of all financial assets, from the simple maturity of an instrument to the more complex securitisation transactions. Despite the requirements having been in place for a few years, entities are still learning how to implement some aspects – in particular, the unique model of continuing involvement, which can be challenging to apply in practice. This is also an evolving area because the IFRIC is considering some key issues, and the results of its discussions could significantly affect how some transactions are accounted for. This publication aims to provide an understanding of the requirements and how to apply them in practice.

What are the requirements in IAS 39?

The standard provides a flowchart (below) that summarises IAS 39's requirements for evaluating whether, and to what extent, a financial asset is derecognised. Every transaction should be analysed using the strict sequence set out in the flowchart. Most importantly, there are two separate approaches to derecognition under IFRS – the 'risks and rewards' approach and the 'control' approach. The control approach is only used where the risks and rewards approach does not provide a clear answer. So the risks and rewards approach should also be evaluated first. A detailed explanation of these two approaches and each step of the flow chart follows.



Step 1 – Consolidate all subsidiaries, including any SPEs

The first step is to determine what is the reporting entity that is considering whether to derecognise the financial asset – that is, whether it is the consolidated or the individual entity. If it is the consolidated entity, the entity should first consolidate all subsidiaries, including any special purpose entities (SPEs), in accordance with IAS 27, ‘Consolidated and separate financial statements’, and SIC 12, ‘Consolidation – Special purpose entities’. It then applies the derecognition analysis to the resulting group.

As most complex financing transactions incorporate a number of SPEs, this step is fundamental to understanding the nature of the transaction and the consequential accounting. For example, there may be a legal sale from the entity into a trust (SPE), but if the entity has control of the trust, the analysis of the transaction from the perspective of the consolidated group may be that there is no sale for accounting purposes under IAS 39.

A variety of factors need to be evaluated to determine the substance of the arrangement between an entity and an SPE and whether control is present such that the SPE is consolidated. Indicators of control provided in SIC 12 are:

- the SPE conducts its activities on behalf of the reporting entity;
- the reporting entity has the decision-making power;
- the reporting entity can obtain the majority of the benefits of the SPE; or
- the reporting entity has the majority of the residual or ownership risks of the SPE or of its assets.

The decision to consolidate an SPE is always dependent on specific facts and circumstances; if those change, entities will need to re-assess their consolidation decisions. This is especially relevant in light of current market conditions, where companies are stepping in to support SPEs when there was previously no contractual relationship to do so. The illustrations in this publication provide some examples. For further details on SIC 12, see our publication *SIC-12 and FIN 46R – the substance of control*.

Step 2 – Determine whether the item to be considered for derecognition is all or part of an asset

The next step is to determine whether the analysis should be applied to a part of a financial asset (or part of a group of similar financial assets) or to the financial asset in its entirety (or a group of similar financial assets in their entirety). The derecognition requirements should be applied to a part of a financial asset (or part of a group of similar financial assets) only if the part being considered for derecognition meets one of the following three conditions:

- The part comprises only specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, if an entity enters into an interest rate strip whereby the counterparty obtains the right to the interest cash flows, but not the principal cash flows from a debt instrument, the derecognition requirements are applied to only the interest cash flows.
- The part comprises only a fully proportionate (pro rata) share of the cash flows from a financial asset (or a group of similar financial assets). For example, if an entity enters into an arrangement in which the counterparty obtains the rights to a 90% share of all cash flows of a debt instrument, the derecognition requirements are applied to that 90% of the cash flows. If the rights to 90% of the cash flows of an asset of C100 are transferred and only C90 is recovered, the transferee receives C81 and not C90.

- The part comprises only a fully proportionate (pro rata) share of specifically identified cash flows from a financial asset (or a group of similar financial assets). For example, if an entity enters into an arrangement in which the counterparty obtains the rights to a 90% share of interest cash flows from a financial asset (the specifically identified part), the derecognition requirements are applied to that 90% of the interest cash flows.

The above criteria should be applied strictly to determine whether the derecognition requirements should be applied to the whole asset or to only a part of the asset. If none of the above criteria is met, the derecognition requirements are applied to the financial asset in its entirety (or to the entire group of similar financial assets).

Once it has been established whether the derecognition requirements should be applied to the whole asset (or the whole of a group of similar assets) or to a qualifying part or portion identified in step 2, the remaining steps are applied to the whole or part identified. This is referred to as ‘the financial asset’ in the steps below [IAS 39.16].

Helpful hint

IFRIC is considering the treatment of transfers of groups of dissimilar but related contracts in a single transaction (for example, a transfer of loans and interest rate swaps or loans and guarantees). Our view on this issue is set out in Q&A 2.12 but may change if IFRIC reaches a consensus.

Step 3 – Determine whether the rights to the cash flows from the asset have expired

Once the entity has determined at what level (entity or consolidated) it is applying the derecognition requirements and to what identified asset (individual, group or component) those requirements should apply, it can start assessing whether derecognition of the asset is appropriate.

Step 3 considers whether the contractual rights to the financial asset have expired. If they have, the financial asset is derecognised. This would be the case, for example, when a loan is extinguished, in the normal course, by payment of the entire amount due, thereby discharging the debtor from any further obligation. Derecognition at this step is generally obvious and requires little or no analysis [IAS 39.17].

Helpful hint

The sale of a financial asset does not fall under this step, as the contractual rights to cash flows from the asset continue to exist even if the seller no longer has the rights to them. The seller would therefore need to consider the steps further down the flowchart.

Transfers

Step 4 – Is there a transfer?

If the contractual rights to the cash flows from the asset still exist, the asset is transferred before derecognition is possible. IAS 39 identifies two ways in which a transfer can be achieved. An entity ‘transfers’ a financial asset only if it either:

- transfers the contractual rights to receive the cash flows of the financial asset, or
- retains the contractual rights to receive the cash flows of the financial asset, but assumes a contractual obligation to pay the cash flows to one or more recipients, in what is often referred to as a ‘pass-through arrangement’ [IAS 39.18].

IAS 39 does not explain what is meant by the phrase ‘transfers the contractual rights to receive the cash flows of the financial asset’. A literal reading of the words could suggest an asset’s legal sale, or a legal assignment of the rights to the cash flows from the asset. For example, an entity that has sold a financial asset (such as a legal sale of a bond) has transferred its rights to receive the cash flows from the asset. In this situation, the transferee has unconditional, currently exercisable rights to all the future cash flows. The transfer should then be assessed in step 6 to determine whether it qualifies for derecognition.

Some types of financial asset (for example, a receivable or a portfolio of receivables) cannot be ‘sold’ in the same way as other types (for example, a bond), but they can be transferred by means of a novation or an assignment. Both novation and assignment will generally result in the transfer of contractual rights to receive the financial asset’s cash flows. However, any conditions or obligations placed upon the transferor should be considered and may impact this assessment.

Sometimes transfers of financial assets are made subject to certain conditions. Conditions attached to a transfer could include provisions relating to the existence and value of transferred cash flows at the date of transfer or conditions relating to the future performance of the asset (see Q&A 2.3). In our view, such conditions would not affect whether the entity has transferred the contractual rights to receive cash flows (under paragraph 18(a)). However, the existence of conditions relating to the future performance of the asset might affect the conclusion related to the transfer of risks and rewards, as well as the extent of any continuing involvement by the transferor in the transferred asset.

In some instances, following the transfer of the contractual rights to receive a financial asset’s cash flows, the transferor may continue to administer or provide servicing on the transferred asset. For example, a transferor may transfer all rights to cash flows but continue to collect cash flows on behalf of the transferee in the capacity of an agent rather than for its own benefit. This could occur where the original asset counterparties are notified that their obligation has been legally transferred to the transferee and are requested to pay the cash flows into a bank account for the transferee’s benefit. In this case, the transferor acts purely as an agent in managing the collection of the transferee’s cash flows. Determining whether the contractual rights to cash flows have been transferred is not affected by the transferor retaining the role of an agent to administer collection and distribution of cash flows. Therefore, retention of servicing rights by the entity transferring the financial asset does not in itself cause the transfer to fail the requirements in paragraph 18(a) of IAS 39.

Helpful hint

IFRIC has a project on its agenda to consider what is meant by a transfer of contractual rights. Specifically, do transfers in the form of equitable assignments (where the debtor is not notified that their debt has been transferred), or where there are set-off rights, etc, preclude a transfer from being in IAS 39 paragraph 18(a) and therefore require those transactions to meet the pass-through requirements? Our views on these issues are set out in Q&As 2.4, 2.5, 2.7, 2.8, and 2.9 but may change once IFRIC has reached a consensus.

Pass-through arrangements

If there is no transfer of contractual rights under IAS 39 paragraph 18(a), an entity should determine if there is an obligation to pass on the cash flows of the financial asset under a pass-through arrangement. For example, a transferor that is a trust or SPE may issue beneficial interests in the underlying financial assets to investors but continue to own those financial assets.

All the following conditions have to be met to conclude that such pass-through arrangements meet the criteria for a transfer:

- The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.

- The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.
- The entity has an obligation to remit any cash flows that it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except in cash or cash equivalents (as defined in IAS 7, 'Cash flow statements') during the short settlement period from the collection date to the date of required remittance to the eventual recipients, with any interest earned on such investments being passed to the eventual recipients [IAS 39.19].

The financial assets remain on the balance sheet if any one of these conditions is not met.

Helpful hint

An eventual recipient is any party that may receive cash flows from the assets, excluding the transferor. Most often, they are the noteholders that have invested in a group of securitised assets, but they can also be swap counterparties or credit insurers that have an interest in the assets.

If a transfer meets the pass-through requirements, the transferor is deemed to have transferred the asset. However, the transferor will still then need to assess whether it has transferred sufficient risks and rewards associated with the asset to achieve derecognition.

These pass-through conditions follow from the definitions of assets and liabilities in the IASB Framework.

The first condition ensures that the transferor is not obliged to transfer any cash flows to the transferee other than those it has collected from the transferred asset. This implies that the transferor has no liability arising from the transaction, as it has no obligation to pay cash.

The second condition regarding the transferor's ability to sell or pledge the financial assets highlights that the transferor does not control access to the future economic benefits associated with the transferred cash flows and therefore may not have an asset.

The third condition ensures that the transferor does not have use of or benefit from the specific cash flows it collects on behalf of the transferee and is required to remit to them 'without material delay'. Again, this condition helps ensure that the transferor does not have an asset. An immaterial delay is permitted for practical reasons. For example, in some pass-through arrangements, such as a securitisation of a portfolio of mortgages, it is not practical for the entity to transfer the relatively small amount of cash collected from many individual accounts as and when they arise. Instead, for administrative convenience, the contractual arrangement may provide for cash flows to be remitted in aggregate on a monthly or quarterly basis.

The third condition also restricts any investment made for the transferee's benefit to cash or cash equivalents as defined in IAS 7. This means that the transferor is not allowed to invest the funds in other high-yielding medium-term investments, even for the benefit of the transferee. Furthermore, the transferor is not permitted to retain any interest from such short-term highly liquid investments. All such interest received is remitted to the transferee. In practice, the funds are often paid into a trustee bank account for the transferee's benefit

Helpful hint

Most revolving securitisation transactions that involve a consolidated SPE fail to meet the pass-through requirements. This is because the cash flows from the assets are not passed on to eventual recipients without material delay and are reinvested in new assets that are not cash and cash equivalents, before being passed onto eventual recipients. See Q&A 2.10.

The effect of meeting all three pass-through conditions above is that the transferor does not have the rights to particular cash flows arising from the asset (second and third conditions) or a liability to pass on those

particular cash flows (first condition), as defined in the Framework. In these situations, the transferor may act more as an agent of the eventual recipient than the owner of the asset. Therefore, when those conditions are met, the arrangement is treated as a transfer of the contractual rights to the cash flows and considered for derecognition (ie, is subject to the risks and rewards and control tests – see below). When the conditions are not met, the transferor acts more as an owner of the asset, with the result that the asset should continue to be recognised. In this case, the transferor still has the rights to the particular cash flows arising from the asset.

Helpful hint

IFRIC is considering the treatment of transfers of group of dissimilar but related contracts in a single transaction (for example, loans and interest rate swaps or loans and guarantees). This will have implications for what is meant by the original asset in the pass-through tests. Our view on this issue is set out in Q&A 2.12 but may change once IFRIC has reached a consensus.

Risks and rewards

Step 5 – Analysis of risks and rewards

Once an entity has established that it has transferred a financial asset either by transferring the contractual rights to receive the cash flows or under a qualifying pass-through arrangement as discussed above, it carries out the risks and rewards test. This requires the entity to evaluate whether it has:

- transferred substantially all the risks and rewards of ownership of the financial asset;
- retained substantially all such risks and rewards; or
- has neither transferred nor retained substantially all such risks and rewards. In this case, the entity moves on to assess whether it has transferred control [IAS 39.20].

An entity derecognises an asset if it transfers substantially all the risks and rewards of ownership of the asset. Examples of when an entity has transferred substantially all the risks and rewards of ownership are:

- An unconditional sale of a financial asset for a single fixed cash sum;
- A sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase. In this situation, the entity is no longer exposed to any value risk (potential for gain or exposure to loss) on the transferred asset, which is borne by the buyer. The ability for the seller to buy the asset back at its fair value at the date of repurchase is, in terms of risks and rewards, no different from buying a new asset; and
- A sale of a financial asset together with a put or call option that is deeply out of the money (that is, an option that is so far out of the money that it is highly unlikely to go into the money before expiry). In this situation, the seller has no substantial risks and rewards because there is no real possibility that the call or put option will be exercised.

Conversely, the entity continues to recognise the asset if it retains substantially all the risks and rewards of ownership of the asset. Derecognition requires the transferor's exposure to the risks and rewards of ownership to change substantially. Examples of when an entity has retained substantially all the risks and rewards of ownership are:

- A sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return (for example, a repo or securities lending agreement);
- A sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity; and
- A sale of a financial asset together with a deep in-the-money put or call option (that is, an option that is so far in the money that it is highly unlikely to go out of the money before expiry).

The transfer of risks and rewards is evaluated based on the entity's exposure, before and after the transfer, to the variability in amount and timing of the net cash flows. All reasonably possible variability in net cash flows (as to amounts and timing) should be considered, and greater weight should be given to those outcomes that are more likely to occur [IAS 39.21]. The determination of whether the entity has transferred or retained substantially all the risks and rewards of ownership will often be apparent from the terms and conditions of the transfer. Where this is not obvious, the entity should undertake a quantitative evaluation. That evaluation requires the entity to compute and compare the entity's exposure before and after the transfer to the variability in the amounts and timing of the net cash flows of the transferred asset. If the entity's exposure to such variability is no longer significant in relation to the total variability associated with the financial asset, the entity is regarded as having transferred substantially all the risks and rewards of ownership of the financial asset.

If this comparison demonstrates that the entity's exposure to the variability in the present value of the future net cash flows (discounted at the appropriate current market interest rate) from the financial asset does not change significantly as a result of the transfer, the entity is regarded as having retained substantially all the risks and rewards of ownership of the asset. The computational comparison for derecognition is a relative and not an absolute test: the significance of the entity's exposure to variability in the amounts and timing of the net cash flows of the transferred asset is measured in relation to the total variability of that asset.

Example – Variability in the amounts and timing of cash flows

An entity sells a portfolio of short term 30-day receivables with a nominal value of C1 billion to a third party. The entity guarantees first losses on the portfolio up to 1.25% of the loan volume. The average loss on similar receivables over the last 10 years amounts to 2%.

The expected losses are C20m, and the entity has guaranteed C12.5m. It might therefore appear that, as the entity has guaranteed 62.5% of all the expected losses, it has retained substantially all the risks and rewards of ownership. This is not so, as the calculation cannot be done in this manner. The test looks to who absorbs variability in the asset's cash flows, rather than who has most of the expected losses. By giving a guarantee, the entity has effectively retained a subordinated interest in the receivables. If the subordinated retained interest absorbs all of the likely variability in net cash flows, the entity retains the risks and rewards of ownership and continues to recognise the receivables in their entirety. However, this is not the case in this example. Therefore, in order to perform a risk and rewards analysis, it is necessary to determine the variability in the amounts and timing of the cash flows both before and after the transfer on a present value basis.

One way in which such a determination can be made is outlined below:

- The first step is to model different scenarios of cash flows from the C1 billion receivables portfolio that reflects the variability in the amounts and timing of cash flows before the transfer.
- For each scenario, the present value of the cash flows is calculated by using an appropriate current market interest rate.
- Probabilities are then assigned to each scenario considering all reasonably possible variability in net cash flows, with greater probability weighting given to those outcomes that are more likely to occur.
- An expected variance is then calculated that reflects the cash flows' total variability in the amounts and timing.

The above steps are repeated for cash flows that remain after the transfer.

The expected variance after the transfer is compared with the variance before the transfer to determine whether there has been a significant change in the amounts and timing of cash flows as a result of the transfer. If the change is not significant, it can be concluded that there has been no substantial transfer of the risks and rewards of ownership. If the change is significant, it can be concluded that the risks and rewards of ownership have been substantially transferred.

An illustration of the above modelling is shown below. For illustrative purposes, only six scenarios are included in this example. More scenarios may be required in practice to adequately model the variability in net cash flows of the asset.

Pre-transfer

Scenarios	PV of future cash flows	Probability %	Expected PV	Variability in PV	Probability weighted	Expected Variability
	1	2	3 = 1*2	4 = 1- \sum 3	5=2*4	
Low loss	990,000	15.00	148,500	11,050	1,658	1,658
Normal loss and few late payments	985,000	20.00	197,000	6,050	1,210	1,210
Normal loss	980,000	35.00	343,000	1,050	368	368
Normal loss and many late payments	970,000	25.00	242,500	-8,950	-2,238	2,238
High loss	960,000	4.50	43,200	-18,950	-853	853
Very high loss	950,000	0.50	4,750	-28,950	-145	145
		<u>100.00</u>	<u>978,950</u>	<u>-38,700</u>	<u>0</u>	<u>6,472</u>

Post-transfer

Scenarios	PV of future cash flows	Probability %	Expected PV	Variability in PV	Probability weighted	Expected Variability
	1	2	3 = 1*2	4 = 1- \sum 3	5=2*4	
Low loss	10,000	15.00	1,500	-2,125	-319	319
Normal loss and few late payments	12,500	20.00	2,500	375	75	75
Normal loss	12,500	35.00	4,375	375	131	131
Normal loss and many late payments	12,500	25.00	3,125	375	94	94
High loss	12,500	4.50	563	375	17	17
Very high loss	12,500	0.50	63	375	2	2
		<u>100.00</u>	<u>12,125</u>	<u>-250</u>	<u>0</u>	<u>638</u>

The relative variability retained after the transfer = $638/6,470 = 9.86\%$. This implies that the entity has transferred substantially all of the risks and rewards of ownership of the receivables.

In the above example, the cash flows' present value with their associated probabilities constitutes a discrete random variable, for which it is possible to derive an absolute value for the variability, as indicated above. A better measure would be to calculate the variance. However, in this example, that would also produce the same conclusion.

Warning

In practice, the calculation may not be so simple and specialist advice should be sought. This example is for illustrative purposes only.

Helpful hint

Examples of the various risks and rewards that will need to be considered include: interest rate risk, credit risk, foreign exchange risk, equity price risk, late-payment risk and pre-payment risk, depending on the particular asset that is being considered for derecognition. For example, in the case of short-term trade receivables, the main risks to consider are likely to be credit risk and late-payment risk and perhaps foreign currency risk if they have been transacted in a foreign currency. In the case of mortgages, the key risks to consider are likely to be interest rate risk, credit risk, and in the case of fixed rate mortgages, in particular, pre-payment risk.

Control and continuing involvement**Step 6 – Control**

Under IAS 39, control in this context is different from the notion of control in IAS 27 – the power to govern so as to obtain benefits. The notion in IAS 27 focuses on the powers of the entity (transferor) and implies an ability to manage the asset actively. In contrast, in the context of derecognition under IAS 39, control is based on whether the transferee has the practical ability to sell the asset. This IAS 39 notion addresses the extent that the transferor continues to be exposed to the cash flows of the particular asset that was the subject of the transfer as opposed to be exposed to risks of a more general nature, similar to a derivative.

IAS 39 explains that the transferee has the ‘practical ability’ to sell the transferred asset if:

- The transferee can sell the asset in its entirety to an unrelated third party; and
- The transferee is able to exercise that ability unilaterally and without imposing additional restrictions [IAS 39.23].

In the context of the first bullet point above, the transferee has the practical ability to sell the transferred asset if it is traded in an active market because the transferee could repurchase an identical asset in the market if it needs to return the asset to the entity. For example, an entity (the transferor) may transfer a security with an option (neither deeply in nor out of the money) attached that allows the entity to repurchase the security at some future date. If there is an active market in the security, the transferee is able to sell the security to a third party, knowing that it will be easy to obtain a replacement asset and fulfil its obligation if the transferor exercises the option.

The concept of control focuses on what the transferee is able to do in practice; in this case, it is important that an active market exists. If there is no market, as is commonly the case for many kinds of loans and receivables, the transferee is unable to ensure that it can fulfil its obligation to return the asset to the transferor if it sells the asset with no right to repurchase it. Whether the transferee intends to sell the transferred asset is of no relevance as long as it has the practical ability to do so. Similarly, a contractual right to dispose of the transferred asset has little practical effect if there is no market for the transferred asset.

In the context of the second bullet point above, the transferee should also be able to exercise its ability to transfer the asset independent of the actions of others and without having to impose additional restrictions or ‘strings’ to the transfer. For example, if the transferor has imposed obligations on the transferee concerning the servicing of a loan asset, the transferee should attach a similar provision to any transfer that it makes to a third party. Such ‘additional restrictions’ or ‘strings’ impede the free transfer of the asset and fail the ‘practical ability to sell’ test.

Where the transferor writes a put option or provides a guarantee of the original asset, the transfer will also often fail the control test. In these cases, the transferee has effectively bought two assets: the asset that is subject to the transfer and either a guarantee or a put option. Selling the transferred asset on its own immediately invalidates the remaining asset, as the transferee immediately loses any ability to realise its value. In the absence of an active market, the transferee will only be able to realise the value of the asset by selling a

similar guarantee or put option with the assets. Put another way, if the put option or guarantee is valuable enough for significant risk to be retained by the transferor, it precludes the transfer of control. That is, it will be so valuable to the transferee that the transferee would not, in practice, sell the transferred asset to a third party without attaching a similar option or guarantee, or otherwise mirroring the conditions attached to the original transfer. Under these circumstances, as the transferee is constrained from selling the asset without attaching additional strings, the ‘practical ability’ test is failed. The result is that control of the transferred asset is retained by the transferor.

If the transferee has the practical ability to sell the transferred asset, the transferee has control over the asset and the transferor has lost control. The transferor derecognises the asset. On the other hand, if the transferee does not have the practical ability to sell the transferred asset, the transferor has retained control of the transferred asset and continues to recognise the asset to the extent of its continuing involvement.

Helpful hint

Why is control so important? This concept helps determine how the transferor’s remaining interest in the asset will be presented: if the transferor has retained control, it still has an interest in the specific assets that have been transferred; therefore, it continues to show that interest on the balance sheet, gross of an offsetting liability. If control has been lost, the transferor still shows its remaining economic interest on the balance sheet, but it is presented net. This recognises that the transferor’s interest is a net exposure (ie, more akin to a derivative) rather than an interest directly related to the specific assets that have been transferred.

Continuing involvement

The continuing involvement approach applies if the entity has neither transferred nor retained substantially all the risks and rewards of ownership and control has not passed to the transferee. Under the continuing involvement approach, the entity continues to recognise part of the asset. That part represents the extent of its continuing exposure to the risks and rewards of the transferred asset. That is, the continuing involvement asset will include both obligations to support the risks arising from the asset’s cash flows (for example, if a guarantee has been provided) and the right to receive benefits from these cash flows. A liability is also recognised in these circumstances. IAS 39 contains some guidance on how to account for certain scenarios.

The principle underlying continuing involvement is to reflect on the balance sheet the maximum amount of the entity’s exposure to the particular asset being transferred. For example, in the case where a guarantee is the cause of the continuing involvement, the continuing involvement asset is measured at the lower of the carrying amount of the asset and the maximum amount the entity could be required to pay under the guarantee (for example, the guaranteed amount).

For example, an entity sells a C10,000,000 portfolio of receivables to a factor where the average expected losses are 5% and the seller guarantees the first 4% of losses. If the analysis shows that the transaction falls into the continuing involvement box in the flowchart, the continuing involvement asset is C400,000, as that is the maximum amount the entity could be required to repay. The associated liability is measured at that maximum amount plus the fair value of the guarantee (for example, if the fair value of guarantee is C50,000, the liability is C450,000). Therefore the net result of the asset and liability recognised in the balance sheet is the fair value of the guarantee (ie, C50,000). If the transaction results in control being transferred, the entity derecognises the asset and recognises only the fair value of the guarantee as a liability.

Another example of continuing involvement is presented in paragraph AG52 of IAS 39. Consider a securitisation transaction in which C1,000 of assets are transferred and the seller retains a subordinated interest of C100 in that pool. If the analysis shows that the transaction is to be accounted for using the continuing involvement approach (which, inter alia, requires that the buyer assumes some risks and rewards), the continuing involvement approach typically results in the seller showing an asset of C200 and a liability of C100. This gives a net asset of C100, which might be expected as it represents the retained subordinated

interest of C100. However, the gross numbers can be confusing. AG52 analyses the transaction as comprising (a) a retention of a non-subordinated 10% interest in the assets, plus (b) the subordination of that interest, that is equivalent to the seller providing a credit guarantee. Both these elements result in continuing involvement and both are accounted for. The first element (the retention of a non-subordinated 10% interest) results in a continuing involvement asset of C100. In addition, the second element (the subordination of that interest, which is equivalent to the seller providing a guarantee of the first C100 of losses) also results in a continuing involvement asset of C100, and a liability of C100 (being the maximum amount the entity may have to pay by losing the C100 asset recognised for the first element). Therefore the seller will recognise a total continuing involvement asset of C200 and a liability of C100.

Continuing involvement is a unique model, and the IASB has provided limited guidance on how to apply it. There are challenges in interpreting this model, and it is not always easy to rationalise what it means. Illustrations 6, 8, and 9 in section 3 provide further examples of how it might be interpreted.

Accounting treatment

If there is a transfer, the accounting results can be summarised in the following diagram:

Risks and rewards			
←			→
Transferred substantially all	Transferred some		Retained substantially all
↓	Do not control assets	Control assets	↓
↓	↓	↓	↓
Full derecognition*	Full derecognition*	Continuing involvement	No derecognition

*With recognition of any new assets or liabilities

Full derecognition (off balance sheet)

An entity that derecognises a financial asset in its entirety includes the difference between the carrying amount of the asset and the consideration received (including any cumulative gain or loss that had been recognised directly in equity) in the income statement. An entity that derecognises only a part of a larger financial asset allocates the previous carrying amount of the financial asset between the part that continues to be recognised and the part that is derecognised based on relative fair values at the date of transfer. The difference between the carrying amount allocated to the part derecognised (including any cumulative gain or loss relating to the part derecognised that had previously been recognised in equity) and the consideration received is included in the gain or loss on derecognition

Helpful hint

It may be difficult to determine the fair values of the parts of a larger asset that are derecognised and continue to be recognised. Where there are no available market prices, the best estimate of the fair value of the part that continues to be recognised is the difference between the fair value of the larger financial asset as a whole and the consideration received from the transferee for the part of the asset that is derecognised.

No derecognition (on balance sheet)

A transaction is accounted for as a collateralised borrowing if the transfer does not satisfy the conditions for derecognition. The entity recognises a financial liability for the consideration received for the transferred asset. If the transferee has the right to sell or repledge the asset, it is presented separately in the balance sheet (for example, as a loaned asset, pledged security or repurchased receivable). In subsequent periods, the entity recognises income relating to the transferred assets and any expense incurred on the financial liability. Where a derivative forms part of the transaction and precludes the asset from being derecognised, the derivative is not accounted for separately, as this would result in the derivative being accounted for twice.

Full derecognition with recognition of new assets or liabilities retained

When an entity has neither transferred nor retained substantially all the risks and rewards but has transferred control, it derecognises the financial asset and recognises separately as assets or liabilities any rights and obligations created or retained in the transfer. For example, if an entity sells an asset that is traded in an active market but retains a call option to buy back that asset at a fixed price, the transferor derecognises the asset and recognises the call option.

Continuing involvement

Under the continuing involvement approach, the entity continues to recognise part of the asset. The amount of the asset that continues to be recognised is the maximum amount of the entity's exposure to that particular asset or its previous carrying amount, if lower. The presentation of the asset and liability will result in the recognition of the entity's remaining exposure on the balance sheet on a gross basis (ie, both an asset and a liability). The asset will be measured either at fair value if the asset was previously held at fair value, or at amortised cost if the asset was previously accounted for on that basis. The treatment of the changes in the liability should be consistent with the treatment of changes in the asset. Consequently, when the transferred asset is classified as available for sale, gains and losses on both the asset and the liability are taken to equity.

Where a guarantee causes the continuing involvement, the asset recognised at the date of transfer is measured at the lower of the carrying amount of the asset and the maximum amount of the consideration received in the transfer that the entity could be required to repay (the guaranteed amount). As the net amount of the asset and associated liability represents the fair value of the guarantee, the associated liability is the balancing number. The liability is initially measured at the guarantee amount plus the fair value of the guarantee (which is normally the consideration received for the guarantee). The diagram below explains this visually.

Guarantee first x% of credit losses

Balance sheet	
Asset	Liability
Lower of carrying amount and maximum payment (guaranteed amount)	Guaranteed amount + fair value of guarantee
<div style="border: 1px solid black; padding: 5px; display: inline-block;"> Net balance sheet position is the fair value of the guarantee </div>	

The component of the liability attributable to the guarantee is subsequently recognised in profit or loss on a systematic basis in the same way as any other guarantee fee is amortised under IAS 18, to the extent that the asset was previously measured at amortised cost, or remeasured to fair value if the asset was previously at fair value. Repayments on the underlying assets are reflected by a reduction in the carrying amount of both the asset and the liability. For assets previously measured at amortised cost, any impairment in the recoverability of the asset is accounted for as normal under IAS 39, with no adjustment to the carrying amount of the liability.

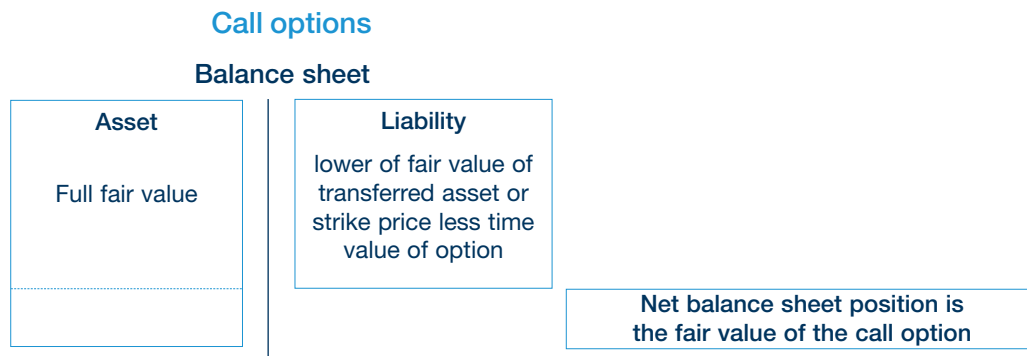
Where a written put option is the cause of the continuing involvement, and the asset was previously measured at fair value, the transferred asset is measured at the lower of fair value and the option's strike price, as the entity has no exposure to increases in fair value above the strike price (ie, the maximum amount it continues to be exposed to is the lower of the strike price or fair value). As the net amount of the asset and associated liability has to be the fair value of the option, the associated liability is the balancing number. It is initially measured at the option strike price plus the time value of the option.

Put option

Balance sheet	
Asset	Liability
Lower of strike and fair value	Strike + time value of put
<div style="border: 1px solid black; padding: 5px; display: inline-block;"> Net balance sheet position is the fair value of the put option </div>	

Subsequently, any changes in the fair value of the transferred asset and associated liability are accounted for consistently such that at all times the net amount is the fair value of the option. For example, if the asset was previously classified as an AFS equity investment, any changes in the fair value of the transferred asset and associated liability (other than impairments) are recognised in a separate component of equity.

Where a purchased call option is the cause of the continuing involvement and the asset was previously measured at fair value, the transferred asset continues to be measured at fair value. The net amount of the asset and associated liability is always the fair value of the option. The associated liability is the balancing number and is measured initially at (a) the lower of the fair value of the transferred asset or the strike price less (b) the time value of the option. Where the asset was previously measured at amortised cost, the asset continues to be measured at amortised cost, and the liability is measured at the consideration received (cost). The liability is subsequently adjusted for the amortisation of any difference between its initial cost and the carrying value of the transferred asset at the expiration date of the option. If the option is exercised, any difference between the carrying amount of the associated liability and the exercise price is recognised in profit or loss.



Subsequently, any changes in the fair value of the transferred asset and associated liability are accounted for consistently with each other.

Helpful hint

If a written put option or a purchased call option prevents a transferred asset from being derecognised and the transferred asset was previously measured at amortised cost, the associated liability is measured at its cost (ie, the consideration received) adjusted for the amortisation of any difference between that cost and the amortised cost of the transferred asset at the date of expiry of the option.

For example:

- the transferor sells an amortised cost asset and writes a put to the transferee for C95.
- The amortised cost of the asset on the date of transfer is C98.
- The amortised cost of the asset on the expiration of the option will be C100.
- The fair value of the asset on the date of the transfer is C92.
- The exercise price of the written put is C90 and therefore the premium received for writing the option consists entirely of time value, being C3.

In this case, the accounting is as follows:

- The asset will continue to be recognised at C98.
- The associated liability will be recognised at the consideration received, C92.
- The difference between the C95 and C100 is recognised in profit or loss using the effective interest method.
- If the option is exercised, any difference between the carrying amount of the associated liability and the exercise price is recognised in profit or loss.

Servicing assets and liabilities

If an entity transfers a financial asset that qualifies for derecognition and retains the right to service it for a fee, it recognises either a servicing asset or a servicing liability for the servicing contract that is initially measured at fair value. A liability for the servicing obligation is recognised if the fee to be received is not expected to compensate the entity adequately for performing the servicing. An asset is recognised for the servicing contract if the fee to be received is expected to be more than adequate compensation for the servicing. Adequate compensation is determined by benchmarking what a normal market servicer would earn for providing the servicing. Subsequently, servicing assets or liabilities are amortised rateably over the service period.

Transferee's accounting

The transferee cannot account for an asset that the transferor was not able to derecognise and vice versa. It is therefore important for a transferee to assess whether IFRS would require the transferor to derecognise the asset.

- **Full derecognition for the transferor**
If a transfer of a financial asset qualifies for derecognition, the transferee recognises the asset as its own and classifies it according to the criteria in IAS 39. In addition, it will derecognise the cash or other consideration it paid for that asset.
- **No derecognition for the transferor**
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. If the transferor has both a right and an obligation to reacquire the entire transferred asset for a fixed amount (such as under a repurchase agreement), the transferee may account for its receivable as a loan or receivable in IAS 39. In other cases, available for sale would be the most likely classification.

Presentation and disclosure

IFRS 7 requires specific disclosures for transfers that result in either failed derecognition or continuing involvement. In particular, an entity should disclose:

- the nature of the assets;
- the nature of the risks and rewards of ownership to which the entity remains exposed;
- when the entity continues to recognise all of the asset, the carrying amounts of the asset and the associated liability; and
- when the entity continues to recognise the asset to the extent of its continuing involvement, the total amount of the asset, the amount of the asset that the entity continues to recognise and the carrying amount of the associated liability.

In addition, if the transferee has the right by contract or custom to sell or repledge non-cash collateral, the transferor reclassifies that asset in its balance sheet (for example, as a loaned asset, pledged equity instrument, etc) separately from other assets.

Summary comparison with US GAAP

There are a number of key differences between IFRS and US GAAP as regards derecognition of financial assets, as follows:

	IFRS	US GAAP
Overview	IFRS is based on an evaluation of the transfer of risks and rewards of ownership of an asset. Only if that test is not conclusive is there is then an evaluation of the transfer of control.	US GAAP applies a control-components approach and does not specifically look to risks and rewards.
Control	The evaluation of control in IFRS is based on whether the transferee has the practical ability to sell the asset unilaterally without additional restrictions.	The transferor has surrendered control (and the transfer is accounted for as a sale) if all of the following conditions are met: a) the transferred asset is legally isolated from the transferor and beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership; b) the transferee is able to pledge or exchange the transferred asset free from constraint; and c) the transferor does not maintain effective control through a right or obligation to repurchase or redeem assets or a right to purchase or redeem 'not readily obtainable' assets.
SPEs	An entity first consolidates all subsidiaries in accordance with IAS 27 and SIC 12; it then applies the derecognition principles in IAS 39 to the resulting consolidated group. If an asset is transferred to an SPE, often the entity will consolidate the SPE resulting in the assets often remaining on balance sheet.	There is a concept of a qualifying special purpose entity (QSPE), which is specifically exempted from consolidation. To be considered a QSPE, an entity must meet specific detailed conditions. Those conditions taken together mean that the SPE is on autopilot. Transactions involving a sale of an asset to a QSPE generally result in the assets being off balance sheet.
Continuing involvement	There is a concept of continuing involvement, which results in partial derecognition, with the amount that continues to be recognised being mirrored by a gross liability.	There is no such concept. The resulting accounting can therefore be very different in terms of both balance sheet presentation and whether any gains or losses can be recognised.

Possible longer-term developments

The IASB and the FASB have agreed to explore developing a common approach to derecognition as a long-term project that will replace both IFRS and US GAAP requirements. The first stage in this project is scheduled to be a staff research paper in 2008.

Section 2

Questions and answers





Questions and answers

Introduction

This section sets out, in question and answer format, the questions we are most frequently asked when companies apply the derecognition requirements of IAS 39. This section is designed as a quick reference guide for those seeking a short answer on a particular point. The questions and answers in this section are relatively brief; many of the issues are covered in further detail in the illustrations in Section 3.

We have organised the questions and answers under individual topics. Where questions cover more than one point, they have been classified under the main topic covered. An index of all the questions and answers is provided on the following pages.

Please note that derecognition of financial assets can only be achieved if all of the conditions in IAS 39 are met. While individual questions and answers may focus on only one aspect of derecognition, this does not imply that the other requirements are unimportant. In addition, the solutions only apply to the specific fact patterns outlined in the background section to the question and should not be extrapolated to any other (similar) fact pattern.

Please also note that the IFRIC is currently addressing a number of issues in relation to derecognition. The views expressed in this publication are current at the date of publication but are subject to change pending any interpretation issued by the IFRIC. Please ensure that you seek up-to-date information and advice regarding the application of IAS 39 to the particular facts and circumstances involved in any specific transaction.



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IFRIC has a project on its agenda to consider a number of issues that may change the answers to the following Q&A's: 2.3, 2.4, 2.7, 2.8, 2.11 and 2.12.

1 General

1.1 Consolidated financial statements versus company only accounts

Question

If an entity is preparing separate financial statements (sometimes called ‘company-only’ accounts), does the first step in the flowchart need to be considered?

Solution

No. Only in the consolidated financial statements should an entity first consolidate all subsidiaries, including any SPEs, before considering the derecognition tests.

1.2 Sale of disproportionate interest

Question

Can the sale of the rights to the first of any cash collections from a group of similar financial assets be considered a part of those assets for derecognition purposes?

Background

Entity A originates a portfolio of similar five-year interest-bearing loans of 10,000. A then enters into an agreement with entity B. A agrees to pay to B the first 9,000 of cash collected from the portfolio plus interest in exchange for an upfront cash payment from B. A retains the rights to the last 1,000 plus interest, representing a subordinated interest in the portfolio.

Solution

No. The derecognition guidance should be applied to the entire portfolio of loans. The transfer of the rights to the first of any cash collections from a group of financial assets cannot be assessed for derecognition separately. The first 9,000 of cash flows plus interest is not a fully proportionate share of the cash flows because any credit losses are borne in the first instance by A and are not shared proportionally between the parties. Also, the first 9,000 of cash flows plus interest cannot be regarded as specifically identified cash flows, as it is not possible to identify which loans in the portfolio the first 9,000 cash flows will arise from.

1.3 Sale of asset with a guarantee

Question

Are the derecognition tests applied to the whole or only part of a financial asset that is sold subject to a guarantee?

Background

Entity C enters into an arrangement to transfer the rights to 90% of the cash flows of a group of receivables to Entity D. C also provides a guarantee to compensate D for any credit losses up to 8% of the principal amount of the receivables.

Solution

The derecognition tests should be applied to the asset in its entirety. Although the transferor has transferred 90% of all cash flows from the asset, the existence of the guarantee means that the transferor bears a disproportionate share of any credit losses.



1.4 Sale of asset for part of life

Question

Does a transfer of an asset for part of its life qualify as a separate asset for derecognition purposes?

Background

Entity E enters into an arrangement to transfer the rights to 100% of the cash flows arising in the last four years of a 10-year instalment loan. That is, E has transferred the last four equal cash repayments due on this instalment loan.

Solution

Yes. The derecognition requirements can be applied to the specifically identifiable cash flows.

1.5 Sale of dividends

Question

Is a right to receive the dividends of certain specified year(s) specifically identified cash flows and hence 'a part of a financial asset' (ie, a separate asset under IAS 39 paragraph 16)? For example, entity F that has a holding of shares in Company X (an available-for-sale financial asset) transfers to entity G the right to receive the dividends paid on those shares in the next year. Is that year's dividend itself a separate asset for the purpose of F's derecognition test?

Solution

Yes. If the entitlement to dividends of those year(s) is clearly specified, the dividend strip of those year(s) is specifically identified cash flows and therefore a separate asset under paragraph 16.

1.6 Sale of shares but retained rights to dividends

Question

Entity H transfers to J its holding of shares but retains the right to receive the dividends paid in the next year. Is that financial asset, other than the first year's dividend retained, a separate asset for the purpose of H's derecognition test?

Solution

Yes. The cash flows arising from this financial asset from the second year to perpetuity are also specially identified cash flows.

2 Transfers and pass-through arrangements

2.1 Transfer versus agency relationship

Question

Is the transfer of securities to a custodian a transfer of the contractual rights under IAS 39 paragraph 18(a)?

Background

Entity K enters into an arrangement with bank L whereby L will manage K's securities. K transfers the securities to a safe custody account of L. L will receive a management fee for its service. K can decide when and which assets should be sold and can require surrender of the securities at any time.

Solution

No. The transfer of securities to a custodian is not a transfer under paragraph 18(a). The contractual rights to the cash flows from the financial asset have to be transferred to satisfy the conditions in paragraph 18(a). L does not have rights to the cash flows of the transferred securities. L acts as agent of K.

2.2 Transfer of disproportionate share in pass-through

Question

Can the transfer of a disproportionate share of the cash flows from a loan meet the conditions for a pass-through arrangement?

Background

Entity M originates a five-year interest-bearing loan of 100. M then enters into an agreement with entity N in which, in exchange for a cash payment of 85, M agrees to pass to N the first 90 of all principal and interest payments collected from the loan. M accepts no obligation to make any payments to N other than the first 90 collected. M is prohibited by the terms of the agreement from selling or pledging the loan and has to remit the first 90 of collected cash flows to N without material delay.

Solution

Yes. The transfer of a disproportionate share of cash flows can qualify as a pass-through arrangement. In the above arrangement, the three conditions for a pass-through arrangement are met: M has no obligation to pay cash to N unless it collects the cash from the loan; M has an obligation to pay the cash flows collected from the loan to the eventual recipients (ie, N) without material delay; and M has no right to sell or pledge the transferred asset. Entity M is able to assess whether the entire asset can be derecognised following the remaining steps in the derecognition flow chart, as the arrangement meets the criteria for a transfer.

2.3 Warranties

Question

Do normal warranties as to the condition of the asset at date of transfer (not to its future performance) prevent a transfer from being a transfer of contractual rights under paragraph 18(a)?

Background

An entity sells goods to its customers and provides a warranty that if the goods are faulty the customer can return the goods within 30 days and get their money back. If the entity sells its receivables associated with the sales of those goods to a factor, those receivables are subject to that warranty provision as well – ie, the entity agrees to compensate the factor for any receivables relating to goods returned under the warranty.



Solution

No. Normal warranties would not preclude a transfer from being in paragraph 18(a), as they do not preclude the seller from transferring the contractual rights to the cash flows of the asset. Normal warranties relate to business risks of the underlying transaction that affect the existence of the receivable rather than to the financial risks associated with the receivable itself. The implications for warranties for risks and rewards and continuing involvement are found in Q&A 3.5 and Q&A 5.3.

2.4 Contractual credit notes

Question

Do contractual credit notes associated with trade receivables prevent a transfer from being a transfer of contractual rights under paragraph 18(a)?

Background

Entity P issues a credit note when its customers qualify for a volume discount. The volume discount is included in the general sales conditions between Entity P and its customers, rather than in a particular invoice. Entity P sells its receivables to a factor and agrees to compensate the factor when a credit note is issued on a transferred receivable.

Solution

No. Such contractual credit notes do not prevent a transfer of receivables from being in paragraph 18(a), as they are related to the overall contractual relationship between the seller and its customer and not to the contract that is the receivable. The implications of contractual credit notes for risks and rewards and continuing involvement are found in Q&A 3.6 and Q&A 5.4 respectively.

2.5 Servicing

Question

Does the retention of servicing prevent a transfer from being a transfer of contractual rights under paragraph 18(a)?

Background

Entity R has transferred the contractual rights to the cash flows of a financial asset to Entity S but continues to service the transferred asset.

Solution

No. The determination of whether the contractual rights to cash flows have been transferred is not affected by the transferor retaining the role of an agent to administer collection and distribution of cash flows. Therefore, retention of servicing rights by the entity transferring the financial asset does not in itself cause the transfer to fail the requirements in paragraph 18(a).

2.6 Servicing and co-mingling of cash flows

Question

If a servicer co-mingles cash collections from transferred assets with its own assets, does that prevent a transfer from being a transfer of contractual rights under paragraph 18(a)?

Background

Entity T has transferred the contractual rights to the cash flows of a financial asset to Entity U but continues to provide servicing on the transferred asset. T may co-mingle the cash flows it collects on the transferred assets with T's other own cash balances not subject to the transfer.

Solution

No. As the retention of servicing rights by the entity transferring the financial asset does not in itself cause the transfer to fail the requirements in paragraph 18(a), neither does the ability for the servicer to co-mingle cash collections from the transferred assets with its own assets.

2.7 Two-party offset

Question

Do two-party offset arrangements prevent a transfer from being a transfer of contractual rights under paragraph 18(a)?

Background

Entities V and W owe each other amounts that are subject to a legal right of set off. W sells its receivables from V to Entity X and agrees with X that if V exercises its right of set off on a transferred receivable, W will make an equivalent payment to X.

Solution

No. Two-party offset arrangements do not prevent a transfer from meeting paragraph 18(a), as they do not preclude the seller from transferring the contractual rights to the cash flows of the receivables. The payment made by the seller to the buyer if the right of offset is exercised merely transfers to the buyer the value the seller obtained when its liability to the debtor was extinguished. The implications of set-off rights for risks and rewards and continuing involvement are found in Q&A 3.8 and Q&A 5.6 respectively.

2.8 Sub-contractor offset

Question

Do three-party offset arrangements prevent a transfer from being a transfer of contractual rights under paragraph 18(a)?

Background

Entity Y contracts with Entity Z for Z to build a property for Y. Entity Z sub-contracts a large part of the work to Entity A. Entity Z then sells its receivables (including the one from Entity Y) to a factor B. Entity A has the right to offset amounts due from Entity Z against Z's receivable from Entity Y. If A exercises its right, Entity Z makes a cash payment to factor B, the buyer, for the amount offset.

Solution

Yes. Sub-contractor and other third-party offset rights preclude a transfer from meeting paragraph 18(a). Entity Z has not transferred the contractual rights to the cash flows as the debtor Y does not have to pay B if A, the sub-contractor, offsets amounts owed it by Z against entity Y. In this case, a third party (A, the sub-contractor) has the unilateral ability to extinguish the contractual right to receive cash flows from the debtor Y.

2.9 Option or commitment to repurchase on contingent event

Question

Does a transferor's commitment to repurchase the transferred assets on a change in circumstances (for example, a change in tax law/regulation) prevent a transfer from being a transfer of contractual rights under paragraph 18(a)?

Background

An entity has sold receivables to a factor. Within the terms of the sale agreement, if there is a change in the tax law/regulation, the entity has committed to repurchase the transferred receivables from the factor at par.

Solution

No. Given the examples in AG51, such commitments do not prevent a transfer of receivables from being in paragraph 18(a). The implications of a commitment to repurchase the assets on a contingent event for risks and rewards and continuing involvement are found in Q&A 3.7 and Q&A 5.5 respectively.

2.10 Revolving structures

Question

Do revolving structures involving a consolidated SPE meet the pass-through requirements in paragraph 19?

Background

An entity sets up a programme to sell specified receivables originated over five years to a consolidated SPE. The SPE issues long-term notes to investors. As cash flows are collected on the receivables, those amounts are used by the SPE to purchase new receivables automatically. At the end of five years, collections from the receivables are used to repay the principal of the long-term notes rather than being reinvested in new receivables.

Solution

No. Revolving structures will generally not meet the pass-through requirements. In a revolving structure, an entity collects cash flows on behalf of eventual recipients and uses the amounts collected to purchase new assets instead of remitting the cash to the eventual recipients. On maturity, the principal amount is remitted to the eventual recipients from the cash flows arising from the reinvested assets. Most revolving arrangements involve a material delay before the original collection of cash is remitted. Furthermore, the nature of the new assets typically acquired means that most revolving arrangements involve reinvestment in assets that would not qualify as cash or cash equivalents.

2.11 Original assets (contracts between the seller and a consolidated SPE)

Question

Does a transfer of loans to a consolidated SPE in which the seller enters into related contracts, such as derivatives or guarantees with the SPE, meet the pass-through requirements in paragraph 19(a)?

Background

Entity E, the transferor, sells assets (for example, loans) to a consolidated SPE. The SPE issues notes to investors that are secured on those assets. Entity E also enters into derivatives (for example, interest rate swaps), guarantees, or contributes a cash reserve fund directly with that SPE to mitigate some of the risk on the assets for the noteholders.

Solution

No. Any cash flows that come from the transferor – for example, from swaps or guarantees – except for collections from the transferred asset, are not considered to be cash flows from the original asset. The arrangement therefore fails paragraph 19(a).

2.12 Original assets (contracts between a seller and a third party that are transferred to a consolidated SPE)

Question

Should contracts between a seller and a third party that are transferred with the underlying loans (ie, contracts existing/in force at date of transfer) be considered part of the 'original asset' for purposes of paragraph 19(a)?

Background

Entity F has entered into contracts with other third parties to mitigate some of the risks of its loans (for example, credit insurance and interest rate swaps). Entity F then transfers the loans and the related third-party contracts to a consolidated SPE. The SPE issues notes to investors that are secured on those loans.

Solution

In the absence of further guidance, the term original asset can be interpreted to mean either:

- all related contracts, including purchased options, swaps and insurance contracts, transferred with the loans/receivables in a single transaction that share and mitigate some of the risks on the loans because those are the cash flows that will be paid to eventual recipients. Under this view, the related contracts do not cause paragraph 19(a) to be failed; or
- only the transferred loans/receivables themselves. Under this view, the related contracts would cause paragraph 19(a) to be failed, and therefore the loans would not be derecognised.

An entity should choose one of these two approaches as its policy and apply it consistently to similar transactions for both the transfer and the risks and rewards tests. See Q&A 3.1.

2.13 Material delay

Question

What is meant by ‘without material delay’ in paragraph 19(c)?

Solution

The term ‘without material delay’ is not defined in the standard. Management should therefore exercise judgement in making this assessment. The underlying facts and circumstances should be reviewed carefully to assess whether the time interval between collection of the cash flows and their remittance to eventual recipients is reasonable in relation to the timings of payments on the underlying asset and market practices. If the transfer transaction is a securitisation, generally a period of three months or less is acceptable, as in most securitisations interest is paid on the securitisation finance on a quarterly basis.

2.14 Fixed payments and pass-through arrangements

Question

Does an arrangement whereby the transferor pays a fixed amount of cash to the transferee on a monthly basis meet the requirements of a pass-through arrangement?

Background

Manufacturer G offers a financing scheme for the sale of its office furnishing products. A customer has the option to pay the purchase price and accrued interest in fixed monthly instalments over a maximum period of 24 months. G agrees to pay to Bank H every month a predetermined amount of cash equal to the instalments due from its customers in exchange for an upfront cash payment.

Solution

No. Payment of a fixed amount of cash does not qualify as a pass-through arrangement, as it fails the requirements in paragraph 19(a). The amounts G is obliged to pay to H are not dependent on actual cash collections from the office furnishing receivables. G is obliged to pay an amount of cash that has been predetermined at the outset of the contract even if it has not collected the cash from its customers.



2.15 Pass-through arrangements

Question

Can an agreement whereby one party assumes a contractual obligation to pay cash flows from a financial asset to another party meet the definition of a pass-through arrangement?

Background

Manufacturer J enters into an arrangement with Factory K. Entity J agrees to pass on the cash flows it collects from specified trade receivables to K for an upfront payment. Entity J has to transfer the collected cash flows within two working days. J has no obligation to transfer cash to K unless it collects equivalent amounts from the trade receivables and is prohibited by the terms of the arrangement with J from selling or pledging the trade receivables to a third party.

Solution

Yes. The three conditions for a pass-through arrangement are met.

- Entity J retains the contractual rights to receive the cash flows of the financial asset but it assumes an obligation to pass on the cash flows from the underlying assets without material delay.
- Entity J cannot sell or pledge the asset.
- Entity J also has no obligation to make payments unless it collects equivalent amounts from the asset.

Entity J now assesses whether the other criteria for derecognition in IAS 39 are met – ie, it applies the risks and rewards and control tests.

2.16 Credit enhancements and pass-through arrangements

Question

Can a credit enhancement in the form of over-collateralisation result in an entity meeting the pass-through requirements?

Background

Entity L sells 10,000 of receivables to a consolidated SPE for an up-front cash payment of 9,000 and a deferred payment of 1,000. The SPE issues notes of 9,000 to investors. Entity L will only receive the deferred payment of 1,000 if sufficient cash flows from the receivables remain after paying amounts due to investors. This provides credit enhancement to the noteholders in the form of over-collateralisation – that is, L suffers the first loss on the transferred assets up to a specified amount.

Solution

Yes. Providing credit enhancement via over-collateralisation may result in an entity meeting the pass-through requirements (provided these requirements are not failed due to other features in the arrangement). If the other pass-through requirements are met, Entity L now assesses whether the other criteria for derecognition in IAS 39 are met – ie, it applies the risks and rewards and control tests.

2.17 Loan sub-participations

Question

Does a loan sub-participation meet the pass-through requirements?

Background

Bank M originates a large loan for a corporate client. M agrees with other banks that in return for an upfront cash payment, it will pass on a percentage of all payments of principal and interest collected on the original loan to the participating banks as soon as they are received from the corporate client. The arrangement is non-recourse – ie, M has no obligation to pay the other banks unless it collects equivalent amounts from the corporate loan. M also cannot sell or pledge the loan.

Solution

Yes. The three conditions for a pass-through arrangement are met.

- M retains the contractual rights to receive the cash flows of the financial asset, but it assumes an obligation to pass-on the cash flows from the underlying assets without material delay.
- M cannot sell or pledge the assets.
- M also has no obligation to make payments unless it collects equivalent amounts from the asset.

M now assesses whether the other criteria for derecognition in IAS 39 are met – ie, it applies the risks and rewards and control tests.

2.18 Liquidity reserve

Question

Does a liquidity reserve breach the pass-through requirements in paragraph 19?

Background

In a securitisation transaction, SPE N (a consolidated subsidiary of the transferor O) is required to maintain a liquidity reserve to enable timely payments to be made to noteholders despite delayed receipts from the original assets. O has pre-funded this reserve when establishing N.

Solution

Yes. Establishing a pre-funded liquidity reserve, results in an obligation to pay amounts to eventual recipients that were not collected from the original asset (paragraph 19(a)).

2.19 Funding commitment

Question

Does a funding commitment, breach the pass-through requirements in paragraph 19?

Background

In a securitisation transaction, SPE P (a consolidated subsidiary of the transferor Q) may be required to provide a liquidity facility to enable timely payments to be made to noteholders despite delayed receipts from the original assets. Transferor Q has provided a commitment to advance cash to P when required (which can be recovered only via retention of future cash flows from the original transferred assets).

Solution

Yes. A commitment by the transferor to provide funding subsequently results in an obligation to pay amounts to eventual recipients that were not collected from the original asset (paragraph 19(a)). Amounts paid do not represent allowable short-term advances, as there is no right of recovery in the event of insufficient cash flows from the original asset.



2.20 Reserve fund from excess cash

Question

Does a reserve fund created from excess cash breach the requirements in paragraphs 19(a) and (c)?

Background

In a securitisation transaction, SPE R established a reserve fund created out of ‘excess’ cash flows collected from the transferred assets over and above those required to pay noteholders. It is contractually specified which cash flows are considered to be ‘excess’ cash flows. When the notes issued by R are fully repaid at the end of the arrangement, the transferor is entitled to the remaining balance of the reserve fund.

Solution

No. First, for paragraph 19(a), the transferor is not paying the eventual recipients any amounts other than those collected from the original asset because the fund is created through the cash flows from the transferred assets. Second, for paragraph 19(c), any amounts due to the transferor that are held in this reserve fund are not ‘collected on behalf of eventual recipients’ and therefore not subject to the ‘material delay’ requirement. The purpose of setting up the fund is to make sure the cash is passed to eventual recipients without material delay once amounts become due to those eventual recipients. The risks and rewards analysis should then be applied to the transferred assets in their entirety.

3 Risks and rewards

3.1 What are the net cash flows?

Question

When performing a risks and rewards analysis, what are the 'net cash flows of the transferred asset'?

Solution

These should be determined consistently with the 'original asset', as set out in Q&A 2.12.

If the entity adopts the first approach, the pre-transfer net cash flows of the transferred asset will include any insurance policies, options and swaps that were transferred with the loans in a single transaction that share and mitigate some of the risks on the loans. Similarly, the post-transfer cash flows of the transferred asset will be the seller's residual cash flows from the asset after taking into account payments to or from eventual recipients – including noteholders and insurance contracts – that are included in the original asset. Under this approach, it is less likely that significant risks and rewards will be transferred.

Conversely, if the entity adopts the second approach in Q&A 2.12, the pre-transfer net cash flows of the transferred asset will exclude any insurance policies, options and swaps that were transferred with the loans. Similarly, the post-transfer cash flows of the transferred asset will be the seller's residual cash flows from the asset before taking into account payments to or from such insurance policies, options and swaps. This is important if an entity does not have an outright transfer in paragraph 18(a) and should meet the pass-through requirements in paragraph 19(a).

3.2 Subordinated residual interest

Question

Does the retention of a subordinated residual interest in a transferred portfolio of receivables preclude derecognition?

Background

Entity S transfers a portfolio of interest bearing receivables of 10,000 to Entity T. The historical loss ratio of similar receivables is 5% and over the last 10 years has varied in line with a normal distribution from 3-7%. Entity T makes a cash payment of 9,000, and S agrees to pay to T the first 9,000 (plus interest) of cash collected from the loan portfolio. S retains rights to the last 1,000 (plus interest) – that is, it retains a subordinated residual interest. Apart from credit risk the receivables bear no other significant risks.

Solution

Yes. The retention of a subordinated residual interest precludes derecognition if it absorbs substantially all of the variability in net cash flows. S retains substantially all the risks and rewards of ownership because the subordinated retained interest absorbs all of the likely variability in net cash flows. Therefore S continues to recognise the portfolio in its entirety.

3.3 Right to repurchase at fair value

Question

Does a right to repurchase at fair value result in the retention of substantial risks and rewards?

Background

Entity U sells a 5% equity investment in an unlisted competitor to investment entity V. V intends to resell the investment in the near future. U has the right to repurchase the investment at fair value when V has found a potential buyer.

Solution

No. Entity U will not benefit from future increases or decreases in the value of the shares because the call option strike price is set at fair value. U has transferred substantially all risks and rewards.

3.4 Factoring with seller retaining late-payment risk

Question

If the seller provides a guarantee of late-payment risk, does this result in it retaining substantially all the risks and rewards?

Background

Entity X sells a pool of non-interest bearing receivables due in 60 days to a factor. X agrees to compensate the factor for the late-payment risk up to 210 days by paying interest to the factor on the amount of the receivables up to the earlier of the day they pay or 210 days. Any risk of payment beyond 210 days and of non-payment is borne by the factor. Past experience shows that virtually all receivables that do not pay by 210 days will default, and that both slow-payment risk and credit-default risk are significant.

Solution

No. In this example, entity X has transferred some significant risk – the risk of default to the factor, but has also retained some risk – late payment risk. X needs to apply the control test to determine whether it achieves derecognition or should apply continuing involvement accounting. See also Illustration 6.

3.5 Warranties and risks and rewards

Question

Should normal warranties as to the condition of the asset at date of transfer (not to its future performance) be taken into account for the risks and rewards analysis?

Background

An entity sells goods to its customers and provides a warranty that if the goods are faulty the customer can return them within 30 days and get their money back. If the entity sells its receivables associated with the sales of those goods to a factor, those receivables are subject to that warranty provision as well – ie, the entity agrees to compensate the factor for any receivables relating to goods returned under the warranty.

Solution 2

No. Such warranties relate to the condition of the asset at the date of sale and to whether a valid receivable exists (rather than to its future performance). Hence they should not be taken into account for the risks and rewards analysis. The implications of contractual credit notes for transfers and continuing involvement are found in Q&A 2.3 and Q&A 5.5 respectively.

3.6 Contractual credit notes and risks and rewards

Question

Should contractual credit notes be taken into account for the risks and rewards analysis?

Background

Entity Y issues a credit note when its customers qualify for a volume discount. The volume discount is included in the general sales conditions between Y and its customers, rather than in a particular invoice. Y sells its receivables to Entity Z and agrees to pay Z when a credit note is issued on a transferred receivable.

Solution

No. As the contractual credit notes relate to the overall contractual relationship between the seller and its customer and not to the contract that is the receivable, they should not be taken into account for the risk and rewards analysis. The implications of contractual credit notes for transfers and continuing involvement are found in Q&A 2.4 and Q&A 5.4 respectively.

3.7 Discretionary repurchase option

Question

Should a transferor's option to repurchase the transferred assets at its discretion at par value be taken into account in the risks and rewards analysis?

Background

Entity A sold trade receivables to entity B. A has an option to repurchase the receivables at its discretion at par value. This is primarily to enable A to maintain good relationships with its customers. A has entered into these types of arrangements in the past and historically has always repurchased the receivables once they default.

Solution

Yes. Risks and rewards are measured as an entity's exposure to variability in cash flows from the transferred asset, with greater weight being given to those outcomes that are more likely to occur. Therefore, if the entity can repurchase the transferred asset at nominal value and doing so would result in it incurring a loss, it has retained some of the risks and rewards. The extent of risks and rewards retained will depend on how likely A is to repurchase non-performing receivables. The fact that A has a history of repurchasing similar receivables when they default indicates that it has retained significant default risk. The implications of commitments to repurchase at par value for transfers and continuing involvement are found in Q&A 2.9 and Q&A 5.5 respectively.

3.8 Two-party offset arrangements

Question

Should two-party offset arrangements be taken into account in the risks and rewards analysis?

Background

Entities C and D owe each other amounts, and these amounts are subject to a legal right of set-off. D sells its receivables due from C to E; it agrees with E that, if C exercises its right of set-off on a transferred receivables, D will make an equivalent payment to E.

Solution

No. Two-party offset arrangements would not be factored into the risks and rewards analysis. The payment made by the seller to the buyer if the right of offset is exercised merely transfers to the buyer the value the seller obtained when its liability to the debtor was extinguished. The implications of two-party offset arrangements for transfers and continuing involvement are found in Q&A 2.8 and Q&A 5.6 respectively.



4 Control

All the questions below assume in the fact pattern that (a) there has been a transfer, and (b) an analysis of risks and rewards shows the transferor has neither transferred nor retained substantially all the risks and rewards. Hence the transferor is now evaluating the control criterion.

4.1 Additional restrictions

Question

Has the transferor transferred control if it has issued a credit default guarantee to the transferee on the transferred assets?

Background

Entity F sells a portfolio of loans to bank G for cash. The loans have an average historical loss ratio of 5%. F guarantees credit default losses on the transferred assets of up to 4% as part of the arrangement.

Solution

No. The credit default guarantee means that control has not been transferred. G would lose the value of the credit default protection if it sold the transferred asset without giving similar credit default protection to the new buyer. Hence in practice, G would only sell the transferred asset if it also gave similar credit default protection to the buyer. However, giving such credit default protection is the insertion of an additional restriction and therefore fails the control test.

4.2 Active market

Question

Has the transferor retained control if the transferred asset is not traded in a market?

Background

Entity H enters into an agreement with bank J: in exchange for a cash payment of 65, H agrees to sell a 15% shareholding in a construction company to J. The shares are subject to a call option that allows H to repurchase the shares for a price of 70. The shares are not listed and there is no market for such large shareholdings.

Solution

Yes. H has retained control. J does not have the practical ability to sell the transferred shares, as there is no market in which it could buy replacement shares should J decide to sell them and then H exercises its call option. Therefore, J would have to hold the shares until the option expires. See also Illustration 2.

4.3 Consolidated SPE

Question

Can the control test be passed when a consolidated SPE is involved?

Background

Entity K, which consolidates SPE L, meets the pass-through requirements for the sale of its receivables to investors. One of these requirements is that L is not able to sell or repledge the receivables. In addition, there is no market in this kind of receivable. However, the consolidated group has neither transferred nor retained substantially all the risks and rewards relating to those receivables and should therefore determine if the consolidated group has lost control.

Solution

No. As L is not able to sell or repledge the receivables under the contractual terms, the transferee will never have the practical ability to sell the receivables.

5 Continuing involvement

All the questions below assume in the fact pattern that (a) there has been a transfer, (b) an analysis of risks and rewards shows the transferor has neither transferred nor retained substantially all the risks and rewards, and (c) control remains with the transferor. Hence the transaction is now accounted for under continuing involvement.

5.1 Late-payment risk

Question

What is the amount of an entity's continuing involvement asset when it takes the form of the entity retaining a capped amount of late-payment risk?

Background

Entity M sells a pool of non-interest bearing receivables due in 60 days to a factor. M agrees to compensate the factor for the late-payment risk up to 210 days, by paying interest to the factor at a specified fixed rate on the amount of the receivables up to the earlier of the day they pay or 210 days. Any risk of payment beyond 210 days and of non-payment is borne by the factor. Past experience shows that virtually all receivables that do not pay by 210 days will default, and that both slow payment risk and credit default risk are significant.

Solution

The continuing involvement asset is the maximum payment the seller might have to pay – ie, the amount of receivables, multiplied by 210 days, multiplied by a specified fixed interest rate. See also Illustration 6.

5.2 Guarantee of credit losses

Question

What is the amount of an entity's continuing involvement asset when it takes the form of the entity guaranteeing 10% of each and every credit loss on a pool of transferred receivables?

Background

Entity N sells a pool of non-interest bearing receivables due in 60 days to a factor. N agrees to guarantee 10% of each and every credit loss on those transferred receivables.

Solution

When N's continuing involvement takes the form of a guarantee of the transferred asset, the extent of its continuing involvement is the lower of (a) the amount of the asset, and (b) the maximum amount of the consideration received that N could be required to repay. In this case, it is 10% of the par value of the assets. See also Illustration 8.

5.3 Warranty

Question

Does an entity need to include in the measurement of its continuing involvement asset the risk from a warranty as to the condition of the asset on the date of sale?

Background

Entity O sells goods to its customers and provides a warranty that if the goods are faulty, the customer can return the goods within 30 days and get their money back. If O sells its receivables associated with the sales of those goods to a factor, those receivables are subject to that warranty provision as well – ie, O agrees to compensate the factor for any receivables relating to goods returned under the warranty.

Solution

No. Such warranties relate to the condition of the asset at the date of sale and to whether a valid receivable existed (rather than to its future performance). They should not be taken into account in measuring O's continuing involvement.

5.4 Contractual credit notes

Question

Does an entity need to include in the measurement of its continuing involvement asset the risk arising from future contractual credit notes (see Q&A 2.4)?

Solution

No. Such credit notes are related to the overall contractual relationship between the seller and its customer and not to the contract that is the receivable. Therefore, they should not be taken into account in measuring the entity's continuing involvement.

5.5 Commitment to repurchase upon contingent events

Question

Does an entity need to include in the measurement of its continuing involvement asset a commitment to repurchase the transferred assets on a change in circumstances (for example, a change in tax law/regulation)?

Background

An entity has sold receivables to a factor. Within the terms of the sale agreement, if there is a change in the tax law/regulation, the entity has the commitment to repurchase the transferred assets from the factor at par.

Solution

Yes. Such commitment is related specifically to a particular receivable and therefore should be taken into account in measuring the entity's continuing involvement. If the commitment is to repurchase any receivable, the continuing involvement asset would be the entire group of trade receivables – ie, no derecognition would be achieved.

5.6 Two-party offset arrangements

Question

Does an entity need to include in the measurement of its continuing involvement asset the effect of two-party offset arrangements?

Background

Entities R and S owe each other amounts, and these amounts are subject to a legal right of set-off. S sells its receivables from R to T and agrees with T that, if R exercises its right of set off on a transferred receivables, S will make an equivalent payment to T.

Solution

No. Two-party offset arrangements do not need to be included in the measurement of the continuing involvement asset. The payment made by the seller to the buyer if the right of offset is exercised merely transfers to the buyer the value the seller obtained when its liability to the debtor was extinguished.

6 Accounting and other

6.1 Servicing assets and liabilities

Question

When does an entity recognise a servicing asset or liability?

Background

Bank U sells specified loans to bank V. Bank U retains the servicing and receives a 1 basis point fee as compensation.

Solution

It is common for a transferor to continue to service the transferred assets for a fee. The fee usually takes the form of part of the interest receipts on the transferred assets that the transferor retains as compensation for servicing those assets. When the benefits of servicing (for example, the fee received) is less than a current market fee for servicing the assets, the entity should recognise a liability for the fair value of the servicing obligation. The servicing is an obligation because the servicer would have to pay another entity to assume the servicing contract or use its assets in the future to perform under the contract. When the benefits of servicing (for example, the fee received) equals a current market fee for servicing the assets, the servicer has neither an asset nor a liability, as the fair value of this servicing contract is zero. When the benefits of servicing (for example, the fee received) exceeds a current market fee for servicing the assets, an asset should be recognised.

6.2 Transferee's accounting – failed derecognition

Question

How does a transferee account for the transferred asset when the transfer does not qualify for derecognition?

Solution

If the transferor fails derecognition, the transferee does not recognise the transferred asset. Instead the transferee recognises a financial asset from the transferor.

6.3 Transferee's accounting – full derecognition

Question

How does a transferee account for the transferred asset when the transfer qualifies for full derecognition?

Solution

If the transferor achieves derecognition, it no longer recognises the transferred asset. The transferee will recognise the transferred asset.



6.4 Disclosure

Question

IFRS 7 paragraph 13 sets out specific disclosure requirements for transfers that do not qualify for derecognition. What general disclosures should be made in relation to both transactions that qualify for derecognition and those that do not?

Solution

IAS 1 paragraph 108 requires entities to disclose the significant accounting policies used that are relevant to an understanding of the financial statements. IAS 1 paragraph 113 requires an entity to disclose the judgements that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

Therefore, the entity should disclose any significant accounting policy choices and judgements it has made in relation to derecognition. Examples include:

- (a) what the entity regards as a transfer of contractual rights for the purposes of IAS 39 paragraph 18(a); and
- (b) what the entity regards as the 'original asset' for the purpose of paragraphs 19(a) and 20.

For transfers that fail to qualify for derecognition, where relevant, an entity might also disclose that the assets are pledged against the related liability.

6.5 Current/non-current classification – failed derecognition

Question

Are financial assets for which the entity has failed the derecognition requirements, as well as the associated liability, presented in a classified balance sheet as current or non-current?

Solution

For the asset, the entity will maintain the same classification as it had prior to the failed derecognition. Classification of the associated liability depends on the earliest date it can be settled. Generally, its classification will be the same as that of the asset. However, in the case of a revolving structure, the receivables that failed the derecognition test might be classified as current, whereas the notes to the investors may be non-current if they are not due to be settled within the next 12 months.

In a securitisation of long-term assets funded by short-term commercial paper issuances, the converse could arise.

Section 3

Illustrations





Illustrations

Introduction

This section sets out 10 detailed illustrations of how derecognition is applied in practice. The objective is to present the mechanics of applying the IAS 39 requirements for derecognition of financial assets, starting with an analysis of the transaction using the flowchart, and culminating with the initial and subsequent accounting entries for both the transferor and transferee in most cases.

The 10 fact patterns illustrate some of the traditional transactions, as well as some of the newer more challenging derecognition transactions, that we are seeing in practice. They cover:

1. Sale of specifically identified cash flows
2. Sale of asset subject to call option
3. Sale of asset subject to fixed price repurchase agreement
4. Factoring of receivables without recourse
5. Factoring of receivables with recourse
6. Factoring of receivables with late-payment risk retained
7. Securitisation: revolving structure
8. Sale of loans: guarantee retained
9. Securitisation: all-in interest rate swap retained
10. Securitisation: excess spread retained

The issues addressed are summarised below.

	18(a) transfer	18(b) transfer	Transfer substantially all risks and rewards	Retain substantially all risks and rewards	Retain control
Illustration 1 Sale of specifically identified cash flows	Yes	N/A	Yes	No	N/A
Illustration 2 Sale of asset subject to call option	Yes	N/A	No	No	No (base case) Yes (alternative scenario)
Illustration 3 Sale of asset subject to fixed price repurchase agreement	Yes	N/A	No	Yes	N/A
Illustration 4 Factoring of receivables without recourse	Yes	N/A	Yes	No	N/A
Illustration 5 Factoring of receivables with recourse	Yes	N/A	No	Yes	N/A
Illustration 6 Factoring of receivables late-payment risk retained	Yes	N/A	No	No	Yes
Illustration 7 Securitisation – revolving structure	No	No	N/A	N/A	N/A
Illustration 8 Sale of loans – guarantee	Yes	N/A	No	No	Yes
Illustration 9 Securitisation – all-in interest rate swap	Yes	N/A	No	No	Yes

In all cases, the functional currency of the transferor and transferee is the euro; foreign currency risk is not relevant.

Illustration 1: Sale of specifically identified cash flows

Background and assumptions

Entity A holds a portfolio of AAA-rated fixed-rate corporate eurobonds classified as available for sale, which all mature in approximately five years time. The bonds are traded in a highly liquid market. Interest rates have fallen since entity A bought the bonds; as a result, the value of the bonds, originally bought for €100 million, has increased to €111 million. Entity A assigns to Entity B rights to 90% of the principal payments on the bonds for a cash payment of €70 million. A will continue to receive all interest payments on the whole portfolio and 10% of the principal payments. When the bonds mature in five years' time, A will pass on to B 90% of the principal amount that is repaid. B bears the credit risk on any defaults of its newly acquired 90% of the principal amount.



Step 2

Additional information:

- Fair value of portfolio at date of transfer – €111 million
- Fair value of interest only strip at date of transfer – €33 million
- Amount of gain previously recognised in equity – €11 million

Analysis using the flowchart

Step 1 Consolidate all subsidiaries

This step is not applicable in this example.

Step 2 Determine whether the derecognition model should be applied to part of a financial asset (or a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety.

- The financial instruments included in entity A's debt securities portfolio have similar characteristics. They are of the same type and currency (corporate eurobonds), have the same credit rating (AAA), mature at approximately the same date (five years after the transaction) and all carry a fixed rate coupon. They should be assessed as a group of similar financial assets.
- The transaction relates to a fully proportionate share (90%) of specifically identified cash flows (the principal repayments) from the portfolio. The derecognition model should therefore be applied to that part of the portfolio.

Step 3 Have the rights to the cash flows expired?

The bonds have not yet matured so the rights to the cash flows still exist.

Step 4 Is there a transfer?

Entity A has assigned 90% of the principal cash flows of these debt securities to entity B. This qualifies as a transfer under paragraph 18(a), even though A continues to act as collection agent. While A would be able to sell the remaining 10% principal strip and the interest strip to a third party, it has no further rights in respect of the 90% principal.



Step 5 Risks and rewards analysis

Entity A has transferred the credit and late payment risks associated with the transferred asset (90% of the principal cash flows). No variability in the cash flows from movements in interest rates is expected, as the transferred asset is a fixed amount that does not vary with interest rate movements. The variability in the fair value of the asset from movements in interest rates has been transferred to entity B. Entity A has therefore transferred substantially all the risks and rewards in relation to the transferred asset (90% of the principal cash flows from the portfolio) and should derecognise that portion.

Transferor's accounting

On the date of the transfer

Where only part of the asset is sold, the previous carrying amount of the larger financial asset is allocated between the part that continues to be recognised and the part that is derecognised, based on the relative fair values of those parts on the date of transfer.

Fair value of entire portfolio = 111
 Less fair value of interest only strip = 33

 Fair value of principal only = 78

Fair value of entire principal = 78
 * 90% transferred

 Fair value of 90% of principal only = 70

The gain or loss on sale is calculated as the difference between:

- the carrying amount allocated to the part derecognised (70), and
- the sum of the consideration received for the part derecognised (70) and any cumulative gain or loss allocated to it (on the basis of relative fair values) that had been recognised directly in equity ($11 \times (70/111)$).

		€ millions
Carrying amount allocated to part derecognised	90% of principal payments (90% of 78)	-70
Consideration received for part derecognised	70	+70
Cumulative gain or loss allocated to part derecognised previously recognised in equity	$11 \times (70/111)$	+7
Gain recycled on derecognition		7

Accounting entries on the date of the transfer

(In € millions)	Dr	Cr
Cash	70	
Debt securities		70
AFS reserve equity	7	
Gain on derecognition (profit or loss)		7

To recognise the cash received for 90% of the principal of the debt securities and to recycle the gain of 7 on the sale of that proportion.

Subsequently, entity A's 10% principal strip and its entire interest strip will continue to be measured at fair value through equity subject to the recognition of interest using the effective interest rate method and normal impairment testing.

Transferee's accounting

On the date of the transfer

As entity A derecognised 90% of the principal of the bonds, entity B will recognise the 90% of the principal of the bonds and derecognise the cash consideration it paid in return.

(In € millions)	Dr	Cr
Debt securities	70	
Cash		70

To recognise the purchase of a 90% principal strip in this portfolio of eurobonds.

Subsequently, the accounting will depend on how B classifies its asset under IAS 39 (ie, fair value through profit or loss, available for sale or held to maturity).



Illustration 2: Sale of equities subject to call option

Background and assumptions

Entity C holds a 0.1% shareholding in a construction company it bought one year ago for €58 million and that is classified as available for sale. C enters into an agreement with bank D in which, in exchange for a cash payment of €65 million, C agrees to sell those shares to D. The shares are sold subject to a call option that allows C to repurchase the shares for €70 million, at anytime during the next three years. The shares are quoted in an active market.

Additional information:

- Fair value of shares at date of transfer – €68 million
- Amount of gain previously recognised in equity – €10 million
- Fair value of call option on date of transfer – €3 million (only time value, no intrinsic value and neither deeply in nor deeply out of the money)



Steps 5 and 6

Analysis using the flowchart

Step 1 Consolidate all subsidiaries

This step is not applicable in this example.

Step 2 Determine whether the derecognition model should be applied to part of a financial asset (or a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety.

The asset being transferred is the shares in their entirety.

Step 3 Have the rights to the cash flows expired?

No, the rights to dividends continues to exist as the shares are still outstanding.

Step 4 Is there a transfer?

Yes, entity C has sold the shares to bank D.

Step 5 Risks and rewards analysis

Entity C has neither transferred nor retained substantially all the risks and rewards of the shares, as the call option is neither deeply in nor deeply out of the money.

Step 6 Control

As the shares are quoted in an active market, D has the practical ability to sell them, and C has lost control. Hence it should derecognise the shares and recognise the call option.

Helpful hint – alternatives relating to call options

If an entity holds a call option on an asset that is readily obtainable in the market and the option is neither deeply in the money nor deeply out of the money, the asset is derecognised. This is because the entity (a) has neither retained nor transferred substantially all the risks and rewards of ownership, and (b) has not retained control. However, if there is no market for the asset, derecognition is precluded to the extent of the amount of the asset that is subject to the call option because the entity has retained control of that amount of the asset.

If a transferred financial asset can be called back by the transferor and the call option is deeply in the money, the transfer does not qualify for derecognition regardless of whether there is a market for the asset. This is because the transferor has retained substantially all the risks and rewards of ownership. Conversely, a financial asset that is transferred subject only to a deep out-of-the-money call option held by the transferor is derecognised regardless of whether there is a market for the asset. This is because the transferor has transferred substantially all the risks and rewards of ownership. A transfer of a financial asset that is subject only to a call option agreement that has an exercise or repurchase price equal to the fair value of the financial asset at the time of repurchase also results in derecognition regardless of whether there is a market for the asset. This is because the transferor has transferred substantially all the risks and rewards of ownership.

Transferor's accounting*On the date of the transfer*

Entity C derecognises the shares in their entirety and recognises a new financial asset (the purchased call option) at fair value. C should calculate the gain or loss on the sale of its shares. The gain or loss on sale is calculated as the difference between:

- the carrying amount of €68 million, and
- the sum of the consideration received of €68 million (ie, €65 million cash plus the new call option obtained whose fair value is €3 million) and any cumulative gain or loss that had been recognised directly in equity (€10 million).

	€ millions
Carrying amount	68
Consideration received	68
Cumulative gain or loss in equity	10
Gain on derecognition	10

Accounting entries on the date of the transfer

(In € millions)	Dr	Cr
Shares	68	
Cash	3	
Written call option		68
AFS reserve equity	10	
Gain on derecognition (profit or loss)		10

To recognise the cash received for sale of the shares and to recognise the purchased call option and gain of €10 million.



Subsequently, entity C will measure its call option at fair value through profit and loss. If the price of the shares never reaches €70 million, the time value of the option will be recognised in profit and loss during the next three years. If the price of the shares rises above €70 million, C has the right to exercise its call option and pay cash of €70 million to D to obtain back the shares.

Transferee's accounting

On the date of the transfer

As entity C derecognised the shares, D will recognise them. D will also recognise a liability for its written call option to C.

(In € millions)	Dr	Cr
Shares	68	
Cash		65
Written call option		3

To recognise the purchase of shares and the writing of the call option.

Subsequently, D will measure the shares at fair value. Depending on whether they are classified as fair value through profit or loss or available for sale, gains or losses will be recognised through profit and loss or equity subject to impairment testing, respectively. D will also have to measure the written call option at fair value through profit or loss. It cannot achieve hedge accounting, as the hedging instrument is a written option. As the shares are quoted in an active market, D is free to sell the shares and can buy back equivalent shares from the market should C exercise its call.

Alternative scenario and accounting consequences – no market for the shares

Assume that the shares are not quoted in an active market but are privately held and that they represent 15% of the construction entity (rather than 0.1%). As there is no market for the asset, derecognition is precluded to the extent of the amount of the asset that is subject to the call option because the entity has retained control of the asset.

Transferor's accounting

On the date of the transfer

Where a purchased call option is the cause of the continuing involvement, and the asset was previously measured at fair value, the transferred asset continues to be measured at fair value. The net amount of the asset and associated liability is always the fair value of the option. The associated liability is the balancing number and is measured at (a) the option exercise price less the time value of the option if the option is in or at the money, or (b) the fair value of the transferred asset less the time value of the option if the option is out of the money. Subsequently, any changes in the fair value of the transferred asset and associated liability are accounted for consistently with each other.

Accounting entries on the date of the transfer

(In € millions)	Dr	Cr
Cash	65	
Liability		65

The amount of the liability (€65 million) is the fair value of the transferred asset (€68 million) less the time value of the option (€3 million) as the option is out of the money.

Subsequent accounting

At the next reporting date, assume the fair value of the shares has increased to €69 million and the fair value of the option has decreased to €2 million (still all time value). The entries would be as follows:

(In € millions)	Dr	Cr
Asset	1	
ASF reserve equity To continue to recognise the asset at fair value		1
ASF reserve equity	2	
Liability		2

To adjust the liability for the change in the time value of the option and the change in fair value of the shares.

The liability now has a carrying value of €67 million which is comprised of the fair value of the asset (€69 million) less the value of the option (€2 million) as the option is still out of the money.

At the next reporting date, assume the fair value of the shares has increased to €72 million and C exercises its call option.

(In € millions)	Dr	Cr
Asset	3	
ASF reserve equity To continue to recognise the asset at fair value		3
Liability	67	
Cash		70
ASF reserve equity	3	

To record the exercise of the option and the receipt of €72 million from Company C.

It is worth noting that the net effect is:

- Cr Cash 5 (net of 65 received on sale and 70 paid on repurchase)
- Dr Asset 4 (increase in value from 68 to 72)
- Cr AFS 1 (increase in value of asset less time value of the option)



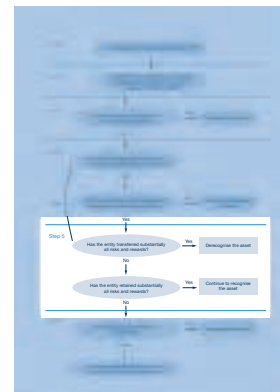
Illustration 3: Repurchase agreement

Background and assumptions

Bank E enters into an agreement with bank F to sell a debt security classified as held to maturity. The security is traded in an active market. At the same time, E agrees to repurchase the security from F at a specified fixed price on a fixed date. F pays E €1 million for the debt security, and E agrees to repurchase the security in six months' time for €1.03 million. F can sell or repledge the debt security under this agreement. The €0.03 million is a lender's return – that is, current six-month interest rates are 3%.

Additional information:

- Fair value of debt security at date of transfer – €1 million
- Fair value of forward purchase agreement on date of transfer – €0 million
- Carrying value at date of transfer – €0.95 million



Step 5

Analysis using the flowchart

Step 1 Consolidate all subsidiaries

This step is not applicable in this example.

Step 2 Determine whether the derecognition model should be applied to part of a financial asset (or a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety.

The asset being transferred is the debt security in its entirety.

Step 3 Have the rights to the cash flows expired?

No, the debt security has not yet reached maturity so the rights to the cash flows still exist.

Step 4 Is there a transfer?

Yes, bank E has sold the debt security to bank F.

Step 5 Risks and rewards analysis

E has retained substantially all the risk and rewards of the debt security. F is receiving only a lender's return on the cash it has provided to E. Therefore, the transaction fails derecognition, and E treats this transfer as a collateralised borrowing.

Helpful hint – alternatives relating to repurchase agreements

If the repurchase price is the market price of the asset at the time of repurchase, the transferor has transferred substantially all of the risks and rewards of ownership of the asset and consequently derecognises the asset. If a financial asset is sold under an agreement to repurchase substantially the same asset at a fixed price (usually equal to sales price plus lender's return), or provides the transferee with a right to substitute assets that are similar and of equal fair value to the transferred asset at the repurchase date, the transferor retains substantially all the risks and rewards of ownership of the asset and consequently fails derecognition.

Transferor's accounting

On the date of the transfer

As a result of the failed derecognition, bank E continues to recognise the transferred asset. E also recognises a financial liability for the consideration received for the transferred asset from F. As F has the right to sell or repledge the debt security, E presents the asset separately in the balance sheet (for example, as a loaned asset, or pledged securities).

Accounting entries on the date of the transfer

(In € millions)	Dr	Cr
Cash	1	
Repo liability To recognise the transfer as a collateralised borrowing		1
HTM asset		1
Loaned asset To recognise the transfer as a collateralised borrowing	1	

Helpful hint

As there is no derecognition, bank E has not tainted its held-to-maturity portfolio as a result of this transaction.

Subsequent accounting

Subsequently, bank E will continue to account for the transferred asset as it previously had as held to maturity; however, it will be reclassified on the balance sheet to loaned asset. E will account for the liability at amortised cost, with the difference between the sales and repurchase prices being accrued as an expense over the six-month term of the agreement using the effective interest rate method.

(In € millions)	Dr	Cr
Interest expense	0.3	
Repo liability		0.3

To accrue interest on the repo liability.

On the date the repo liability matures the entries would be as follows:

(In € millions)	Dr	Cr
Repo liability	1.03	
Cash		1.03

To record the settlement of the repo liability.



Transferee's accounting

On the date of the transfer

As the transfer 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.

(In € millions)	Dr	Cr
Loan to bank E (reverse repo)	1	
Cash		1

To recognise the transfer as a collateralised lending.

Subsequent accounting

Subsequently, bank F will account for this loan at amortised cost using the effective interest method, unless it elects to classify it as available for sale or as at fair value through profit or loss.

(In € millions)	Dr	Cr
Loan to bank E (reverse repo)	0.3	
Interest income		0.3

To record interest income on the loan to bank E.

On the date the repo matures the entries would be as follows:

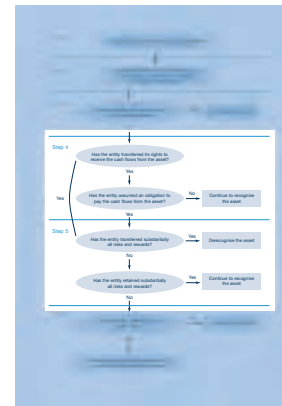
(In € millions)	Dr	Cr
Cash	1.03	
Loan to bank E (reverse repo)		1.03

To record the repayment of the loan by bank E to bank F.

Illustration 4: Factoring without recourse

Background and assumptions

Entity G enters into an agreement to assign its portfolio of €20 million trade receivables without recourse to Factor H. The receivables have 60-day terms and are subject to normal warranties on the existence of the receivables at the date of transfer (for example, if a customer returns the goods purchased because they are faulty, the receivable does not exist. Entity G will pay Factor H the amount received from H for the receivable.) H pays G €19 million in cash for the receivables. There is no obligation on G to make good any shortfall on the receivables to H due to either default or late payment, and G receives no compensation from H for faster than expected payments or lower than expected levels of default. As G continues to service the receivables, the debtors have not been notified that their receivables have been transferred. G also receives a fee of 0.2% of the notional amount of each receivable transferred for servicing the receivables.



Steps 4 and 5

Additional information:

- Fair value of portfolio of trade receivables on date of transfer – €19 million
- Carrying value of portfolio of trade receivables on date of transfer – €20million
- The servicing fee is expected to adequately compensate entity G for servicing the receivables
- The receivables were classified as loans and receivables under IAS 39

Analysis using the flowchart

Step 1 Consolidate all subsidiaries

This step is not applicable in this example.

Step 2 Determine whether the derecognition model should be applied to part of a financial asset (or a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety.

The financial instruments being transferred have similar characteristics. They are all trade receivables, have similar credit ratings and mature at approximately the same date (60 days). They should be assessed as a group of similar financial assets.

Step 3 Have the rights to the cash flows expired?

No, the portfolio of receivables has not yet reached maturity so the rights to the cash flows still exist.

Step 4 Is there a transfer?

Yes, entity G has assigned the rights to the cash flows from the receivables to factor H and therefore there has been a transfer under paragraph 18(a). Although G has provided normal warranties, these relate to business risks of the underlying transaction – which affect the existence of the receivable – rather than to the financial risks associated with the receivable itself and do not prohibit transfer of rights to cash flows. In addition, although the debtors have not been notified that their receivables have been transferred, this does not preclude this transaction meeting the definition of a transfer, as G is only servicing the receivables and has no rights to cash flows from them.



Step 5 Risks and rewards analysis

Entity G has transferred the credit and late payment risk. G has therefore transferred substantially all the risks and rewards and should derecognise the receivables.

Transferor's accounting

On the date of the transfer

Entity G derecognises the receivables. The difference between the carrying amount and consideration received is a gain or loss on sale.

Accounting entries on the date of the transfer

(In € millions)	Dr	Cr
Cash	19	
Receivables		20
Loss on sale	1	

To recognise the sale of receivables and corresponding loss. There is no adjustment for the servicing, as it is adequate compensation.

Transferee's accounting

On the date of the transfer

As entity G derecognised the receivables, factor H will recognise the receivables.

(In € millions)	Dr	Cr
Receivables	19	
Cash		19

To recognise the purchase of the receivables.

Subsequently, factor H will account for these receivables based on the appropriate classification in IAS 39 – that is, either as a loan and receivable at amortised cost using the effective interest method, as available for sale, or as at fair value through profit or loss.

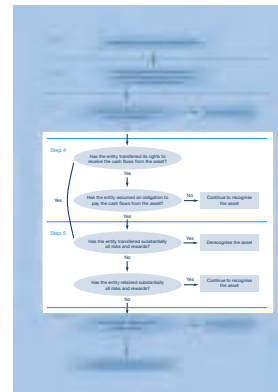
Helpful hint – factoring

It may be, as in this example, that the seller is not contractually obligated to repurchase the receivables once they default. However, often the seller will have the right to repurchase defaulted or overdue receivables at face value in order to maintain its customer relationships. To the extent there is an expectation that the seller will repurchase the receivables once they stop performing, this should be factored into the risks and rewards analysis. For example, if entity G has a history of repurchasing all receivables that default, it will have retained substantially all of the default risk and it is likely that substantially all the risks and rewards have not been transferred.

Illustration 5: Factoring with recourse

Background and assumptions

Entity J enters into an agreement to assign its portfolio of €20 million trade receivables with recourse to factor K. The receivables have 90-day terms and are subject to normal warranties on the existence of the receivables at the date of the transfer (for example, if a customer returns the goods purchased because they are faulty, the receivable does not exist; J will pay to K the face amount of the receivable plus interest). K agrees to pay J an initial amount of €16 million in cash for the rights to the cash flows from the receivables. Once the receivables have been repaid, K will pay a further sum to J calculated as the balance of €4 million less interest on the €16 million initial payment until the date debtors pay and less any defaults (defined as any debts that remain unpaid after 120 days). As J continues to service the receivables, the debtors have not been notified that their receivables have been transferred. J also receives a fee of 0.2% of the notional amount of each receivables transferred for servicing the receivables.



Steps 4 and 5

Additional information:

- Fair value of portfolio of trade receivables on date of transfer – €19.5 million
- Carrying value of portfolio of trade receivables on date of transfer – €20 million
- The servicing fee is expected to adequately compensate entity J for servicing the receivables
- The receivables were classified as loans and receivables under IAS 39

Analysis using the flowchart

Step 1 Consolidate all subsidiaries

This step is not applicable in this example.

Step 2 Determine whether the derecognition model should be applied to part of a financial asset (or a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety.

The financial instruments being transferred have similar characteristics. They are all trade receivables, have similar credit ratings and mature at approximately the same date (90 days). They should be assessed as a group of similar financial assets

Step 3 Have the rights to the cash flows expired?

No, the portfolio of receivables has not yet reached maturity so the rights to the cash flows still exist.

Step 4 Is there a transfer?

Yes, entity J has assigned the rights to the cash flows from the receivables to factor K; therefore there has been a transfer under paragraph 18(a). Although J has provided normal warranties, these relate to business risks of the underlying transaction, which affect the existence of the receivable rather than to the financial risks associated with the receivables themselves and do not prohibit the transfer of rights to cash flows. In addition, although the debtors have not been notified that their receivables have been transferred, this does not preclude this transaction meeting the definition of a transfer, as J is only servicing the receivables.

Step 5 Risks and rewards analysis

Entity J has retained the credit and late payment risk as the expected losses/variability is such that the likelihood of losses exceeding the €4 million withheld is remote. J has therefore retained substantially all the risks and rewards and should continue to recognise the receivables.



Transferor's accounting

On the date of the transfer

As a result of the failed derecognition, entity J continues to recognise the receivables. J also recognises a financial liability for the consideration received for the transferred asset from factor K.

Accounting entries on the date of the transfer

(In € thousands)	Dr	Cr
Cash	16,000	
Loans from factor K		16,000

To recognise the transfer as a collateralised borrowing.

Subsequent accounting

Subsequently, entity J will continue to account for the transferred asset as receivables at amortised cost, subject to impairment testing. J will account for the liability to factor K at amortised cost and accrue interest until the date receivables pay using the effective interest method. Assume that €19 million pay in 90 days and the other €1 million remains outstanding after 120 days. Interest is charged by the factor at 10%.

On day 90

(In € thousands)	Dr	Cr
Interest expense	400	
Loans from Factor K		400

To accrue interest on the loan from factor K of €16 million ($10\% \times 16m \times 90/360 = 400$).

On day 120

(In € thousands)	Dr	Cr
Cash	19,000	
Receivables		19,000
Cash		19,000
Loans from K	16,400	
Receivable from K	2,600	

To pay cash to the factor when received, remove the liability and set up a receivable from factor for the deferred purchase consideration still to be received.

	€ millions
Cash received from debtors	19
Less interest	0.400
Less upfront payment	16
Additional cash received from factor	2.600

Note: In reality, the cash probably does not move in a gross basis, as the transferor would normally net settle the amount. We have presented it this way for illustration purposes only.

The entries would be as follows:

On day 120

(In € thousands)	Dr	Cr
Cash	2,600	
Receivable from K		2,600
Impairment	1,000	
Receivables		1,000

To record the settlement of the receivables from Factor K, as at day 120 the relationship with K ceases, entity J also needs to record impairment on the remaining €1,000 of receivables if it has not already.

Transferee's accounting

As the transfer does not qualify for derecognition, the transferee K does not recognise the transferred receivables as their assets. K derecognises the cash or other consideration paid and recognises a receivable from the transferor J.

On the date of the transfer

(In € thousands)	Dr	Cr
Loan to company J	16,000	
Cash		16,000

To recognise the transfer as a collateralised lending.

Subsequent accounting

Subsequently, factor K will account for this loan at amortised cost using the effective interest method unless designated as available for sale or as at fair value through profit or loss.

On day 90

(In € thousands)	Dr	Cr
Loan to J	400	
Interest income		400
Cash	19,000	
Loan to J		16,400
Loan from J		2,600

To accrue interest on the loan to entity J and extinguish the loan to J as €19 million of receivables have been paid.

When factor K makes the additional payment to J, the entries would be as follows:

On day 120

(In € thousands)	Dr	Cr
Cash		2,600
Loan from entity J	2,600	

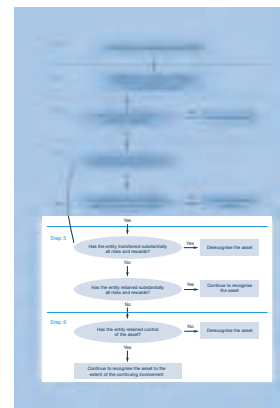
To record the settlement of the loan with J.



Illustration 6: Factoring with late payment risk retained

Background and assumptions

Entity L enters into an agreement on 1 January 20X1 to assign its portfolio of €20 million trade receivables to factor M. M pays L €19.5 million in cash for the rights to the cash flows from the receivables. As M is a banking subsidiary of an insurance company, it assumes the default risk. The receivables have 60-day terms and are subject to normal warranties on the existence of the receivables at the date of the transfer (for example, if a customer returns the goods purchased because they are faulty – the receivable does not exist – L will pay M the face amount of the receivable). The debtors have not been notified that their receivables have been transferred. L will pay interest (at Euribor set at the date of transfer + 50bps) to M should any of the receivables pay late for up to 210 days after their due date. After 210 days, the receivables will be considered defaulted, and the factor will suffer any further loss. Historically, an average of 30% of customers pay late, and an additional 1.25% of customers default. L has determined that both credit risk and slow-payment risk are significant risks of its trade receivables. L has performed an analysis that shows that some significant risk has been transferred and some significant risk has been retained.



Steps 5 and 6

Note that continuing involvement is a unique accounting model for which little guidance is provided in IAS 39. There may therefore be other acceptable ways to account for the following transaction.

Additional information:

- Fair value of portfolio of trade receivables on date of transfer – €19.35 million
- Carrying value of portfolio of trade receivables on date of transfer – €20 million
- Fair value of late payment guarantee on date of transfer – €0.15 million
- 270 day Euribor on date of transfer – 3.3%
- L continues to service the receivables and is adequately compensated for doing so

Analysis using the flowchart

Step 1 Consolidate all subsidiaries

This step is not applicable in this example.

Step 2 Determine whether the derecognition model should be applied to part of a financial asset (or a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety.

The financial instruments being transferred have similar characteristics. The trade receivables have similar credit ratings and mature at approximately the same date (60 days). They should be assessed as a group of similar financial assets.

Step 3 Have the rights to the cash flows expired?

No, the portfolio of receivables has not yet reached maturity so the rights to the cash flows still exist.

Step 4 Is there a transfer?

Yes, entity L has assigned the rights to the cash flows from the receivables to factor M; therefore there has been a transfer under paragraph 18(a). Although L has provided normal warranties, these relate to business risks of the underlying transaction, which affect the existence of the receivable rather than the financial risks associated with the receivable itself and do not prohibit a transfer of rights to cash flows. In addition, although the debtors have not been notified that their receivables have been transferred, this does not preclude this transaction meeting the definition of a transfer, as L is only servicing the receivables and has no rights to cash flows from them. Therefore L has transferred its rights to the cash flows to M.

Step 5 Risks and rewards analysis

Before the transaction, L was exposed to all the risks of the receivables, both credit default risk and late payment risk. After the transaction, L has only retained the late-payment risk up to 210 days. The credit risk and the slow-payment risk beyond 210 days have been transferred to the factor. Therefore, according to L's analysis, it has neither retained nor transferred substantially all the risks and rewards relating to the receivables.

Step 6 Control

Factor M does not have the practical ability to sell the receivables unilaterally. There is no market in trade receivables, and should M sell the receivables, it would have to do so with the attached late-payment guarantee. That guarantee as well as the servicing is an additional restriction, hence L still controls the receivables. Therefore L will continue to recognise the receivables to the extent of its continuing involvement.

Transferor's accounting*On the date of the transfer*

As entity L has neither retained nor transferred substantially all the risks and rewards of ownership of the receivables, and factor M does not have the practical ability to sell the receivables, L should continue to recognise the receivables to the extent of its continuing involvement. The extent of L's continuing involvement is the extent to which it is exposed to changes in the value of the receivables, which in this case is the late-payment guarantee. The continuing involvement asset is the lower of the amount of the receivables and the maximum amount of consideration received that L could be required to repay. The associated liability will be the amount of the continuing involvement asset plus the fair value of the late-payment guarantee (in this case, €150,000). This results in the net position on the balance sheet of the continuing involvement asset and liability being the fair value of the late payment guarantee.

The continuing involvement asset is calculated as follows:

Amount of receivables	20,000,000
* Interest rate	3.3%
* Number of days / 360	210/360
= Continuing involvement asset	385,000



Accounting entries on the date of the transfer (1 January 20X1)

(In €)	Dr	Cr
Cash	19,500,000	
Receivables		20,000,000
Continuing involvement asset	385,000	
Continuing involvement liability (the guaranteed amount + FV of guarantee of €150k)		535,000
Loss on transfer	650,000	

To recognise entity L's continuing involvement in the form of a late-payment guarantee.

Subsequent accounting

Subsequently, over the next 270 days as the receivables repay, the continuing involvement asset and liability will decrease similarly. In addition, the initial fair value of the guarantee will be amortised in profit and loss. An impairment charge on the asset will be taken if a payout is required under the guarantee.

For example, assume entity L prepares an interim set of financial statements at 30 June 20X1 and at that time 20% of receivables still have not paid (the remaining 80% paid within 60 days). The journal entries for the transaction under continuing involvement would be as follows:

(In €)	Dr	Cr
Continuing involvement liability	308,000	
Continuing involvement asset To decrease the continuing involvement asset and liability to reflect that 80% paid on time; therefore no payment will be required under the late payment guarantee (80% * 443,333 = 354,667)		308,000
Cash paid out under late payment guarantee as late for 120 days now (20,000,000 * 20% * 3.8% * 120/360)		44,000
Continuing involvement liability To recognise the payment made under late payment guarantee	44,000	
Other income – amortisation of guarantee fee (4 months/7 months of 20% of 150,000=17143) + (80% of 150,000 = 120,000) in full as has been repaid)		137,143
Continuing involvement liability To amortise the guarantee fee	137,143	
Impairment charge in profit and loss	44,000	
Continuing involvement asset To impair the asset to reflect the payout under the late payment guarantee		44,000

After these entries have been made, the resulting continuing involvement asset is €33,000. This represents the maximum remaining payout on the 20% that has not yet paid. The resulting continuing involvement liability is €45,857. This represents the €33,000 for the 20% that has not yet paid + remaining fee of €12,857 yet to be amortised.

Note: if the guarantee fee is insufficient to cover the losses, an additional provision would need to be recognised in accordance with IAS 37, 'Impairment of assets'.

Illustration 7: Securitisation – revolving structure

Background and assumptions

Bank N assigns €100 million of its credit card receivables to an SPE on a revolving basis for five years. The SPE is formed for the purpose of this securitisation; its activities are limited to holding the credit card receivables, issuing notes to investors and associated activities. To fund the assignment of receivables, the SPE issues both senior (€90 million) and subordinated (€10 million) floating-rate notes. Third-party investors purchase the senior notes from the SPE. N purchases the subordinated notes from the SPE. Each month when cash is collected from the receivables, the interest element collected is used to pay interest on the notes, and any principal collected is reinvested in new receivables. At the end of five years, the notes mature and the principal is repaid from the collections on the receivables. The senior notes are paid first, and only if there is sufficient collections will the subordinated note be repaid. During the five years, the SPE cannot sell or pledge the credit card receivables. The average level of default on the revolving pool of the credit card receivables over the five years is 5%.

Additional information:

- Fair value of credit card receivables on date of transfer – €100 million
- Carrying value of portfolio of receivables on date of transfer – €100 million
- Credit card receivables are not considered cash and cash equivalents and are accounted for as loans and receivables under IAS 39

Analysis using the flowchart

Step 1 Consolidate all subsidiaries

For the purposes of this illustration, it is assumed the SPE is consolidated because in substance bank N controls the SPE. The activities of the SPE are conducted on behalf of N according to its specific business needs, and N retains the majority of the residual or ownership risks of the SPE through holding the subordinated note.

Helpful hint – judgements on consolidation

Consolidation is an area of judgement that is beyond the scope of this publication. For further information on SIC 12, see our publication *SIC-12 and FIN 46R – the substance of control*.

Step 2 Determine whether the derecognition model should be applied to part of a financial asset (or a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety.

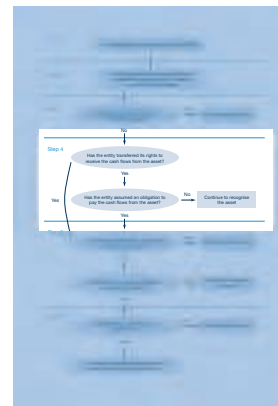
The financial instruments being transferred have similar characteristics. They are all credit card receivables. They should be assessed as a group of similar financial assets in their entirety.

Step 3 Have the rights to the cash flows expired?

No, the portfolio of receivables has not yet matured so the rights to the cash flows still exist.

Step 4 Is there a transfer?

As the SPE is consolidated by bank N, there is no outright transfer of the contractual rights to the cash flows under paragraph 18(a). Hence N Group (including the SPE) should assess whether it meets the pass-through requirements.



Step 4



- Test (a) passed – N Group has no obligation to pay amounts to the eventual recipients (investors in the notes) unless it collects equivalent amounts from the credit card receivables.
- Test (b) passed – N Group is prohibited by the terms of the transfer contract from selling or pledging the receivables other than as security to the investors for the obligation to pay them cash flows.
- Test (c) failed – N Group does not have an obligation to remit any cash flows it collects on behalf of the investors without material delay, as the principal is not repaid until year five. In addition, N Group is entitled to reinvest such cash flows in future credit card receivables and not just in cash or cash equivalents.

N therefore fails the pass-through requirements and should continue to recognise the receivables.

Transferor's accounting

On the date of the transfer

As bank N failed the pass-through tests, it cannot derecognise the receivables. It will recognise the notes issued by the SPE as collateralised borrowings. It does not recognise the subordinated notes issued by the SPE that it has purchased, as from the consolidated entity's perspective those notes are inter-company and hence are eliminated.

Accounting entries on the date of the transfer

(In € millions)	Dr	Cr
Cash	90	
Senior notes issued		90

To recognise the notes issued to third-party investors.

Subsequently, bank N will account for the credit card receivables as it did prior to the transfer, at amortised cost using the effective interest method. N will account for the issued note also at amortised cost using the effective interest method.

Transferee's accounting

On the date of the transfer

As the transfer did not meet the derecognition requirements, the investors cannot recognise the credit card receivables. They will instead recognise an asset for the asset-backed (collateralised) notes issued from the SPE.

Accounting entries on the date of the transfer

(In € millions)	Dr	Cr
Cash		90
Asset backed securities	90	

To record the purchase of the asset backed securities issued by the SPE.

Subsequently, the investors will account for the securities as either loans and receivables (if they are not quoted in an active market), available for sale or at fair value through profit or loss depending on the facts and circumstances and chosen classification.

Illustration 8: Sale of loans – guarantee retained

Background and assumptions

Entity P has originated a group of similar five-year fixed rate corporate loans for €9,980,000 with the intention of selling them to a bank in the near future. It is therefore accounting for these loans at fair value through profit or loss before the sale. Subsequently, P assigns the loans to a third-party bank for €10.1 million but guarantees one-third of any default losses associated with the loans (under the terms of the guarantee, if a payment on a loan is 180 days overdue, the loan is considered to have defaulted and a payment becomes due under the guarantee). There is no active market in these loans. Credit risk is the only significant risk. There is no late-payment risk, as interest is charged on late payments.

Note that continuing involvement is a unique accounting model for which little guidance is provided in IAS 39. There may therefore be other acceptable ways to account for the following transaction.

Additional information:

- Fair value of loans €10 million (fair value = book value, originated for €9,980,000, so the fair value has increased by €20,000 since origination)
- Fair value of guarantee obligation €100,000
- Fair value of guarantee fee €57,000 (PV of 13bp fee on OPB)
- The servicing fee is expected to adequately compensate entity P for servicing the loans
- The debtors have not been notified that their loans are being transferred

Analysis using the flowchart

Step 1 Consolidate all subsidiaries

There are no SPEs involved. P has sold the loans directly to the bank.

Step 2 Determine whether the derecognition model should be applied to part of a financial asset (or a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety.

The financial instruments being transferred have similar characteristics. They are all fixed-rate loans to similar counterparties that mature at approximately the same time (five years). They may be assessed as a group of similar financial assets in their entirety.

Step 3 Have the rights to the cash flows expired?

No, the portfolio of loans has not yet reached maturity so the rights to the cash flows still exist.

Step 4 Is there a transfer?

Yes, P has assigned the loans to the bank. In addition, although the debtors have not been notified that their loans have been transferred, this does not preclude this transaction meeting the definition of a transfer, as P is only servicing the loans and has no rights to cash flows (other than the servicing fee of 13bp).

Step 5 Risks and rewards analysis

P has retained one-third of any credit losses that are incurred by the bank on these loans. P has not retained any other risk on these loans. Therefore, P has retained some risks and rewards, as credit risk is the only significant risk, but not substantially all risks and rewards and should ask the control question.



Step 6



Step 6 Control

The bank does not have the ability to sell the loans unilaterally. There is no market in the loans and, as the loans are subject to the guarantee, the bank would want to also sell the loans subject to that guarantee. That additional restriction means that P still controls the loans. Therefore, P will continue to recognise the loans to the extent of its continuing involvement.

Transferor's accounting

P has neither retained nor transferred substantially all the risks and rewards relating to the loans and has retained control; it should therefore account for the transfer using continuing involvement. The continuing involvement is the lower of (a) the amount of the asset, and (b) the maximum amount of the consideration received that the entity could be required to repay ('the guarantee amount').

- (a) The amount of the asset equals €10 million.
- (b) The maximum amount of the consideration received (€10.1 million) that the entity could be required to repay – the guaranteed amount – is one-third of the principal balance and amounts to €3,333,333.

The continuing involvement asset is therefore €3,333,333 (the lower of (a) and (b)).

The associated liability is measured in such a way that the net carrying amount of the transferred asset and the associated liability is equal to the fair value of the rights and obligations retained by the entity when measured on a stand-alone basis, as per paragraph 31(b) of IAS 39.

The entity has the obligation to provide a guarantee for one-third of credit losses. The fair value of the guarantee obligation is €100,000. Accordingly, the liability is €3,433,333, being the aggregate of the amount of the continuing involvement asset above (€3,333,333) and the guarantee (€100,000).

Accounting entries on origination of the loans

(In €)	Dr	Cr
Cash		9,980,000
Loans	9,980,000	

To record the cash lent at origination of the loan.

Accounting entries just before transfer, as fair value of loans has increased

(In €)	Dr	Cr
Loans	20,000	
Profit or loss		20,000

To record the cash lent at origination of the loan.

Accounting entries on date of the transfer

(In €)	Dr	Cr
Cash	10,100,000	
Loans To record the cash received on the sale of the loans		10,000,000
Continuing involvement asset (inclusive of the guarantee receivable of 57,000)	3,333,333	
Continuing involvement liability (inclusive of the guarantee liability of 100,000) To record P's continuing involvement in the loans resulting from the guarantee.		3,390,333

Helpful hint

For illustration purposes, we have shown a credit to loans of €10 million and a debit of €3,333,333 for the new continuing involvement asset. In practice, these entries would be combined, as the continuing involvement asset is a retained part of the transferred loans – it is not a new asset. There is no gain or loss on disposal, as the assets were already carried at fair value.

Subsequent accounting

Subsequently, the continuing involvement asset will continue to be measured at fair value through profit or loss. To the extent there is an expected payout under the guarantee, this will be reflected by a negative fair value change in the asset and so the net of the continuing involvement asset and liability will reflect the fair value of the guarantee. In addition, as amounts are collected on the loans, both the continuing involvement asset and liability are similarly reduced.

Assume we are one year later, and the fair value of the loans has decreased by €384,000, of which we still have continuing involvement in one-third, and the fair value of the guarantee is now €174,000.

(In €)	Dr	Cr
Continuing involvement assets (reflecting the change in fair value of assets) (one-third of 384,000)		128,000
Continuing involvement liability (reflecting the change in fair value of assets and increase in fair value of guarantee 128,000-74,000)	117,000	
Net profit and loss	74,000	

To record the cash fee received for the guarantee, the fall in the fair value of the asset and the increase in the fair value of the liability.

Note that an alternative way to look at this might be to separately assess two transfers of proportions of the asset for derecognition – one without recourse (67% of the asset) and one with recourse (33% of the asset), which would achieve similar accounting in this example.



Illustration 9: Securitisation – all in interest rate swap retained

Background and assumptions

Bank Q assigns 10-year 10% fixed rate pre-payable mortgages with a notional principal of €10 million to an SPE for €10 million of cash on 1 January 20X1. The SPE issues 10-year floating-rate (Libor based) notes to investors (with quarterly interest payment dates) in various credit-rated tranches that are repaid as the mortgages themselves are repaid. Q does not purchase any of the notes issued by the SPE. An insurance company purchases the unrated notes, which absorb all the expected credit losses on the mortgages.

Q enters into an ‘all-in’ interest rate swap with the SPE, such that Q will continue to receive all the fixed interest (10%) cash flows on the mortgages and pay a floating rate (Libor +2%) to the SPE so the SPE can pay the interest to the noteholders. The notional amount of the swap is set equal to the principal amount of the mortgages. If a mortgage prepays without penalty, the notional amount of the swap is reduced by an equivalent amount without compensation. Such pre-payments may arise due to mortality, the mortgagee moving house or mortgagees paying up to 15% of the loan per annum. In all other cases, if a mortgagee wishes to pre-pay and interest rates have fallen, it must pay an early redemption penalty equal to the difference between the principal amount repaid and its fair value based on current market interest rates. On such a pre-payment, the notional amount of the swap is reduced by an equivalent amount, but the pre-payment penalty that the mortgagee pays – ie, compensation equal to the fair value of the reduction – is paid to Q. If the mortgagee prepays when rates have risen, there is no rebate, and Q, by way of the swap, retains the benefits of such early pre-payments.

Under the terms of the sale agreement, the SPE cannot sell the mortgages. A third party has been hired by the SPE to service the mortgages for a current market fee.

Q has prepared an analysis that shows that pre-payment risk and credit risk are the only significant risks on these loans. However, pre-payment risk is lower than credit risk, as there are limited circumstances in which a mortgagee can prepay without penalty. Q’s analysis demonstrates that it retains less than a majority of the risks and rewards of the mortgages. There is no market for selling mortgages to which Q has access.

Note that continuing involvement is a unique accounting model for which little guidance is provided in IAS 39. There may therefore be other acceptable ways to account for the following transaction.

Additional information:

- Fair value of portfolio of mortgages – €10.5 million
- Carrying value of portfolio of mortgages – €10 million
- Fair value of all-in interest rate swap – €0.5 million (an asset from Q’s perspective)
- 10-year Libor is 7.2% (assume a flat curve), and the credit spread remains at 2%.
- The servicing fee is expected to adequately compensate the third-party servicer



Step 6

Analysis using the flowchart

Step 1 Consolidate all subsidiaries

The issue of consolidation is beyond the scope of this publication and depends on facts and circumstances (see our publication *SIC-12 and FIN 46R – the substance of control* for more guidance). For the purpose of this illustration, it is assumed that the SPE is not consolidated.

Step 2 Determine whether the derecognition model should be applied to part of a financial asset (or a group of similar financial assets) or a financial asset (or a group of similar financial assets) in its entirety.

The financial instruments being transferred have similar characteristics. They are all fixed-rate mortgages that mature at approximately the same time (10 years). They should be assessed as a group of similar financial assets in their entirety.

Step 3 Have the rights to the cash flows expired?

No, the portfolio of mortgages has not yet reached maturity, so the rights to the cash flows still exist.

Step 4 Is there a transfer?

Yes, as bank Q has assigned the mortgages to a non-consolidated SPE, it has transferred the contractual rights to the cash flows from loans to the SPE, a third party, and would have a transfer under paragraph 18(a) of IAS 39.

Helpful hint

Had it been concluded that bank Q does consolidate the SPE, the pass-through tests would need to be assessed as follows:

- Test (a) failed – Q has an obligation to pay amounts to the eventual recipients (investors in the notes) even if it does not collect equivalent amounts from the mortgages. This is because the all-in interest rate swap may require a net payment to the SPE (that is then passed to noteholders) if interest rates rise so that the interest due on the notes exceeds that due on the mortgages.
- Test (b) passed – Q is prohibited by the terms of the transfer contract from selling or pledging the mortgages other than as security to the investors for the obligation to pay them cash flows.
- Test (c) passed – Q does have an obligation to remit any cash flows it collects on behalf of the investors without material delay – ie, quarterly.

Q would fail one of the pass-through requirements and therefore fail derecognition.

Step 5 Risks and rewards analysis

Bank Q has transferred all of the credit risk on the mortgages to the holders of the notes issued by the SPE. Q retains all the pre-payment risk on the mortgages. Q's analysis shows that pre-payment risk is lower in comparison to credit risk because generally if pre-payment occurs, the mortgagee is required to pay a pre-payment penalty with the effect that Q receives the then current fair value of the loan and therefore suffers no loss from pre-payment. Hence pre-payment risk arises only in cases when a loan may be prepaid without penalty (in which case, Q suffers the pre-payment risk). Such pre-payments may arise due to mortality, mortgagees moving house or mortgagees paying up to 15% of the loan per annum. Therefore, Q has retained some but not substantially all risks and rewards.



Step 6 Control

The SPE does not have the practical ability to sell the mortgages unilaterally. The terms of the transfer prevent the SPE from selling the mortgages, and hence Q still controls those mortgages. Therefore, Q will continue to recognise the mortgages to the extent of its continuing involvement.

Transferor's accounting

On the date of the transfer

As Q has neither retained nor transferred substantially all the risks and rewards of ownership of the mortgages and the SPE does not have the practical ability to sell the mortgages, it should continue to recognise the mortgages to the extent of its continuing involvement. The extent of Q's continuing involvement is the extent to which it is exposed to changes in the value of the mortgages, which in this case arises from the retained pre-payment risk on the mortgages. This will be calculated as the maximum amount of interest receipts on the mortgages to which Q is still exposed – ie, all of the interest receipts on the mortgages at 10%.

The associated liability will be the continuing involvement asset minus the fair value of the all in interest-rate swap. The resulting net position on the balance sheet of the continuing involvement asset and liability will be the fair value of the interest rate swap.

The continuing involvement asset is calculated as follows:

(In € thousands)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Maximum cash flows	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000
Discount factor of 10%	0.91	0.83	0.75	0.68	0.62	0.56	0.51	0.47	0.42	0.39
PV of cash flows	909	826	751	683	621	564	513	467	424	386

The asset is €6,145,000, which is the present value of a 10% interest strip for 10 years (discounted at the original effective interest rate of 10%), assuming no pre-payments. This represents the maximum cash flows the transferor is exposed to.

The liability is the present value of the cash flows arising on the floating leg of the swap.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Floating leg cash flows	920	920	920	920	920	920	920	920	920	920
Discount factor of 9.2%	0.92	0.84	0.77	0.70	0.64	0.59	0.54	0.49	0.45	0.41
PV of cash flows	842	772	707	647	592	543	497	455	417	382

Accounting entries on date of transfer (1 January 20X1)

(In €)	Dr	Cr
Cash	10,000,000	
Mortgages To record the cash received on sale of the mortgages		10,000,000
Continuing involvement asset	6,145,000	
Continuing involvement liability		5,853,000
Profit or loss		292,000

To recognise Q's continuing involvement asset in the form of the interest strip on the mortgages and its associated liability such that the net is the amortised cost of the rights and obligations retained by the entity [IAS 39 AG31(a)].

This results in:

- The continuing involvement asset being recorded at the previous carrying amount of the interest strip, assuming no pre-payments (ie, €1,000 per annum discounted at the original effective interest rate of 10%).
- The profit recognised on partial disposal reflecting the difference between the carrying amount of the principal discounted at the original effective interest rate ($10,000/(1+10\%)^{10}$) and the fair value of the principal discounted at the current market rate of interest ($10,000/(1+9.2\%)^{10}$).
- The continuing involvement liability representing the obligation to pay the floating leg of the swap, discounted at the current market rate of interest (ie, €920 per annum discounted at 9.2%).

Helpful hint

For illustration purposes, we have shown a credit to loans of €10 million and a debit of €6,145,000 for the new continuing involvement asset. In practice, these entries would be combined, as the continuing involvement asset is a retained part of the transferred loans – it is not a new asset. In addition, the entity might have concluded that their maximum exposure was only to an interest rate strip of 8%, as there is +2% on the floating leg of the swap, which would make the gross balance sheet asset and liability different, but the net would still be the same.

Subsequent accounting

Subsequently, bank Q will amortise the continuing involvement asset and liability using the effective interest method. To the extent pre-payments, without penalties, are greater than expected, this will result in impairment of the asset.



Assume Q is preparing its 31 December 20X1 financial statements. Only 0.1% of the mortgages have pre-paid during the year in line with expectations. There were no pre-payment penalties associated with these early redemptions. Assume the floating leg (Libor + 2%) of the interest-rate swap has risen to 10.5%. The journal entries would be as follows:

(In €)	Dr	Cr
Cash Coupon of 10% received – on a notional principal of €9.99 million (€10 million less 0.1% pre-payment)	999,000	
Interest income To accrue interest on the continuing involvement asset at 10%		614,500
Continuing involvement asset To record interest income on the asset on an effective interest rate basis		384,500
Cash (pay floating leg of swap at 10.5% on principal of €9.99 million)		1,048,950
Interest expense To accrue interest on the continuing involvement liability at the original effective interest rate, which for the floating leg is the market rate at the date of transfer – 9.2%	538,476	
Continuing involvement liability To record interest expenses on the liability on an effective interest rate basis	510,474	
As there are now different cash flow expectations due to the amount that has been prepaid and the change in interest rates, an AG8 cumulative catch-up adjustment should be made to both the continuing involvement asset and liability, with a corresponding adjustment to profit or loss.		
Continuing involvement asset ¹ To remeasure the asset to reflect the change in cash flows due to pre-payments of 0.1% (5,753,264 – (6,145,000 - 384,500))		7,236
Continuing involvement liability ² To remeasure the liability to reflect the change in expected cash flows based on the current floating rate of 10.5% (Libor + 2%) under a cumulative catch up method (6,237,904 – (5,853,000 - 510,474))		895,378
Profit or loss	902,614	

¹ The continuing involvement asset should represent the gross amount of cash Bank Q might receive under the fixed leg of the swap (for example the fixed cash flows on the remaining mortgages that have not repaid). As some mortgages have pre-paid, the maximum cash flows need to be amended for that. On an amortised cost basis, an adjustment to the carrying amount of the asset of €7,236 as per IAS 39 AG8 is required to remeasure the asset to the new maximum cash out flows of €999,000 for the next nine years discounted at the original EIR of 10% (ie, €5,753,264) assuming no further changes to pre-payments.

² The continuing involvement liability should represent the gross amount of cash Q is required to pay under the floating leg of the swap, discounted at the original effective interest rate (ie, its obligations on an amortised cost basis). As interest rates have increased, more cash will be paid under the floating leg of the swap. On an amortised cost basis, an adjustment to the carrying amount of the liability of €895,318 is required by IAS 39 AG8 to remeasure the liability to the new estimated cash out flows of €1,048,950 for the next nine years (ignoring pre-payments and assuming a flat yield curve) discounted at the original EIR of 9.2% (ie, €6,237,904).

Glossary

Glossary

Amortised cost of a financial asset or financial liability	The amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility.
Available-for-sale financial assets	Non-derivative financial assets that are designated as available for sale or are not classified as (a) loans and receivables, (b) held-to-maturity investments, or (c) financial assets at fair value through profit or loss. On subsequent measurement changes in fair value are other than interest calculated using an effective interest rate method and foreign currency gains and losses on a monetary item recognised in a separate component of equity until the asset is sold or impaired.
Derivative	<p>A financial instrument or other contract within the scope of IAS 39 with all three of the following characteristics:</p> <p>(a) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the ‘underlying’);</p> <p>(b) it requires no initial net investment, or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and</p> <p>(c) it is settled at a future date.</p>
Derecognition	The process of removing an asset or liability from the balance sheet.
Effective interest method	<p>A method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) and of allocating the interest income or interest expense over the relevant period.</p> <p>The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument, or when appropriate a shorter period, to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, an entity estimates cash flows considering all contractual terms of the financial instrument (for example, pre-payment, call and similar options) but does not consider future credit losses. The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see IAS 18, Revenue), transaction costs and all other premiums or discounts.</p> <p>There is a presumption that the cash flows and the expected life of a group of similar financial instruments can be estimated reliably. However, in those rare cases where it is not possible to estimate reliably the cash flows or the expected life of a financial instrument (or group of financial instruments), the entity uses the contractual cash flows over the full contractual term of the financial instrument (or group of financial instruments).</p>
Embedded derivative	<p>A component of a hybrid (combined) instrument that also includes a non-derivative host contract – with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.</p> <p>An embedded derivative causes some or all of the cash flows that otherwise would be required by the contract to be modified according to a specified interest rate, financial</p>

instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract.

A derivative that is attached to a financial instrument but is contractually transferable independently of that instrument, or has a different counterparty from that instrument, is not an embedded derivative but a separate financial instrument.

An embedded derivative is separated from the host contract and accounted for as a derivative only if:

- (a) the economic characteristics and risks of the embedded derivative are not closely related to the economic characteristics and risks of the host contract (see IAS 39, Appendix A paragraphs AG30 and AG33);
- (b) a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative; and
- (c) the hybrid (combined) instrument is not measured at fair value with changes in fair value recognised in profit or loss (ie, a derivative that is embedded in a financial asset or financial liability at fair value through profit or loss is not separated).

Equity

Any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities.

Factoring

A factoring transaction involves an entity (transferor) transferring its rights to some or all of the cash collected from a financial asset (usually trade or other receivables) to another entity (the factor) in exchange for a cash payment. Factoring of receivables is a well established method of obtaining finance, sales ledger administration services, or protection from bad debts. Factoring arrangements may take various forms, but some of the principal features are as follows:

- The cash payment – this may be fixed at the outset or vary according to the actual period the receivables remain unpaid (slow payment risk). Sometimes the factor may provide a credit facility that allows the seller to draw up to a fixed percentage of the face value of the receivables transferred.
- The nature of the agreement – may be a clean sale without recourse (the transferor has no obligations to make good any shortfall on the transferred assets) or may be more complex with various recourse provisions. These recourse provisions may take the form of guarantees by the seller for non-payment (bad debt or credit risk) up to a certain limit or for the full default amount, a call option held by the transferor (clean up calls) or a put option held by the factor for any defaulted assets.
- Other provisions – these may include, among others, any representations or warranties provided by the transferor regarding the quality/condition of the receivables at the point of transfer, servicing arrangements (whether the transferor will continue to manage the receivables or management will be taken over by the factor), or any credit protection facility (insurance cover) provided by the factor that may limit or eliminate the extent to which the factor has recourse to the seller.

Fair value

The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Financial instrument

Any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.

Financial asset	<p>Any asset that is:</p> <ul style="list-style-type: none"> (a) cash; (b) an equity instrument of another entity; (c) a contractual right: <ul style="list-style-type: none"> (i) to receive cash or another financial asset from another entity; or (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or (d) a contract that will or may be settled in the entity's own equity instruments and is: <ul style="list-style-type: none"> (i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.
Financial asset or financial liability at fair value through profit or loss	<p>A financial asset or financial liability that meets either of the following conditions:</p> <ul style="list-style-type: none"> (a) It is classified as held for trading. A financial asset or financial liability is classified as held for trading if it is: <ul style="list-style-type: none"> (i) acquired or incurred principally for the purpose of selling or repurchasing it in the short term; (ii) part of a portfolio of identified financial instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking; or (iii) a derivative (except for a derivative that is a designated and effective hedging instrument); or (b) Upon initial recognition it is designated by the entity as at fair value through profit or loss. An entity may use this designation only: <ul style="list-style-type: none"> (i) for a hybrid (combined) contract that contains one or more embedded derivatives, unless: <ul style="list-style-type: none"> – the embedded derivative does not significantly modify the cash flows that would otherwise be required by the contract; or – when it is clear, with little or no analysis when a similar hybrid (combined) instrument is first considered, that separation of the embedded derivative is prohibited, such as a pre-payment option embedded in a loan that permits the holder to prepay the loan for approximately its amortised cost; (ii) when doing so eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as 'an accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognising the gains and losses on them on different bases; or (iii) for a group of financial assets, financial liabilities or both if it is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy, and information about the group is provided internally on that basis to the entity's key management personnel – for example, the entity's board of directors and chief executive officer.

Investments in equity instruments that do not have a quoted market price in an active market, and whose fair value cannot be reliably measured, is not designated as at fair value through profit or loss.

Financial liability

Any liability that is:

(a) a contractual obligation:

- (i) to deliver cash or another financial asset to another entity; or
- (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) a contract that will or may be settled in the entity's own equity instruments and is:

- (i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
- (ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose, the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

Loans and receivables

Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than:

- (a) those that the entity intends to sell immediately or in the near term, which should be classified as held for trading, and those that the entity upon initial recognition designates as at fair value through profit or loss;
- (b) those that the entity upon initial recognition designates as available for sale; or
- (c) those for which the holder may not recover substantially all of its initial investment, other than because of credit deterioration, which should be classified as available for sale.

An interest acquired in a pool of assets that are not loans or receivables (for example, an interest in a mutual fund or a similar fund) is not a loan or receivable.

Repurchase agreements (repos)

Transactions involving the sale of a financial asset (a transfer of all the rights attaching to the financial asset) with a simultaneous agreement to repurchase it at a specified price at a specified future date. In a typical repurchase agreement, an entity sells a security such as a government bond to a third party in return for a cash consideration that is then reinvested in other assets that earn a return. At the specified date, the transferor repurchases that security at the agreed price. Financial institutions and other entities normally enter into these agreements because they provide liquidity and the opportunity to earn excess returns on the collateral. The main features of such agreements are usually:

- The sale price – this may be the market value or another agreed price;
- The repurchase price – this may be fixed at the outset, vary with the period for which the asset is held or be the market price at the date of repurchase; and
- Other provisions – these may include, amongst others, the term of the agreement (overnight, short-term or longer); buyer's ability to return a similar but not identical security to the one that was sold; buyer's ability to sell the security to a third party; seller retaining access to any increase in the value of the asset (subject to the buyer receiving a lender's return) from a future sale to a third party; and seller providing any protection against loss through the operation of guarantees.

Securities lending	Transactions initiated by broker-dealers and other financial institutions generally to cover a short sale or a customer's failure to deliver securities sold. In a typical securities lending agreement, an entity (the transferor/lender) transfers a security to another entity (the transferee/borrower/) for a short period of time. The borrower is generally required to provide 'collateral' to the lender, commonly cash but sometimes other securities or standby letters of credit, with a value slightly higher than the value of the security borrowed. If the collateral is cash, the lender earns a return; if it is other than cash, the lender receives a fee. At a specified date, the borrower returns the security to the lender.
Securitisation	A means of obtaining cost-effective funding by making use of a portfolio of assets, usually receivables held by an entity (such as loans, mortgages and credit cards). These assets are usually sold to an SPE that then re-packages the receivables as asset-backed securities that it sells on in the market to investors for cash consideration. The notes issued to the investors are secured on the underlying assets that have been transferred to the SPE. Often investors require a form of credit enhancement either by way of credit insurance, third-party guarantees, or other collateral. This credit enhancement ensures the notes issued out of the SPE are marketable to investors.
Servicing agreement	Typically includes but is not limited to collecting principal and interest payments from borrowers; remitting payments to investors; paying taxes and insurance; and monitoring delinquencies.
Transferee	The buyer in a transaction.
Transferor	The seller in a transaction.