

STAFF PAPER

June 2014

IASB Meeting

Project	Annual Improvements to IFRSs 2012-2014 Cycle (ED/2013/11)		
Paper topic	IFRS 7 <i>Financial Instruments: Disclosures</i> —Servicing Contracts		
CONTACT(S)	Hannah King	hking@ifrs.org	+44 (0)20 7246 6961

This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Introduction

1. The Exposure Draft ED/2013/11 *Annual Improvements to IFRSs 2012–2014 Cycle* published in December 2013 (the ED) included a proposal for an amendment to IFRS 7 *Financial Instruments: Disclosures*.
2. IFRS 7 requires certain disclosures (the transfer disclosures) when an entity has ‘continuing involvement’ in a transferred financial asset that has been derecognised in its entirety. The proposed amendment in the ED clarifies how an entity should apply the guidance in IFRS 7 to a servicing contract to decide whether that servicing contract is continuing involvement for the purposes of the transfer disclosures.

Purpose of this paper

3. The objective of this paper is:
 - (a) to present to the IASB the Interpretations Committee’s recommendations on the proposed amendment to IFRS 7 following its analysis of the comments made by respondents to the ED; and
 - (b) to ask the IASB to include the amendment with the proposed revisions in the final *Annual Improvements to IFRSs 2012-2014 Cycle* that is due to be published later in 2014.

4. This Agenda Paper:
- (a) provides a description of the issue that led to the proposed amendment;
 - (b) summarises the main comments received as part of the Exposure Draft process;
 - (c) summarises the Interpretations Committee’s recommendations;
 - (d) reassesses the issue against the annual improvements criteria; and
 - (e) asks whether the IASB agrees with the finalisation of this amendment to IFRS 7 as recommended by the Interpretations Committee.

The issue

5. Paragraph 42C of IFRS 7 states that the entity has continuing involvement in a derecognised financial asset if, as part of the transfer, the entity retains any of the contractual rights or obligations inherent in the transferred financial asset or obtains any new contractual rights or obligations relating to the transferred financial asset.
6. Furthermore, paragraph 42C(c) of IFRS 7 explains that a ‘pass-through arrangement’ does not constitute continuing involvement for the purposes of the transfer disclosures. A pass-through arrangement occurs when an entity retains the contractual rights to receive the cash flows of a financial asset but assumes a contractual obligation to pay cash flows to one or more entities and, in addition, the ‘pass-through’ conditions in paragraph 3.2.5(a)-(c) of IFRS 9 *Financial Instruments* are met.
7. The Interpretations Committee received a submission that requested clarification about whether servicing rights and obligations are continuing involvement for the purposes of the transfer disclosures. More specifically, the submitter was concerned about whether the exception described in paragraph 6 for pass-through arrangements applies to servicing contracts, and therefore excludes those contracts from the transfer disclosures in IFRS 7.

The IASB's proposals in the ED

8. In response to the concerns raised, the IASB proposed to add application guidance to clarify how the description of continuing involvement in IFRS 7 should be applied to a servicing contract for the purposes of the transfer disclosure requirements. In particular, the amendment as proposed in the ED would clarify that:
- (a) the right to earn a fee for servicing the financial asset is generally continuing involvement for the purposes of applying the transfer disclosure requirements.
 - (b) servicing contracts should be assessed against the description of continuing involvement in IFRS 7.
 - (c) the servicer has an interest in the future performance of the transferred financial assets as a result of that contract if the amount and/or timing of the servicing fee depend on the amount and/or timing of the cash flows collected from the transferred financial asset.
9. In addition, consistently with the exception in IFRS 7 that a pass-through arrangement does not constitute continuing involvement, the IASB proposed to amend the Application Guidance to IFRS 7 to clarify that an obligation in a contract, including a servicing contract, to pass through an amount collected, is not in itself continuing involvement for the purpose of the transfer disclosures.
10. The ED proposed to provide a transition relief for current IFRS preparers and first-time adopters. That transition relief would exempt entities from applying the amendment to any comparative period presented that begins before the annual period for which the entity first applies the amendment, to avoid the risk of hindsight being applied.

Main comments raised by respondents

11. Two-thirds of respondents to the ED agree with the proposed amendment with little or no further comment. With one exception, the remaining respondents also agree with the amendment, but subject to further considerations.

12. For a detailed description of the comments received and the source of those comments, the IASB should refer to Agenda Paper 17B¹ presented to the Interpretations Committee at the May 2014 meeting.
13. There are two considerations raised by these respondents that we would like to bring to the IASB's attention. These are:
- (a) the presumption that the right to earn a fee for servicing the transferred financial asset is generally continuing involvement; and
 - (b) concerns over the difference in the meaning of the term 'continuing involvement' among IFRSs.

Presumption that a servicing contract is generally continuing involvement

14. Some respondents suggest that the IASB should delete the presumption in the ED that the right to earn a fee in a servicing contract is generally continuing involvement.
15. The staff and Interpretations Committee agree with this suggestion. We think that removing the presumption from the guidance would reflect more accurately the intention of the proposed amendment. The intention is that an entity should assess a servicing contract against the description of continuing involvement in IFRS 7 to decide whether the servicing contract is continuing involvement for the purposes of the transfer disclosure requirements.

Concerns over the difference in the meaning of the term 'continuing involvement' among IFRSs

16. Several respondents raised concerns about the difference in the meaning of the term 'continuing involvement' among some IFRSs. Those respondents note that in IFRS 9² (or IAS 39 *Financial Instruments: Recognition and Measurement*) the term 'continuing involvement' is used in a narrow sense, as it only relates to the

¹ <http://www.ifrs.org/Meetings/MeetingDocs/Interpretations%20Committee/2014/May/AP17B%20-%20AIP%20IFRS%207%20Servicing%20contracts.pdf>

² In IFRS 9 (or IAS 39), continuing involvement refers to circumstances in which an entity “neither transfers nor retains substantially all the risks and rewards of ownership of a transferred asset” and “retains control of the transferred asset” (Paragraphs 3.2.6(c) and 3.2.16 of IFRS 9 (paragraphs 20(c) and 30 of IAS 39)).

question of derecognition of a financial asset and, specifically, the extent of retention of risks and rewards of ownership of a transferred asset. However, the term ‘continuing involvement’ in IFRS 7 and ‘involvement’ in IFRS 10 *Consolidated Financial Statements*³ and IFRS 12 *Disclosure of Interests in Other Entities*⁴ are used in a wider sense.

17. They are concerned that the difference in the use of the term ‘(continuing) involvement’ causes confusion when applying those IFRSs. Consequently, most of those respondents ask the IASB to provide further clarification of the term ‘continuing involvement’ in IFRS 7.
18. We acknowledge that the term ‘(continuing) involvement’ is used in different ways among those IFRSs. However, addressing the difference in the meaning of the term among several IFRSs is beyond the scope of this project. In addition, we think that the term ‘(continuing) involvement’ in those IFRSs can be clearly distinguished by the requirements in those IFRSs. Hence, we think that further clarification of the meaning of term ‘continuing involvement’ in IFRS 7 is unnecessary.
19. The Interpretations Committee pointed out that, despite this, it would be helpful if the IASB could clarify that the term ‘continuing involvement’ in IFRS 7 is used in a different way from that term in IFRS 9 (or IAS 39).

The Interpretations Committee’s recommendations

20. The Interpretations Committee recommended to the IASB that it should finalise the proposed amendment to IFRS 7 to clarify how an entity should apply the guidance in IFRS 7 to a servicing contract to decide whether a servicing contract

³ IFRS 10 states that when analysing the investor’s involvement with the investee, an investor should consider various forms of involvements, including, but not limited to, a bond with fixed interest rate payments, fixed performance fees, credit or liquidity support and tax benefits (paragraphs B55-B57 of IFRS 10).

⁴ The definition of ‘interest in another entity’ in Appendix A of IFRS 12 states that “an interest in another entity can be evidenced by, but is not limited to, the holding of equity or debt instruments as well as other forms of involvement such as the provision of funding, liquidity support, credit enhancement and guarantees”.

is continuing involvement for the purposes of applying the transfer disclosure requirements.

21. Having considered the comments received, the Interpretations Committee recommended to the IASB that the final amendment should be revised as follows:
- (a) delete the presumption that the right to earn a fee for servicing the financial asset is generally continuing involvement for the purposes of the transfer disclosures; and
 - (b) clarify that the term ‘continuing involvement’ in IFRS 7 is used in a different way from that term in IFRS 9 (or IAS 39) in the Basis for Conclusions to IFRS 7.
22. The Interpretations Committee also recommended to the IASB that it should retain the proposed transition provision that an entity need not apply the proposed amendment to any comparative period presented when the entity first applies the amendments.

Annual Improvements criteria reassessment

23. We think that the proposed amendment to IFRS 7 meets the Annual Improvements criteria established by the *Due Process Handbook* issued in February 2013. This is because the proposed amendment clarifies the application of existing principles in IFRS 7 in respect of a narrow and well-defined issue for which there is diversity in practice. These criteria are reported in Appendix A of this paper.

Question for the IASB

Does the IASB agree with the Interpretations Committee’s recommendation to finalise the proposed amendment to IFRS 7, with the revisions to the amendment as described in paragraph 21 above?

Appendix A—Assessment against the Interpretations Committee’s agenda criteria and annual improvement criteria

A1. In the table below, we have assessed the issue against the annual improvement criteria described in the *Due Process Handbook*.

Agenda criteria of the Interpretations Committee	
We should address issues (5.16):	
that have widespread effect and have, or are expected to have, a material effect on those affected;	Met The results of our outreach indicate that this issue is significantly widespread.
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and	Met The results of our outreach indicate that there is significant diversity in practice.
that can be resolved efficiently within the confines of existing IFRSs and the <i>Conceptual Framework for Financial Reporting</i> .	Met This issue can be resolved by amending guidance in, and adding guidance to, IFRS 7 on the basis of the existing principles rather than by amending or adding a principle.
In addition:	
Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process that would be required when making changes to IFRSs (5.17)?	Met This amendment is sufficiently narrow and well defined because the scope of the issue is limited to a servicing contract that an entity retains in a transfer of financial assets that qualifies for derecognition of the financial asset in its entirety.
Will the solution developed by the Interpretations Committee be effective for a reasonable time period (5.21)? (The Interpretations Committee will not add an item to its agenda if the issue is being addressed in a forthcoming Standard and/or if a short-term improvement is not justified).	Met We are not aware of any existing or forthcoming project of the IASB that would affect the issue discussed in this Agenda Paper.

Additional criteria for annual improvement	
<p>Replace unclear wording</p> <p>Provide missing guidance</p> <p>Correct minor unintended consequences, oversights or conflict</p>	<p>Met</p> <p>The potential amendment is intended to provide additional guidance on how an entity should apply the requirements in paragraph 42C of IFRS 7 and guidance in paragraph B30 of IFRS 7 to a servicing contract. The amendment would not change the existing requirements or guidance for the assessment of continuing involvement.</p> <p>Accordingly, we are of the view that it would be a clarification of the existing principle in IFRS 7.</p>
<p>Not change an existing principle or propose a new principle</p>	<p>Met</p> <p>See above.</p>
<p>Not be so fundamental that the IASB will have to meet several times to conclude</p>	<p>Met</p> <p>We think that the IASB will be able to reach a consensus on the potential amendment on a timely basis because the amendment is to clarify the IASB's original intention when it added the transfer disclosure requirements.</p>