Collateral case study

Michael (Mike) Wells prepared this case study to support workshop discussion designed to foster the development of a cohesive understanding of accounting for collateral in general purpose financial information and as a basis for developing capacity to make the judgements necessary to prepare/audit/regulate/analyse such financial information.

The objective of reporting in accordance with International Financial Reporting Standards (IFRS) is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit (paragraph OB2 of the Conceptual Framework). Consequently, existing and potential investors, lenders and other creditors need information to help them assess the prospects for future net cash inflows to an entity (paragraph OB3).

To satisfy the objective of IFRS reporting, to a large extent, financial reports are necessarily based on estimates, judgements and models rather than exact depictions (paragraph OB11). Put another way, the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability[1] (paragraph 4.41).

The economics of collateral

Put plainly, collateral is an asset that a borrower offers a lender as security for a loan. Typically, if the borrower stops making the promised loan payments, the lender has the right to seize the collateral.[2] Since collateral offers some security to the lender should the borrower default, loans that are secured by collateral typically have lower interest rates than unsecured loans.[3] Although the legal rights that flow from collateral are typically specified in the loan agreement, law in some jurisdictions might specify particular overriding rights, obligations, restrictions, etc.

In some cases, at the commencement of the loan, collateral is physically transferred from the borrow to the lender. When such collateral is in the form of a fungible asset (for example, a share that trades actively in a deep and liquid market), the lender might have the right to dispose of the collateral while it holds it. In such cases the lender would need to replace the collateral before the expiry of the loan so that it can return the collateral to the borrower when it is obliged to do so.

You are required to discuss each of the following questions:

1. Which element of financial position applies to collateral promised by a borrower to a lender in the event of the borrower's default? Does your answer depend on:
    a. the form of collateral [consider collateral in the form of: (i) cash; (ii) a fungible item (like gold); or (iii) a non-fungible item (like a purpose built factory)]? and
    b. under whose control the collateral is (ie the borrower's control or the lender's control)?
2. What information about collateral promised by a borrower to a lender in the event of the borrower's default would provide the most relevant information to a primary user deciding

[1] Information is reliable when it is complete, neutral and free from error (footnote to paragraph 4.38).

[2] Law in some jurisdictions restrict the rights of banks to seize collateral by, for example, specifying sometimes onerous procedures that must be followed. Those procedures might vary by collateral type and by the type of lending arrangement.

[3] source: https://www.investopedia.com/terms/c/collateral.asp

whether to buy shares in the lender? Your answer should consider separately: (i) collateral retained by the borrower; (ii) collateral transferred to the lender from borrowers that are not past due; (iii) collateral transferred to the lender from borrowers that are past due; and (iv) foreclosed collateral.

3. Does your answer to Question 2 depend on the form of the collateral? Consider, for example, collateral in the form of: (i) cash; (ii) a fungible item (like gold); or (iii) a non-fungible item (like a purpose built factory).

The IASB's thinking when specifying IFRS 9's collateral related requirements

Collateral and other credit risk mitigants are important factors in an entity's estimate of expected credit losses (paragraph BC48AA of the Basis for Conclusions on IFRS 9 *Financial Instruments*).

The information useful to users is not the total amount of credit exposure less the total amount of collateral, but rather is the amount of credit exposure that is left after available collateral is taken into account. This is so because disclosure of the fair value of collateral held would be potentially misleading when some loans in a portfolio are over-collateralised, and other loans have insufficient collateral (paragraph BC52 of the Basis for Conclusions on IFRS 9).

Consequently, IFRS 7 *Financial Instruments: Disclosures* specifies that an entity must disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period and how those risks have been managed by the entity (paragraphs 31 and 32). When relevant, an entity's risk management disclosures would include its policies and procedures for taking collateral and for monitoring the continuing effectiveness of collateral in mitigating counterparty credit risk.

Paragraph 35K of IFRS 7 requires information that will enable users of financial statements to understand the effect of collateral and other credit enhancements on the amount of expected credit losses.[4] However, application of the cost constraint resulted in the IASB limiting explicitly required **quantitative** collateral disclosures (for example, **quantification** of the extent to which collateral and other credit enhancements mitigate credit risk) to those financial instruments that become **credit-impaired** (paragraph 35K(c) of IFRS 7 and paragraph BC48AA of the Basis for Conclusions on IFRS 7).

Nonetheless, an entity must disclose by class of financial instrument the amount that best represents its **maximum exposure to credit risk** at the end of the reporting period without taking account of any collateral held or other credit enhancements (eg netting agreements that do not qualify for offset in accordance with IAS 32).

Moreover, **qualitative** information about collateral and its effect on amounts of expected credit losses must be disclosed. In particular, paragraph 35K specifies disclosure by class of financial instrument:

(a) the amount that best represents its maximum exposure to credit risk at the end of the

[4] paragraph B8F of IFRS 7 clarifies that an entity is neither required to disclose information about the fair value of collateral and other credit enhancements nor is it required to quantify the exact value of the collateral that was included in the calculation of expected credit losses (ie the loss given default). Consequently, the quantification disclosure requirement specified in paragraph 35K(c) of IFRS 7 can be satisfied in other ways.

reporting period without taking account of any collateral held or other credit enhancements (for example, netting agreements that do not qualify for offset in accordance with IAS 32).

(b) a narrative description of collateral held as security and other credit enhancements, including:

(i) a description of the nature and quality of the collateral held;

(ii) an explanation of any significant changes in the quality of that collateral or credit enhancements as a result of deterioration or changes in the collateral policies of the entity during the reporting period; and

(iii) information about financial instruments for which an entity has not recognised a loss allowance because of the collateral.

Such qualitative disclosures might include information about (paragraph B8G of IFRS 7):

(a) the main types of collateral held as security and other credit enhancements (examples of the latter being guarantees, credit derivatives and netting agreements that do not qualify for offset in accordance with IAS 32);
(b) the volume of collateral held and other credit enhancements and its significance in terms of the loss allowance;
(c) the policies and processes for valuing and managing collateral and other credit enhancements;
(d) the main types of counterparties to collateral and other credit enhancements and their creditworthiness; and
(e) information about risk concentrations within the collateral and other credit enhancements.

To satisfy the requirement (paragraph 36(b) of IFRS 7) to describe collateral available as security for assets it holds and other credit enhancements obtained, an entity might disclose (paragraph IG22):

(a) the policies and processes for valuing and managing collateral and other credit enhancements obtained;
(b) a description of the main types of collateral and other credit enhancements (examples of the latter being guarantees, credit derivatives, and netting agreements that do not qualify for offset in accordance with IAS 32);
(c) the main types of counterparties to collateral and other credit enhancements and their creditworthiness; and
(d) information about risk concentrations within the collateral or other credit enhancements.

PwC illustrate the IFRS 7 disclosure requirements as follows:[5]

[5] Source: IFRS 9 for banks: illustrative disclosures (August 2017) pages 40 and 41

3.1.3.3 Collateral and other credit enhancements

IFRS7(39K)(b) IFRS7(36)(b) IFRS7(B8F) IFRS7(B8G) The Group employs a range of policies and practices to mitigate credit risk. The most common of these is accepting collateral for funds advanced. The Group has internal policies on the acceptability of specific classes of collateral or credit risk mitigation.

The Group prepares a valuation of the collateral obtained as part of the loan origination process. This assessment is reviewed periodically. The principal collateral types for loans and advances are:

- Mortgages over residential properties;
- Margin agreement for derivatives, for which the Group has also entered into master netting agreements;
- Charges over business assets such as premises, inventory and accounts receivable; and
- Charges over financial instruments such as debt securities and equities.

Longer-term finance and lending to corporate entities are generally secured; revolving individual credit facilities are generally unsecured.

Collateral held as security for financial assets other than loans and advances depends on the nature of the instrument. Debt securities, treasury and other eligible bills are generally unsecured, with the exception of asset-backed securities and similar instruments, which are secured by portfolios of financial instruments. Derivatives are also collateralised.

IFRS7(39K)(b)(i) The Group's policies regarding obtaining collateral have not significantly changed during the reporting period and there has been no significant change in the overall quality of the collateral held by the Group since the prior period.

IFRS7 (39K)(b)(ii) A portion of the Group's financial assets originated by the mortgage business has sufficiently low 'loan to value' (LTV) ratios, which results in no loss allowance being recognised in accordance with the Group's expected credit loss model. The carrying amount of such financial assets is CU 5,732 as at 31 December 2018.

IFRS7(39K)(c) The Group closely monitors collateral held for financial assets considered to be credit-impaired, as it becomes more likely that the Group will take possession of collateral to mitigate potential credit losses. Financial assets that are credit-impaired and related collateral held in order to mitigate potential losses are shown below:

	Gross exposure	Impairment allowance	Carrying amount	Fair value of collateral held
Credit-impaired assets	CU'000	CU'000	CU'000	CU'000
Loans to individuals:				
– Overdrafts	310	(264)	46	–
– Credit cards	302	(272)	30	–
– Term loans	326	(218)	108	–
– Mortgages	1,557	(470)	1,087	965
Loans to corporate entities:				
– Large corporate customers	120	(41)	79	100
– Small and medium-sized enterprises (SMEs)	122	(61)	61	86
– Other	5	(4)	1	2
Total credit-impaired assets	**2,742**	**(1,330)**	**1,412**	**1,153**

PwC observation – Fair value of collateral held as security for credit-impaired financial assets

The table above includes a column disclosing the fair value of collateral held as security for credit-impaired financial assets, which has been included to meet the requirement to present quantitative information about collateral held as security and other credit enhancements for such financial assets. However, we note that paragraph B8F of IFRS 7 clarifies that entities are neither required to disclose information about the fair value of collateral and other credit enhancements nor to quantify the exact value of the collateral included in the calculation of ECL. Therefore, this disclosure requirement may be met in alternative ways.

The following table shows the distribution of LTV ratios for the Group's mortgage credit-impaired portfolio:

Mortgage portfolio – LTV distribution	Credit-impaired (Gross carrying amount)
	CU'000
Lower than 50%	31
50 to 60%	62
60 to 70%	93
70 to 80%	171
90 to 100%	529
Higher than 100%	671
Total	**1,557**

Paragraph 7.36(b) of IFRS 7 extends collateral disclosures to all financial instruments within the scope of IFRS 7, but to which the impairment requirements in IFRS 9 are not applied, by requiring disclosure by class of financial instrument a description of collateral held as security and other credit enhancements, and their financial effect (for example, quantification of the extent to which collateral and other credit enhancements mitigate credit risk) in respect of the amount that best represents the maximum exposure to credit risk.

Collateral and the SPPI test

Paragraph BC4.206(b) of the Basis for Conclusions on IFRS 9 explains the IASB's view that financial assets (including investments in contractually linked instruments, ie tranches) can themselves still have contractual cash flows that are solely payments of principal and interest if they are collateralised by assets that do not have contractual cash flows that are solely payments of principal and interest. Consequently, in performing the SPPI test an entity disregards the possibility that the collateral might be foreclosed in the future unless the entity acquired the instrument with the intention of controlling the collateral.

Example

On 01/01/2018 Bank pays $1,000,000 to acquires a promise to receive $1,210,000 from Entity A on 31/12/2019.

If on 31/12/2019 Entity A does not pay Bank $1,210,000, Bank has the right to seize from Entity A 1,000 Entity Z shares (the collateral). Entity A is restricted from selling its 1,000 Entity Z shares before it has extinguished the promise to pay Bank.

Does Bank's financial asset(receivable from Entity A) pass the SPPI test? Choose one of: 1) Yes; 2) No; or 3) It depends (specify on what it depends).

Collateral: effects when determining whether a significant increase in credit risk

Financial instruments are not considered to have low credit risk when they are regarded as having a low risk of loss simply because of the value of collateral and the financial instrument without that collateral would not be considered low credit risk (paragraph B5.5.22 of IFRS 9).

Unless the low credit risk exemption applies, in accordance with paragraph 5.5.10 of IFRS 9 a reporting entity must at each reporting date assess whether there has been a significant increase in credit risk since initial recognition in accordance with paragraph 5.5.3 of IFRS 9, irrespective of the value of the collateral it holds.

Grouping

Paragraph B5.5.5 of IFRS 9 specifies that for the purpose of determining significant increases in credit risk and recognising a loss allowance on a collective basis, an entity can group financial instruments on the basis of shared credit risk characteristics with the objective of facilitating an analysis that is designed to enable significant increases in credit risk to be identified on a timely basis. Such collateral related shared credit risk characteristics might[6] include:

- the type of collateral; and
- the value of collateral relative to the financial asset if it has an impact on the probability of a default occurring (for example, non-recourse loans in some jurisdictions or loan-to-value ratios).

Indicators

Collateral related information that might indicate a significant increase includes (paragraph B5.5.17):

- if significantly increased amounts of collateral would be required if a prexisting instrument was hypothetically originated at the reporting date; and
- significant changes in the value of the collateral supporting the obligation or in the quality of third-party guarantees or credit enhancements, which are expected to reduce the borrower's economic incentive to make scheduled contractual payments or to otherwise have an effect on the probability of a default occurring. For example, if the value of collateral declines because house prices decline, borrowers in some jurisdictions have a greater incentive to default on their mortgages.

[6] Credit risk analysis is a multifactor and holistic analysis; whether a specific factor is relevant, and its weight compared to other factors, depends on the type of product, characteristics of the financial instruments and the borrower as well as the geographical region (paragraph B5.5.16 of IFRS 9).

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Example 1

On 01/01/2018 Entity A borrows $1,000,000 from Bank:

- loan term: 10 years;
- $100,000 capital plus 10% fixed rate interest is paid on 31 December each year over the loan term loan;
- if the Entity A is past due on any contractual payment, Bank has the right to seize from Entity A 1,000 Entity Z shares (the collateral). Entity A is restricted from selling its 1,000 Entity Z shares before it has extinguished its loan from Bank.

On 31/12/2018:

- Entity A pays Bank $200,000. Consequently, the gross carrying amount of the loan reduces to $900,000.
- Bank assesses that due to factors that arose in 2018, the outlook for Entity A is significantly more risky than it was on 01/01/2018.
    - However, Bank judges that should Entity A default Bank will not incur a loss because it would foreclose on Entity A's collateral and sell it without material delay.
    - Entity Z's shares trade in an active market at 31/12/2018 at $1,250 per share (01/01/2018 at $1,000 per share). Entity Z's shares are investment grade.

Regarding its loan receivable asset from Entity, at 31/12/2018 would Bank likely conclude that there is a significant increase in credit risk? Choose one of:

1) Yes;
2) No, the low-credit risk exception applies to the loan receivable from Entity because the collateral LTV ratio is low and the collateral is investment grade; or
3) No, although the low-credit risk exception does not apply to the loan receivable from Entity, the collateral value is sufficient to cover the outstanding loan (ie Bank does not expect to incur a credit loss).

Example 2

On 01/01/2018 Individual borrows $1,000,000 from Bank to finance the entire purchase price of a home (ie a mortgage loan; LTV ratio = 100%):

- loan term: 25 years;
- 10% fixed rate interest is due on 31 December each year over the loan term loan;
- $1,000,000 capital is due on 31/12/2043;
- if Individual is past due on any contractual payment, Bank has the right to seize from Individual the collateral (ie Individual A's home). Individual is restricted from selling the home before it has extinguished its loan from Bank.

On 31/12/2018:

- Individual pays Bank $100,000.

- Bank assesses that property values of the type and area in which Individual's home is located decreased by 25% in 2018 (ie Individual mortgage LTV ratio = 133%).

Regarding its mortgage loan receivable asset from Individual, at 31/12/2018 would Bank likely conclude that there is a significant increase in credit risk?

Choose one of: 1) Yes; 2) No; or 3) It depends (specify on what it depends).

Collateral: measuring expected credit losses

Paragraph B5.5.55 of IFRS 9 specifies that for the purposes of measuring expected credit losses, the estimate of expected cash shortfalls must reflect the cash flows expected from collateral and other credit enhancements that are part of the contractual terms and are not recognised separately by the entity. Such estimates reflect the amount and timing of cash flows that are expected from foreclosure on the collateral less the costs of obtaining and selling the collateral, irrespective of whether foreclosure is probable (ie the estimate of expected cash flows considers the probability of a foreclosure and the cash flows that would result from it). Consequently, any cash flows that are expected from the realisation of the collateral beyond the contractual maturity of the contract should be included in this analysis.

However, when loss given default is estimated on the basis of collateral realisation cash flows, measurement considerations include: (i) collateral type; (ii) projected collateral values; (iii) historical discounts to collateral value due to forced sales; (iv) time to repossession and recovery costs observed.

Example

On 01/01/2018, to facilitate the export of its products, SmallBus borrows $1,000,000 from Bank to finance the entire purchase price of a dockyard warehouse (ie LTV ratio = 100%):

- loan term: 5 years;
- $200,000 capital plus 10% fixed rate interest is paid on 31 December each year over the loan term loan;
- if SmallBus is past due on any contractual payment, Bank has the right to seize from SmallBus the collateral (ie SmallBus's warehouse). SmallBus is restricted from selling the home before it has extinguished its loan from Bank.

On 31/12/2018:

- SmallBus pays Bank $300,000.
- Bank assesses the probability of SmallBus defaulting on the loan has rise significantly in 2018 because of deceasing domestic demand for its products because of:
    - the unanticipated removal of domestic import tariffs leading to cheap imports folding the domestic market; and
    - the unexpected imposition of significant import tariffs by the jurisdiction in which most of SmallBus's foreign customers are located.

These events are expected to have a sustained negative effects for the forseable future. Consequently, SmallBus's free cash flow is expected to be reduced to the point that the coverage of scheduled loan payments could be tight and further deterioration in cash flows might result in SmallBus missing a contractual payment on the loan and becoming past due.

- Bank assesses that warehouse values of the type and area in which SmallBus's warehouse is located increased by 25% in 2018 (ie SmallBus LTV ratio = 64%).

At 31/12/2018 regarding its loan receivable asset from SmallBus:

- **Question 1:** would Bank likely conclude that there is a significant increase in credit risk?
- **Question 2:** would Bank measure the expected credit loss at nil?
- **Question 3:** if your answer to Question 2 is 'no', how would Bank measure the expected credit loss?
- **Question 4:** if your answer to Question 2 is 'yes', what disclosures, if any, would be triggered by that judgement?

Assets obtained by taking possession of collateral held

Any collateral obtained as a result of foreclosure is not recognised as an asset that is separate from the collateralised financial instrument unless it meets the relevant recognition criteria for an asset in IFRS 9 or other Standards (paragraph B5.5.55 of IFRS 9).

If financial or non-financial assets obtained by foreclosure during the period are still held at the reporting date, the reporting entity must disclose (paragraph 38 of IFRS 7):

(a) the nature and carrying amount of the assets; and
(b) when the assets are not readily convertible into cash, its policies for disposing of such assets or for using them in its operations.

Although the IASB had proposed disclosure of the fair value of collateral, it was persuaded that the now limited required disclosures about foreclosed collateral are also useful because they provide cost-beneficial information about the frequency of foreclosures and the reporting entity's ability to obtain and realise the value of the collateral (paragraph BC56 of the Basis for Conclusions on IFRS 7).

The accounting policy note in EY's Good Bank (International) Limited Illustrative consolidated financial statements for the year ended 31 December 2016' illustrate some circumstances in which other Standards might apply:[7]

6.7.5 Collateral repossessed

The Bank's policy is to determine whether a repossessed asset can be best used for its internal operations or should be sold. Assets determined to be useful for the internal operations are transferred to their relevant asset category at the lower of their repossessed value or the carrying value of the original secured asset. Assets for which selling is determined to be a better option are transferred to assets held for sale at their fair value or fair value less cost to sell for non-financial assets at the repossession date in line with the Bank's policy.

IFRS 7.38(a)(b)
IFRS 5.6
IFRS 5.15

[7] Source: http://www.ey.com/Publication/vwLUAssets/ey-good-bank-2016/$FILE/ey-good-bank-2016.pdf

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In the context of IFRS 9 financial derecognition requirements, when non-cash collateral is provided by a transferor to the transferee, the accounting for the collateral by the transferor and the transferee depends on:

- whether the transferee has the right to sell or repledge the collateral; and
- whether the transferor has defaulted.

In particular, the transferor and transferee must account for the collateral as follows (paragraph 3.2.23 of IFRS 9 with **emphasis added**):

(a) If the transferee has the right by contract or custom to sell or repledge the collateral, then the transferor must reclassify that asset in its statement of financial position (for example, as a loaned asset, pledged equity instruments or repurchase receivable) separately from other assets.

(b) If the transferee sells collateral pledged to it, it must recognise the proceeds from the sale and a liability measured at fair value for its obligation to return the collateral.

(c) If the transferor defaults under the terms of the contract and is no longer entitled to redeem the collateral, it must derecognise the collateral, and the transferee must recognise the collateral as its asset <u>initially measured at fair value</u> or, if it has already sold the collateral, derecognise its obligation to return the collateral.

(d) Except as provided in (c), the transferor must continue to carry the collateral as its asset, and the transferee must not recognise the collateral as an asset.

Deloitte International GAAP Bank Limited — Illustrative disclosures under IFRS 7 as amended by IFRS 9[8]

Assets obtained by taking possession of collateral

The Group obtained the following financial and non-financial assets during the year by taking possession of collateral held as security against loans and advances and held at the year end. The Group's policy is to realise collateral on a timely basis. The Group does not use non-cash collateral for its operations.

	Year ended 20XX CU	Year ended 20YY CU
Property	[X]	[X]
Debt securities	[X]	[X]
Other	[X]	[X]
Total assets obtained by taking possession of collateral	[X]	[X]

Examples: foreclosed collateral

You are required to critically evaluate each of the following bank's accounting policies for foreclosed collateral.

Bank A's accounting policy for foreclosed assets:

> Land and other foreclosed collateral are presented in the statement of financial position as a subcomponent of other assets.

8 Source: https://www.iasplus.com/en/publications/global/other/illustrative-disclosures

Foreclosed properties are measured at the item's net realisable value. The excess of carrying amount of the loan receivable over the net realisable value of the foreclosed properties is charged against **allowance for impairment losses**.

The difference between the carrying amount of foreclosed properties and the proceeds from the sale of such properties is recorded as gain or loss at the time of sale.

Management evaluates the value of foreclosed properties periodically. Allowance for impairment losses on foreclosed properties is revised on reduction in the net realisable value of an item of foreclosed property.

The carrying amount of foreclosed properties is written down to recognise a **permanent decline** in the value of the foreclosed properties, which is charged to current operations.

Bank B's accounting policy for foreclosed assets:

Assets foreclosed shown as 'Assets held for sale' in the statement of financial position are accounted for at the lower of cost and fair value less cost to sell similar to the principles of IFRS 5. The cost of assets foreclosed includes the carrying amount of the related loan less allowance for impairment at the time of foreclosure. Impairment loss is recognized for any subsequent write-down of the asset to fair value less cost to sell.

Foreclosed assets not classified as 'Assets held for sale' are accounted for in any of the following classification using the measurement basis appropriate to the asset as follows:

(a) Investment property is accounted for in accordance with IAS 40 *Investment Property* using the cost model;
(b) Bank-occupied property is accounted for in accordance with IAS 16 *Property, Plant and Equipment* using the cost model; and
(c) Financial asset are in accordance with IFRS 9 classified FVOCI.

Bank C's accounting policy for foreclosed assets:

Foreclosed collaterals acquired in settlement of loans (included as part of "Other Assets") are recognized at fair value of the collateral after deducting the estimated costs of disposal or loan outstanding amount, whichever is lower. The excess in loan balances which has not been paid by debtors over the value of foreclosed collaterals is charged to allowance for possible losses on loans in the current year. The difference between the value of the collateral and the proceeds from sale thereof is recognized as a gain or loss at the time of sale of the collateral. Management evaluates the value of foreclosed collaterals periodically. Allowance for losses foreclosed collaterals formed by impairment of foreclosed collaterals. Reconditioning costs arising after foreclosure capitalized in the accounts of the foreclosed collaterals.

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Recognition of collateral held

Paragraphs 3.1.1 of IFRS 9 specifies the financial instrument recognition principle: an entity recognises a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes party to the contractual provisions of the instrument.

Paragraph B3.1.1 qualifies the principle with a number of rules including: if a transfer of a financial asset does not qualify for derecognition,[9] the **transferee** does not recognise the transferred asset as its asset. To give effect to this rule:

- paragraph B3.2.15 specifies that to the extent that a transfer of a financial asset does not qualify for derecognition (by the **transferor**) the **transferee** does not recognise the asset. However, 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 control of the entire transferred asset for a fixed amount (such as under a repurchase agreement), the transferee may measure its receivable at amortised cost if it meets the criteria in paragraph 4.1.2.

Example: cash collateral held

Entity B transfers $1,000,000 cash to Entity A as collateral for a securities borrowing transaction. The cash is not legally segregated from Entity A's assets.

How must Entity A account for the cash collateral it receives from Entity B? Choose one of:[10]

1) No entry because only collateral (ie the cash is not Entity A's asset);
2) Increase asset (asset: cash) and increase liability (liability: contractual obligation to return cash collateral) by $1,000,000; and
3) Increase asset (cash) and increase income (profit or loss) by $1,000,000.

How must Entity B account for the cash collateral it transfers to Entity A?

Choose one of:

1) No entry because the collateral transferred is still its asset (ie the cash is not Entity A's asset);
2) Decrease asset (cash) and increase asset (financial asset: receivable from Entity A) by $1,000,000; and
3) decrease asset (cash) and increase expense (profit or loss) by $1,000,000.

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[9] IFRS 9 specifies complex requirements for the derecognition of financial assets (see paragraphs X to Y and BX to BY.

[10] For further discussion and analysis see the Illustrative Examples that accompany but do not form part of IFRS 9: Illustrative example D.1.1 Recognition: cash collateral

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Example: non-cash collateral held

On 31/12/2018 Entity A transfers 1,000 Entity Z shares to Bank as collateral for a $1,000,000 loan from Bank.

At 31/12/2018 Entity Z shares trade in a deep and liquid market at $1,000 per share.

The Entity Z shares transferred by Entity A to Bank are not legally segregated from Bank's assets and Bank is unrestricted in the sale of the shares provided that upon settlement of the loan by Entity A, Bank transfers to Entity A 1,000 Entity Z shares.

At 31/12/2018, how must Bank account for the collateral (1,000 Entity Z shares) it receives from Entity A?

Choose one of:

1) no entry because only collateral, ie the 1,000 Entity Z shares are not Bank's asset;
2) increase asset (financial asset: 1,000 Entity Z shares) and increase liability (financial liability: obligation to return 1,000 Entity Z shares) by $1,000,000; and
3) increase asset (cash) and increase income (profit or loss) by $1,000,000.

Disclosure of collateral held

Paragraph 15 of IFRS 7 specifies that an entity must disclose for collateral (of financial or non-financial assets) that it holds **and is permitted to sell or repledge** in <u>the absence of default</u> by the owner of the collateral:

(a) the fair value of the collateral held;
(b) the fair value of any such collateral sold or repledged, and whether the entity has an obligation to return it; and
(c) the terms and conditions associated with its use of the collateral.

Collateral pledged

Paragraph 14 of IFRS 7 specifies that an entity must disclose:

(a) the carrying amount of financial assets it has pledged as collateral for liabilities or contingent liabilities, including amounts that have been reclassified in accordance with paragraph 3.2.23(a) of IFRS 9; and
(b) the terms and conditions relating to its pledge.