THE STANDARD STANCE

Derecognition of Financial Assets Under Ind AS 109

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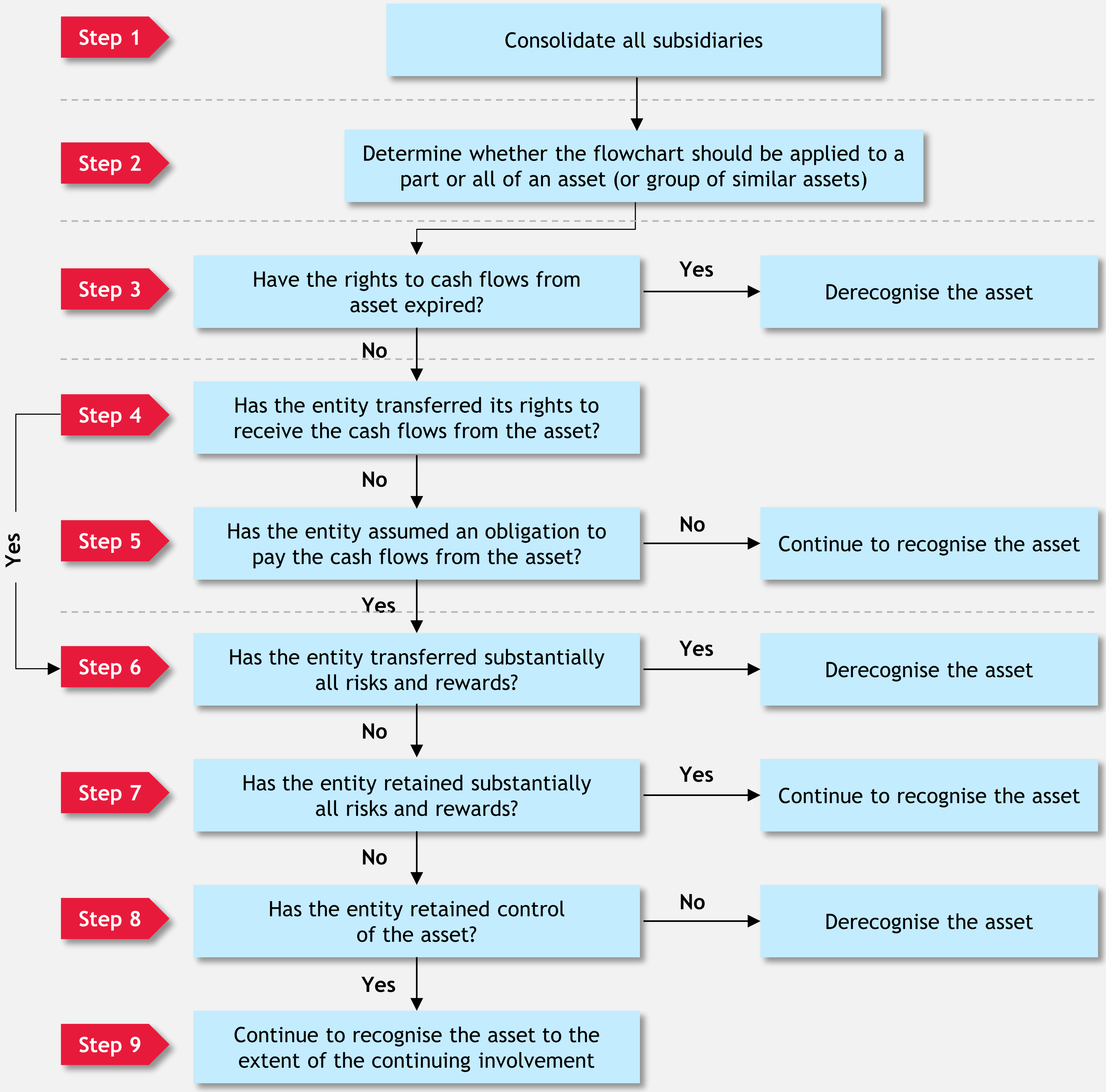
As a Chief Financial Officer, navigating the complexities of financial reporting and compliance is critical to ensuring an organisation's financial health. One of the most challenging aspects of this responsibility is the assessment of the derecognition of financial assets under Ind AS 109. Derecognition of a financial asset refers to the removal of a previously recognised financial asset from the financial statements. On account of the stringent guidance relating to derecognition under Ind AS 109, there is a notion of 'stickiness' around financial assets that has been recognised previously, i.e., it is more difficult to remove an asset from the company's balance sheet than to recognise it in the first place.

The criteria under Ind AS 109 for derecognising a financial asset aim to determine whether an asset has effectively been 'sold' and therefore should be derecognised, or if an entity has merely obtained some form of financing against the financial assets, thus necessitating the recognition of additional financial liability. The substance of the arrangement must be assessed to determine whether an entity has transferred the economic exposure associated with the rights inherent in the asset (i.e., its risks and rewards) and, in some cases, control of those rights.

DERECOGNITION DECISION TREE

The standard provides a flow chart summarising derecognition requirements for evaluating whether, and to what extent, a financial asset is derecognised. Every transaction should be analysed using the strict sequence in the flow chart.



The table below briefly explains each step mentioned above in the decision tree:

Steps	Requirements	Explanations
1	Consolidate all subsidiaries, including structured entities	The first step is to define at which level the derecognition decision is to be applied – in the parent's separate financial statements or in the consolidated financial statements. This first step ensures that the derecognition decision is consistent regardless of whether the transfer of assets is direct to investors or through a consolidated structured entity that obtains the financial assets, and, in turn, transfers those financial assets (or a portion of them) to third-party investors.
2	Determine whether the derecognition principles are applied to a part or all of an asset (or a group of similar assets)	An entity needs to determine what is being evaluated for derecognition; this could be a whole financial asset, a group of financial assets, part of a financial asset, or part of a group of similar financial assets.
3	Have the rights to the cash flows from the asset expired?	An entity derecognises a financial asset when the rights to the cash flows from that financial asset expire. The rights to the cash flows expire when, for example, a financial asset is repaid and there are no further cash flows arising from that asset, or a purchased option reaches its maturity unexercised.
4 & 5	Has the entity transferred its rights to receive the cash flows from the asset?	A financial asset qualifies for derecognition under Ind AS 109: ▪ when an entity 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 on to one or more recipients in an arrangement that meets the criteria of qualifying pass-through arrangement (as explained more in detail below)
6 & 7	Has the entity transferred substantially all of the risks and rewards of ownership of the asset?	Determining the extent to which the risks and rewards of the transferred asset have been transferred and retained is critical in determining the accounting outcome for a transfer. The greater the risks and rewards retained, the greater the likelihood of continued recognition.
8 & 9	Has the entity retained control of the financial asset?	A situation can arise when an entity neither transfers nor retains substantially all the risks and rewards of ownership of the financial asset. In such a situation, the entity determines whether it has retained control of the financial asset. If control has been transferred, the asset is derecognised, otherwise, the entity continues to recognise the asset to the extent of its continuing involvement.

As seen from the flow chart and the table, there are two separate approaches to derecognition under Ind AS 109: the 'risks and rewards' approach and the 'control' approach. Both tests are often criticised for being a mix of two accounting models that can create confusion in the application of the derecognition requirements. However, Ind AS 109 addresses this criticism by providing a clear hierarchy for applying the two sets of tests: risks and rewards tests are applied first, with the control tests used only when the entity has neither substantially transferred all the risks and rewards of the asset nor retained them.

Risk & Reward Test

The Risk & Reward tests require the entity to evaluate whether it has:

- transferred substantially all the financial asset's risks and rewards of ownership
- retained substantially all the risks and rewards of ownership
- neither transferred nor retained substantially all the risks and rewards of ownership

If the entity transfers substantially all risks and rewards, it proceeds to derecognise the asset. Conversely, if the entity retains substantially all risks and rewards, it continues to recognise the asset.

The risks and rewards to be considered include interest rate risk, credit risk, foreign exchange risk, equity price risk, late payment risk and prepayment risk. The applicable risks will depend on the particular asset that is being considered for derecognition.

Generally, it will be clear from the terms of the transfer arrangement whether the entity has transferred substantially all of the risks and rewards. If unclear, evaluation will be required by comparing the entity's exposure, pre-transfer, and post-transfer, to the variability in the amounts and timing of the net cash flows of the transferred asset. This requires quantitative assessment.

Examples of transactions that transfer substantially all the risks and rewards of ownership include

- an unconditional sale of a financial asset
- a sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase
- a sale of a financial asset together with a put or call option that is deeply out of the money

Examples of transactions where substantially all the risks and rewards of ownership has been retained are

- a sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return
- a sale of a financial asset together with a deep-in-the-money written put option or purchased call option
- a sale of receivables with a guarantee to compensate the transferee for credit losses that are likey to occur

Example:

Bank A originates a portfolio of 8-year interest-bearing loans of INR 50mn. Bank A transfers the portfolio to an asset reconstruction company, in exchange for a cash payment of INR 48mn. As per the contract, Bank A shall pay the asset reconstruction company the first INR 48mn (plus interest) of cash collected from the loan portfolio. Bank A retains rights to the last INR 2mn (plus interest), Expected collections on the loan portfolio are INR 49mn, and it is unlikely to be less than INR 48.6mn based on the historical trend.

Bank's A retained interest in the cash flows from the loans is effectively subordinated. In substance, Bank A has provided credit enhancement to the asset reconstruction company. If Bank A collects only INR 48mn out of INR 50mn because of default, it will have to pass on the entire amount to the asset reconstruction company. In effect, Bank A is exposed to all the credit losses that are expected to accrue in a portfolio. In other words, Bank A retains substantially all the risks and rewards of ownership of the loans because the subordinated retained interest absorbs all of the likely variability in net cash flows.

Control Test

When an entity determines that it has neither transferred nor retained substantially all of the risks and rewards of ownership of the transferred assets, it needs to assess whether it has retained control of the assets.

The question of whether the entity has retained control over the transferred asset depends generally on the transferee's (the party the asset was transferred to) ability to sell the asset. The entity is considered to have not retained control, if the transferee can practically sell the asset in its entirety to an unrelated third party and can do so unilaterally and without needing to impose additional restrictions on the transfer. The financial asset is derecognised if the entity has not retained control of the transferred financial asset.

Example:

Bank A transfers a portfolio of mortgage loans to an asset reconstruction company. The transferred loans can be repurchased by Bank A at any time before their maturity. The agreement contains no explicit conditions restraining the asset reconstruction company from selling, exchanging or pledging the assets to a third party. The asset reconstruction company does not have the practical ability to sell the portfolio of mortgage loans because it must have access to the original mortgage loans that were transferred in the event Bank A exercises its right under the call option and the mortgage loans cannot be readily obtained from another source.

The interplay between the 'Risk & Reward' test and the 'Control' test is summarised in the below table:

Degree of Risk and Rewards Transferred	Control Retained?	Accounting Outcome
Substantially all risks and rewards transferred	Not applicable	Derecognition of financial asset
Substantially all risks and rewards retained	Not applicable	No derecognition
Neither transferred nor retained	Yes	No derecognition
Neither transferred nor retained	No	Derecognition of financial asset

KEY PRACTICAL CONSIDERATIONS

Pass Through Transfers

A 'pass through' transfer occurs when an entity retains a financial asset's legal title and cash flow rights but commits to pass those cash flows to a third party. The pass-through arrangements under Ind AS 109 require careful evaluation of whether the transferor has transferred its right to receive cash flows from the assets (Refer to Steps 4 & 5 above). A pass-through arrangement would result in the transfer of the right to receive cash flows only if all the following three conditions are met:

	Conditions	Explanation
Condition 1	The entity has no obligation to pay the eventual recipients unless it collects equivalent amounts from the original asset.	The first condition implies that transactions where cash flows are passed to a third party, and that party can seek recourse from the transferor, do not qualify as transfer. In other words, the entity does not benefit or suffer from the performance or non-performance of the asset.
Condition 2	The entity is prohibited by the terms of the transfer arrangement from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.	This condition implies that the entity does not have control of the future economic benefits associated with the transferred assets.
Condition 3	The entity should remit any cash flows it collects on behalf of the eventual recipients without material delay. Further, the terms of the transfer restrict the transferor to reinvest the cash flows in any instrument other than cash or cash equivalents.	The entity must remit any cash flows it collects on behalf of eventual recipients without material delay. This condition also limits permissible reinvestments to items that qualify as cash or cash equivalents.

Example:

Entity A enters into an arrangement with a factor, Entity B. Entity A agrees to pass on the cash flows that it collects from specified trade receivables to Entity B for an upfront payment. Entity A is required to transfer the collected cash flows within two working days. Entity A has no obligation to transfer cash to Entity B, unless it collects equivalent amounts from the trade receivables. Entity A is prohibited by the arrangement's terms from selling or pledging the trade receivables to a third party. The three conditions for a pass-through arrangement to be treated as a transfer of a financial asset are met in this scenario because Entity A:

a. retains the contractual rights to receive the financial asset's cash flows, but assumes an obligation to pass on the cash flows from the underlying assets without material delay (i.e., within 2 working days);

b. cannot sell or pledge the asset; and

c. has no obligation to make payments, unless it collects equivalent amounts from the asset.

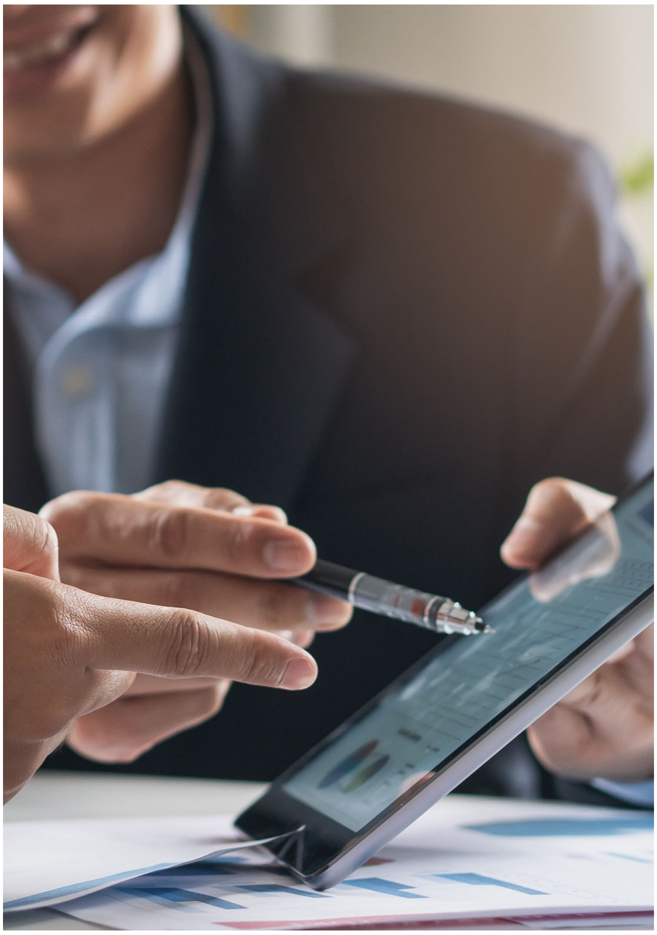
Securitisation Arrangements

Securitisation is a means of making use of a portfolio of assets, usually receivables held by an entity (loans, mortgages, credit cards, etc.) to obtain cost-effective funding. Typical securitisation transactions are executed using structured entities that have limited activities. An entity that has initially advanced the loans (the 'originator') will sell them (loans) to these structured entities in return for cash proceeds. The structured entities finance the acquisition of the loans by issuing loan notes to external investors or sometimes the originator as well. The purpose of the structured entities is to hold the interests in the securitised financial assets and to pass through cash flows earned on these financial assets to the investors (including the originator) as distribution, in lieu of the notes issued by the structured entities.

If financial assets are securitised using a structured entity, then determining whether those financial assets should be derecognised may be a complex issue.

Generally, under securitisation transactions, the arrangements are made to protect the investors from losses occurring on the asset by way of 'credit enhancement'. Credit enhancement may be achieved in several ways, e.g., over-collateralisation (the aggregate value of the assets transferred exceeds the consideration paid by the structured entities). A credit enhancement is often achieved through the issuance of subordinated debt to the originator that has the effect of dividing the risk of loss on the underlying assets, commonly referred to as 'Tranching'. The terms of the transfer are structured in such a way that the cash inflow from the underlying assets is used to first satisfy the senior tranches owned by the investors, followed by distributing the balance cash flow, if any, to the originator, owning junior tranches.

Credit enhancement provided by the transferor may result in the originator retaining substantially all the risks and rewards of ownership of the transferred asset, therefore precluding the derecognition of the financial assets.



Example:

Bank Y transfers a portfolio of financial assets to a special purpose entity (SPE) in a legal sale that meets the criteria for qualifying a pass-through arrangement.

In consideration for the sale, Bank Y receives cash of INR 70mn plus the junior tranche notes of the SPE (Tranche B note and Tranche C note). The INR 70mn that the SPE uses to purchase the financial assets is generated through the issuance of the senior tranche (Tranche A note) for INR 70mn to an independent third-party investor. The Tranche A, Tranche B and Tranche C notes are part of a 'waterfall' structure. This prioritises the payments by the SPE to the holder of the Tranche A note over the payments to the holder of the Tranche B note and prioritises the payments to the holder of the Tranche B note over the payments to the holder of the Tranche C note.

Because Bank Y has received the junior tranche notes (Tranche B and Tranche C note) it is considered to have retained substantially all of the risks and rewards of ownership of the financial assets that it transferred to the SPE. Consequently, derecognition by Bank Y is not permitted. As such, Bank Y continues to recognise the financial assets in their entirety and recognises a financial liability for the cash consideration received of INR 70mn. Because the junior notes (Tranche B and Tranche C notes) are an impediment to derecognition, they are not recognised separately by Bank Y (i.e. to avoid double counting the interest in the underlying assets transferred).

Repurchase Transaction

Repurchase agreements, usually referred to as 'repos', are transactions where there is a legal sale of a financial asset with a simultaneous agreement to repurchase it at a specified price at a fixed future date. The repurchase price may be fixed at the outset, or it may be the market price at the time of the repurchase. Derecognition depends on the pricing arrangement. If the financial asset is loaned or sold under an agreement to repurchase at fair value at the date of repurchase, the transferred asset is derecognised. The transferor has transferred substantially all the risks and rewards of ownership of the transferred asset. On the contrary, if the financial asset is loaned or sold under an agreement to repurchase the asset at a fixed price or at a price that provides a lender's return on the sale price, the transferred asset is not derecognised. The transferor retains substantially all the risks and rewards of ownership of the transferred asset.

Transfer/ Sale of Financial Assets Subject to Call and Put Options

An option giving the right to buy an asset is referred to as a ‘call’ option and one giving the right to sell as a ‘put’ option. An option is referred to as ‘in the money’ when it would be in the holder's interest to exercise it and as ‘out of the money’ when it would not be in the holder's interest to exercise it.

When a financial asset is transferred with call and put options, the assessment of whether the transfer qualifies for derecognition depends on the specifics of these options and the risks and rewards retained or transferred.

Scenario	Explanation
Exercise price of a call or put option is equal to the fair value of the financial asset	A transfer of a financial asset subject only to a call or put option with an exercise price equal to the fair value of the financial asset at the time of repurchase results in derecognition because of the transfer of substantially all the risks and rewards of ownership.
Deeply in the money put and call options	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 because the transferor has retained substantially all the risks and rewards of ownership. Similarly, if the financial asset can be put back by the transferee, and the put option is deeply in the money, the transfer does not qualify for derecognition because the transferor has retained substantially all the risks and rewards of ownership.
Deeply out of the money put and call options	The financial asset is derecognised if the call or put option subject to which it is transferred, is deeply out of the money. This is because the transferor has transferred substantially all the risks and rewards of ownership.
Options that are neither deeply out of the money nor deeply in the money	Under such circumstances in most cases, the entity neither transfers nor retains substantially all the risks and rewards associated with the financial asset. It is therefore necessary to determine whether the transferor has retained control of the assets as summarised above.

Further, it is relevant to note that Ind AS 109 does not provide any explicit guidance for the accounting of an option that was considered at the time of the original transfer to be deeply out of the money, subsequently becoming neither deeply in the money nor deeply out of the money. Ind AS 109 specifies that an asset that was previously derecognised because substantially all the risks and rewards associated with the asset have been transferred are not re-recognised in a future period unless it is reacquired. Therefore, even if a call or put option becomes 'in the money' subsequently, it would not result in recognition of the financial asset previously derecognised.

Continuing Involvement

When an entity retains control of a financial asset for which some but not substantially all of the risks and rewards have been transferred, it continues to recognise the financial asset to the extent of its continuing involvement in the financial asset. If an entity's continuing involvement in a transferred asset takes the form of a guarantee, then the extent of the entity's continuing involvement is the lower of: (1) the carrying amount of the asset; and (2) the maximum amount of the consideration received that the entity could be required to repay.

Example:

Company A transfers short-term receivables of INR 900,000 to Bank B. Per the terms of the transfer, Company A guarantees one-third of any default losses associated with the receivables. Bank B is not permitted to sell or pledge the receivables and there is no market for them. Credit risk is the only significant risk. There is no late payment risk because interest is charged on late payments.

Company A has retained one-third of any credit losses incurred by Bank B on these loans. Company A has not retained any other risk on these loans. Therefore, Company A has retained some risks and rewards, since credit risk is the only significant risk, but not substantially all risks and rewards are transferred. In addition, Bank B is not permitted to sell or pledge the receivables and there is no market for such receivables. Therefore, Company A controls the receivables and continues to recognise the receivables to the extent of its continuing involvement. The maximum extent of Company A's continuing involvement is INR 300,000 (the amount of the guarantee). Therefore, Company A concludes that it should derecognise INR 600,000 and continue to recognise INR 300,000, which is the lower of (1) the carrying amount of the financial asset; and (2) the maximum amount received in the transfer that Company A could be required to repay.

Conclusion:

When a financial asset is derecognised entirely, the difference between the carrying amount at the date of derecognition and the consideration received is recognised in profit or loss.

The decision to derecognise a financial asset has far-reaching implications for a company's financial reporting perspective. While Ind AS 109 provides a structured framework, the complexity of real-world transactions often demands careful judgment and in-depth analysis. The decision on derecognition of financial assets depends on the structure of the transactions, and entities must follow the methodological approach and consider the nuances of each transaction while reaching an appropriate conclusion.

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CONTACT US

For any content related queries, you may please write to the service line experts at accountingadvisory@bdo.in

For any other queries or feedback, kindly write to us at marketing@bdo.in

BDO IN INDIA OFFICES

Ahmedabad
Westgate Business Bay, Floor 6
Office No 601, Block A, Makarba
Ahmedabad, Gujarat 380051, INDIA

Bengaluru - Office 1
Prestige Nebula, 3rd Floor,
Infantry Road,
Bengaluru 560001, INDIA

Bengaluru - Office 2
SV Tower, No. 27, Floor 4
80 Feet Road, 6th Block, Koramangala
Bengaluru 560095, INDIA

Bhopal - Office 1
3rd Floor, Pradhan Business Center,
Ansal Pradhan Enclave, E 8 Arera Colony,
Near Dana Pani Square, Bhopal, Madhya
Pradesh 462026, INDIA

Chandigarh
Plot no. 55, Floor 5,
Industrial & Business Park,
Phase 1, Chandigarh 160002, INDIA

Chennai
No. 443 & 445, Floor 5, Main Building
Guna Complex, Mount Road, Teynampet
Chennai 600018, INDIA

Coimbatore
Pacom Square, Floor 3, 104/1, Sakthi
Main Road, Bharathi Nagar, Ganapathy
Coimbatore, Tamil Nadu – 641006

Delhi NCR - Office 1
The Palm Springs Plaza
Office No. 1501-10, Sector-54,
Golf Course Road, Gurugram 122001, INDIA

Delhi NCR - Office 2
Windsor IT Park, Plot No: A-1
Floor 2, Tower-B, Sector-125
Noida 201301, INDIA

Goa
701, Kamat Towers
9, EDC Complex, Patto Plaza
Panaji, Goa 403001, INDIA

Hyderabad
1101/B, Manjeera Trinity Corporate
JNTU-Hitech City Road, Kukatpally
Hyderabad 500072, INDIA

Kochi
XL/215 A, Krishna Kripa
Layam Road, Ernakulam
Kochi 682011, INDIA

Kolkata
Floor 4, Duckback House
41, Shakespeare Sarani
Kolkata 700017, INDIA

Mumbai - Office 1
The Ruby, Level 9, North West Wing
Senapati Bapat Marg, Dadar (W)
Mumbai 400028, INDIA

Mumbai - Office 2
601, Floor 6, Raheja Titanium, Western
Express Highway, Geetanjali, Railway
Colony, Ram Nagar, Goregaon (E),
Mumbai 400063, INDIA

Mumbai - Office 3
Floor 20, 2001 & 2002 - A Wing, 2001 F
Wing, Lotus Corporate Park, Western
Express Highway, Ram Mandir Fatak Road,
Goregaon (E) Mumbai 400063, INDIA

Mumbai - Office 4
The Ruby, Level 9, South East Wing
Senapati Bapat Marg, Dadar (W)
Mumbai 400028, INDIA

Pune - Office 1
Floor 6, Building No. 1
Cerebrum IT Park, Kalyani Nagar
Pune 411014, INDIA

Pune - Office 2
Floor 2 & 4, Mantri Sterling, Deep Bunglow,
Chowk, Model Colony, Shivaji Nagar
Pune 411016, INDIA

Vadodra - Office 1
1008, 10th floor, "OCEAN", Sarabhai
Compound, Nr. Centre Square Mall,
Dr. Vikram Sarabhai Marg, Vadodara,
Gujarat 390023, INDIA

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