



THE INSTITUTE  
OF CHARTERED  
ACCOUNTANTS  
IN ENGLAND AND WALES

31 July 2009

Our ref: ICAEW Rep 76/09

Your ref:

Sir David Tweedie  
The International Accounting Standards Board  
30 Cannon Street  
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By email: [commentletters@iasb.org](mailto:commentletters@iasb.org)

Dear David

## **DERECOGNITION**

The Institute of Chartered Accountants in England and Wales pleased to respond to your request for comments on the Exposure Draft ED/2009/3 *Derecognition (proposed amendments to IAS 39 and IFRS 7)*, published by the International Accounting Standards Board in March 2009.

Please contact me if you would like to discuss any of the points raised in the attached response.

Yours sincerely

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## ICAEW REPRESENTATION

### ICAEW REP 76/09

#### DERECOGNITION - PROPOSED AMENDMENTS TO IAS 39 AND IFRS 7

Memorandum of comment submitted in July 2009 by The Institute of Chartered Accountants in England and Wales, in response to the Exposure Draft ED/2009/3 *Derecognition (proposed amendments to IAS 39 and IFRS 7)*, published by the International Accounting Standards Board in March 2009.

Contents	Paragraph
Introduction	1
Who we are	2 - 4
Major issues	5 - 23
Answers to specific questions	24 - 51
Detailed points	52
Appendix: Application of the Alternative Approach	

## **DERECOGNITION - PROPOSED AMENDMENTS TO IAS 39 AND IFRS 7**

1. The Institute of Chartered Accountants in England and Wales (the Institute) welcomes the opportunity to comment on the Exposure Draft ED/2009/3 *Derecognition (proposed amendments to IAS 39 and IFRS 7)*, published by the International Accounting Standards Board in March 2009.

### **WHO WE ARE**

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 165 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.
3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.
4. Our members occupy a wide range of roles throughout the economy. This response was developed by the Financial Reporting Committee of the Institute, which includes preparers, analysts, standard-setters and academics as well as senior members of accounting firms and public sector bodies.

### **MAJOR ISSUES**

#### **Need for an exposure draft and its timing**

5. Given the current climate and pressures put on the Board, we understand the Board's desire to act quickly to address concerns raised about derecognition. However, we are not aware of major problems or failings in respect of the IAS 39 derecognition requirements. Therefore, derecognition may be more of a US GAAP issue than one requiring urgent changes to IFRS.
6. We note that FASB has now issued its revision of SFAS 140 which continues to embody a very different approach to the IASB's exposure draft. FASB has committed only to expose the final IASB standard for public comment. Therefore, at least in the short-term, this project will not achieve convergence.
7. While there are certain inconsistencies and some well-understood problems with the IAS 39 derecognition requirements, we believe that they largely work well in practice and it may have been more beneficial to make incremental improvements, targeting areas with known difficulties, particularly given the other changes in the process of being considered for financial instrument accounting, until the time could be taken for a more comprehensive review. If, for example, there were concerns about how the existing provisions regarding continuing involvement work in practice, change could be targeted at this area rather than developing an entirely new model. There are significant uncertainties about what the final requirements will be for financial instrument accounting following the completion of the current comprehensive review, the proposals for which are being advanced piecemeal. We strongly believe that any

changes in the area of derecognition will need to be considered ‘in the round’ in the context of the eventual wider proposals for financial instruments to ensure that they operate as intended as a whole. A piecemeal approach to developing proposals may be necessary given the pressures being put on the IASB, but we advise against a piecemeal approach to field-testing or to real life application. Therefore, we recommend that the IASB consider carefully the effective dates of all financial instrument proposals so that the whole package stands together and to avoid the potential for unintended consequences if some requirements are implemented at an earlier date than others.

8. The exposure draft does not clearly state the objectives of the proposals other than to address perceived complexity. The introduction summarises the areas of complexity, but it seems doubtful whether all of these areas are substantially changed by the proposals or, if they are reduced, then other difficulties seem to be introduced. While there may be concerns about how the ‘substantially all the risks and rewards’ test is applied in practice under the existing standard, it seems likely that the proposals would create similar concerns about how to interpret new requirements such as determining ‘continuing involvement’, whether an asset is ‘readily available’ or whether the counterparty has the ‘practical ability to transfer for own benefit.’ The proposed approach places emphasis on whether the other party has the practical ability to transfer the asset for its own benefit rather than on the rights and obligations of the transferring party, which is the reporting entity. This emphasis may not be appropriate and may be difficult to understand and apply in practice.
9. Overall, considering the lack of stated objectives of the proposals, we wonder what effect the board expects their implementation might have on current practice. If, as seems likely, the only material changes are to be in relation to the derecognition of readily obtainable assets that are subject to repo arrangements (see paragraphs 15 et seq below), we question whether there is any substantive benefit in pursuing the proposals either at all or in advance of the more fundamental review of financial instrument accounting currently in progress. This is particularly true when the risk of unintended consequences is taken into consideration. In addition, we are aware that any concerns expressed about derecognition have been in the context of too much being derecognised rather than too little and the proposals appear to result in more derecognition than under existing IFRS practice. We question whether this would meet the objectives of those with concerns.
10. The alternative model given in the ED (but only described at a high level) would have a more radical impact on current practice. We can see it has some conceptual merits and note it has received some favourable comment at the roundtables. However, we are strongly of the view that the approach is not sufficiently developed in this exposure draft and it would require re-exposure so that it could be analysed appropriately (and therefore be subject to sufficient due process) before it could be finalised as a standard. In fact such a radical change will require additional due process, including field-testing and more analysis of its relationship with other changes to financial instrument accounting, before it could be introduced. We also believe that there is merit in considering derecognition of non-financial assets as well as financial assets so if sufficient time can be taken, the project could be usefully expanded which may help ensure consistency with other projects, such as leasing.
11. In summary, we are not convinced that derecognition is an area that the IASB needs to address urgently or that it can be effectively addressed while there are other revisions to IAS 39 in progress. In common with opinions expressed at the roundtables, we do not support the main approach set out in the ED and consider

that its adoption would not result in improvement to existing practice. While there are merits in the alternative approach and we set out in the appendix some additional suggestions to make this approach more operational, we consider that such an approach could not be finalised without additional due process including a new exposure draft.

12. If, however, the Board believes that urgent change is needed, the IASB should restrict its short-term work on derecognition to address the crisis-related issues arising from the existing derecognition model and only make such incremental changes to the existing requirements that will clearly improve the quality of information provided and/or make the requirements easier to apply. For example, the accounting for 'continuing involvement' could be clarified as it is generally seen as difficult to understand and apply and the disclosure requirements could be improved.

### **The proposed model**

13. The proposed model is in some ways simpler than the one in existing IFRS, so it appears easier to understand. However, this does not necessarily imply that it will be easier to apply in practice. In fact, we are concerned that, as currently drafted, the proposals could lead to more inconsistencies in practice than the existing requirements. For example, defining the 'asset' in terms of cash flow obscures what is being transferred: is it cash flows or the actual instrument? The proposals would also allow for structuring opportunities where a small change in the terms of a transaction can be made in order to achieve a particular treatment. For example, entities may be willing to retain an insignificant subordinated interest in an asset to avoid derecognition.
14. The drafting of the proposed model could be improved. It is not clear whether the Application Guidance sets out additional requirements that are not articulated in the standard. For example, the references to pass-through arrangements, which are not set out in the standard, could be seen to be included in its requirements by virtue of the Application Guidance. If any material in the examples is intended to specify a general requirement then that requirement should be set out in the body of the standard.

### **Repos**

15. Under the proposals, sale and repurchase agreements ('repos') over readily obtainable assets would be represented on the balance sheet as cash and a derivative rather than, as is often currently the case, as an asset and a secured borrowing. While we agree that this could be said to represent the position of the reporting entity at a point in time, we believe that this approach does not represent the substance of the transaction as a whole, so that the balance sheet of the 'transferring' entity would be misleading. We also believe the required disclosures, which appear to be intended to address this problem, are excessive and, as drafted, impracticable. The amount of disclosure also indicates that the derecognition approach in itself would result in important information about future expected cash flows being lost from the primary financial statements. Disclosure cannot be a substitute for the accounting reflecting the economic substance of the transaction.
16. The full effect of this revised treatment of repos is dependent on its interaction with accounting classification rules for financial assets under IAS 39 and will need to be reassessed if the Board change IAS 39 classification requirements. However, under the current IAS 39 model:

- (a) net income gains could be reported by an entity obtaining financing using selected AFS assets showing unrealised gains with, arguably, no economic change in exposure;
- (b) obtaining short-term finance using a held-to-maturity investment would result in tainting of the whole held-to-maturity portfolio; and
- (c) entities (such as certain pension funds) that are legally or contractually constrained from disposing of the assets which they hold may be unable to use such assets in repo or stock-lending transactions if this would result in the assets being derecognised for accounting purposes. Other entities may be unwilling to use their assets to obtain repo funding, if this would result in the crystallisation of unrealised losses on these assets.

We are not convinced that the above outcomes are appropriate or desirable under the current classification model.

17. Overall, we are concerned that the accounting result for repos is different depending on whether the asset is readily obtainable or not. This could create a 'bright line' with binary accounting outcomes that may not be operational or understandable to users of the accounts because transactions with the same substance would be reported very differently. Furthermore, we regard it as inappropriate to underpin the accounting with a judgement as to whether another entity would consider the assets to be 'readily obtainable', a judgment which the transferor may not be able to make with any degree of certainty.
18. As a result of the perceived problems with repo accounting, we understand that consideration is being given to introducing separate accounting to ensure repos remain on balance sheet under revised proposals. We agree that the current proposals do not result in an appropriate treatment of repos, but scoping out repos from the general derecognition requirements suggests that the underlying principles of the proposed approach are inherently wrong. Moreover, it would be difficult to operationalise and define an exemption that took account of the need to address other similar transactions such as stock lending without leaving the door open to abuse. It would be preferable to develop a principle as to why repos should not be derecognised and amend the overall derecognition approach to take account of this.

## **Control**

19. We understand the attraction of a model based on control. This approach is consistent with that proposed by the IASB in other contexts, such as consolidation and revenue recognition. However, we believe that the model presents practical problems that will make it difficult to apply consistently in practice.
20. We have previously responded to the IASB in other contexts to the effect that we do not believe that control can be fully decoupled from risks and rewards. In particular, we believe it is necessary to retain some notion of risks and rewards in order to identify where control lies in cases where control is not exercised through explicit legal rights or other mechanisms. Risks and rewards will generally derive from control, and therefore provide a strong indicator of where that control lies, and by the same token, the party exposed to the risks and rewards of an asset or entity will generally wish to have some form of control over those assets, or at least the ability to prevent others from exercising such control. We believe that it will often be necessary to use risks and rewards as an indicator of where control might lie. We

believe that this is particularly relevant in relation to continuing involvement (see paragraph 32 below).

21. We note that, in some cases, the proposals imply a risk and reward test as part of the notion of control. For example, the definition of the asset based on proportionate cash flows precludes derecognition if the last 10 per cent of the cash flows are retained and the first 90 per cent transferred. It is not clear why retaining the last 10 per cent means that the transferor controls all the cash flows and therefore the asset. It is also not clear how a forward or option to reacquire the asset for which the contract price is not fair value means that the transferor has retained control of the asset. The test of whether or not an asset is readily obtainable in the market does not affect whether or not assets are controlled in other circumstances. For example, entities are considered to control their unlisted subsidiaries, regardless of whether the shares are readily obtainable or not.

### **The alternative model**

22. We have some sympathy for the alternative model, which has the conceptual attraction of being significantly more principles-based and reflecting the assets and liabilities of an entity at any point in time. However, we recognise that this model effectively creates a wider 'fair value option' and hence that it may present significant operational issues outside a full fair value environment. Again, the feasibility of applying this model is closely linked to the IASB's ongoing work on the replacement of IAS 39. We set out in the appendix some initial suggestions to make the alternative model more operational, although we would reiterate that any proposal based on the alternative model would need to be re-exposed in fully developed form before it could be adopted.

### **Disclosures**

23. We believe that the disclosure requirements are excessive, and the degree of detail is not consistent with other disclosures required by IFRS. The potential volume caused by the indiscriminate nature of the requirements would militate against users obtaining any great benefit from them; the wood would definitely be obscured by the trees. The extent of the disclosure requirements suggests that the board has little confidence in the proposed accounting model - and the disclosures are intended to overcome this deficiency. We set out our concerns about the proposed disclosures in more detail in paragraph 47 et seq below).

### **SPECIFIC QUESTIONS**

#### **Question 1—Assessment of 'the Asset' and 'continuing involvement' at reporting entity level**

**Do you agree that the determination of the item (ie the Asset) to be evaluated for derecognition and the assessment of continuing involvement should be made at the level of the reporting entity (see paragraphs 15A, AG37A and AG47A)? If not, why? What would you propose instead, and why.**

24. We agree. However, some field-testing should be undertaken to check how the consolidation and derecognition proposals interact.

## **Question 2—Determination of ‘the Asset’ to be assessed for derecognition**

**Do you agree with the criteria proposed in paragraph 16A for what qualifies as the item (ie the Asset) to be assessed for derecognition? If not, why? What criteria would you propose instead, and why.**

***(Note: The criteria proposed in paragraph 16A are the same as those in IAS 39.)***

25. We agree.
26. In some cases, for example those relating to securitisations in which a residual interest is retained by the transferor, the definition of ‘the asset’ is crucial to the accounting conclusion reached. In this context, it should be noted that a relatively small change to the substance of the transaction (for example retaining an economically insignificant residual interest) may have a substantial impact on the accounting applied. Arguably, the alternative approach, which does not rely on a detailed definition of the asset transferred, will be a more principles-based approach in this area.

### *Interest rate swaps*

27. We agree with the ED that an interest rate swap should only be derecognised if both the receive leg and the pay leg meet derecognition criteria. However, we are confused by fact that the ED and the Basis for Conclusions provide different rationales for this.
28. Paragraph AG41A argues that because interest rate swaps can potentially be assets or liabilities over their terms, the derecognition criteria of both financial assets and financial liabilities must be met for the swap to be derecognised. So if one leg of the swap is transferred, it should not be permissible to continue to recognise just the remaining leg. But paragraph BC36 argues that it is because ‘the cash flows relating to the asset part of the instrument are likely to be netted with the cash flows relating to the liability part. Accordingly, the ‘specifically identified cash flows’ from the instrument that would be observable in this case would be net flows, and thus they would be different from, and less than the cash flows relating to the asset part only.’
29. There does not seem to be anything in the basic principles set out in paragraph 16A (which talks about specifically identified cash flows and proportionate shares of those cash flows) to imply that those basic principles should not be applied if an instrument can change from being an asset to being a liability or vice versa. So either this is an arbitrary rule or a flawed principle. Moreover, the argument in the Basis for Conclusions that refers to cash flows that are likely to be netted appears to have implications for other arrangements that involve netting. We would therefore suggest that this discussion in the Basis for Conclusions should either be developed more fully, to be clear on its application, particularly in the context of balances that are offset under the requirements of IAS 32, or be deleted.

## **Question 3—Definition of ‘transfer’**

**Do you agree with the definition of a transfer proposed in paragraph 9? If not, why? How would you propose to amend the definition instead, and why.**

30. We do not believe the definition is precise enough to determine when a transfer has taken place in a number of circumstances. The definition has been widened such that more transactions would require consideration but is insufficiently clear to ensure consistent application.



31. We have a number of issues relating to the definition of a transfer.
- (a) It is not clear whether the 'asset' being transferred is the cash flows or the actual instrument.
  - (b) There is confusion in the drafting between the ability to transfer when transfer does not lead to derecognition and the ability to dispose of an item. These terms describe different situations, but are used to mean the same thing, particularly in relation to the transferee having the practical ability to transfer. In other words, the definition of 'transfer' for the original transferor is significantly wider than that which would be met if the subsequent transferee is to be considered to have the practical ability to 'transfer the asset for its own benefit'.
  - (c) It appears that an SPV that issues several tranches of notes to different investors, covering all of the cash flows from its assets, would derecognise the underlying assets. It is our understanding from IASB staff that, in the absence of any derivatives that would represent continuing involvement, the SPV would not recognise any assets or liabilities. We are not convinced that increasing the number of empty SPVs in this way is an improvement nor that the derecognition of the liabilities (which are a legally enforceable liabilities of the issuer) is consistent with the *Framework for the Preparation and Presentation of Financial Statements*.
  - (d) The existing IAS 39 guidance on 'pass-through' will be withdrawn under the new proposals, but AG52L (g) - seems to reintroduce a notion of what is in effect pass-through. The ED seems to suggest that any pass-through arrangement, including limited recourse loans, could be considered to be a transfer. As noted above, it will be necessary for the final standard to be clearer about what constitutes a transfer, particularly in these types of arrangement. It is important that this is dealt with in the standard, rather than in the Application Guidance accompanying it.
  - (e) It is not clear whether a pass-through arrangement would need to be contractual or could simply be implicit. For example, would debt issued by an entity which has only one asset which can act as a source of funds to service the debt be considered a 'transfer' of that asset or would it be necessary for the debt to be explicitly secured only on the specific asset? Once again, the wording in the standard itself should be clear.
  - (f) We note that disclosure requirements are dependent on whether or not there is a transfer that achieves or does not achieve derecognition and hence the definition of a 'transfer' is important under the ED, notwithstanding the fact that not all such transfers will result in derecognition of the relevant assets. We comment further in relation to question 11. In our view, it is the uncertainty in the ED over whether a transfer that retriggers derecognition has actually occurred that is driving the perceived need for additional disclosures.
  - (g) The ED does not require that any consideration be received in order for a transfer to exist, which would suggest that the provision of collateral and similar arrangements would meet the definition of transfers. Given the significance of this issue, and the fact that this will be a difference from US GAAP, it is not clear why the IASB has sought to make such a significant change to the treatment of collateral, without adequately drawing attention to

this in the exposure draft. We are not aware that concerns exist about the current accounting treatment for collateral provided to other parties.

#### **Question 4—Determination of ‘continuing involvement’**

**Do you agree with the ‘continuing involvement’ filter proposed in paragraph 17A(b), and also the exceptions made to ‘continuing involvement’ in paragraph 18A? If not, why? What would you propose instead, and why.**

32. We do not oppose a ‘continuing involvement’ filter, but we have reservations about the way it is proposed to be dealt with.
- (a) The definition in paragraph 18A defines continuing involvement by what it is not: for clarity and consistent application the definition needs to be positively stated.
  - (b) We do not understand the principle the examples are aiming for: are they intended to be an exclusive list, examples or indicators? The continuing involvement filter should be expressed as a principle.
  - (c) We do not understand whether paragraph 22A is an application of the model or an exception. If this is an exception, then is it intended to apply to all entities or just those which have restrictions over their operations? If a liquid asset is transferred without restrictions to a completely standalone operating entity in return for (say) a 2% equity interest, then applying the proposed model we would expect the transferor to derecognise the asset. If this is not the case, then this paragraph could preclude the derecognition of any asset sold where the transferor has an investment in the transferee, including intra-group restructurings and business combinations and sales to substantial operating entities in which the transferee has a small unrelated equity holding.
  - (d) AG50A is unclear as to what is meant by ‘or a third party entered into in connection with the transfer’. The following example could be viewed as connected transactions, but we are not sure the IASB intended to capture these relationships. Entity A simultaneously agrees to sell an asset to an unrelated entity B and purchase a TRS on the same asset from another unrelated entity C.
  - (e) Given the very wide definition of the term ‘transfer’, there is the potential for different interpretations of when continuing involvement may arise from a separate agreement ‘in connection with the transfer’. For example, would a straightforward interest rate swap with the transferee of a bond be considered to constitute continuing involvement with the asset sold? The principle needs to be made clearer.
  - (f) It is not clear whether the definition of transfer taken with the retention of rights to service in a fiduciary capacity would result in the derecognition of unit linked and other funds under management. While entities may legally own financial instruments, if the returns belong to fund or policy holders then it would appear that derecognition may be achieved but it is not clear if the ED envisages this outcome. Again, the principles and their implications need to be made clearer.

- (g) Some exposure to risks and rewards needs to be retained if an entity is to have continuing involvement with the asset sold. This is to some extent implied in the ED. For example:

- continuing involvement excludes the right to buy back at fair value, which has a flavour of risks and rewards;
- paragraphs BC14 and BC46 refer to future economic benefits, again implying risks and rewards.

On this basis, it would be helpful if the definition of continuing involvement was clear as to how it relates to the risks and reward of the underlying assets.

#### **Question 5—‘Practical ability to transfer for own benefit’ test**

**Do you agree with the proposed ‘practical ability to transfer’ derecognition test in paragraph 17A(c)? If not, why? What would you propose instead, and why.**

***(Note: Other than the ‘for the transferee’s own benefit’ supplement, the ‘practical ability to transfer’ test proposed in paragraph 17A(c) is the same as the control test in IAS 39.)***

**Do you agree with the ‘for the transferee’s own benefit’ test proposed as part of the ‘practical ability to transfer’ test in paragraph 17A(c)? If not, why? What would you propose instead, and why.**

33. We are not convinced that focusing on what the transferee can do with the asset is an appropriate way of determining the accounting for the transferor or that it is a proper reflection of the economic situation of the transferor for the accounting to be different depending on whether the asset transferred is considered readily obtainable in the market by the particular transferee. We are also concerned about the practicality of making these assessments on a continuous basis, and are unsure how this fits in with BC56 which requires no reassessment for the value of options or other additional contracts entered into between the transferor and transferee on the grounds of impracticality. While treating a repo over a readily obtainable asset as a sale resulting in derecognition of the asset and recognition of a derivative for the forward purchase of the asset is one view of the position at a point of time and does align the accounting for this derivative with that of a derivative unconnected with such an arrangement, we are not convinced it represents the substance of the arrangement which the parties consider to be a secured financing arrangement. The amount of disclosure which the ED requires in this situation also indicates that the derecognition approach in itself would result in important information about future expected cash flows being lost from the primary financial statements. Disclosure cannot be a substitute for the accounting reflecting the economic substance of the transaction.
34. We are also not convinced that the transferee has control of the asset, and not the transferor, as long as the transferee can buy the asset in an active market to return it to the transferor. The ability to sell is just one benefit inherent in an asset. It may be that the transferee is not entitled to any cash flows that arise from the asset such as dividends or that there are no such cash flows that will arise from the asset during the repo period. It may be that the transferee does not have voting or other rights attached to the asset. We also note that AG52A and AG52B refer to the transferee having the ability to dispose of the asset rather than transfer the asset and question

whether this means that the test is intended to refer only to disposals or to transfers more generally.

35. For transfers involving large quantities of assets where it may be difficult to place the whole stake in the market, it is not clear whether, 'the practical ability to transfer' relates to the individual asset or to the total amount transferred. For example, in the case of a short-term repo involving a 30% stake in a listed strategic investment, should derecognition be achieved?
36. The proposed approach will mean that the test of whether an asset is considered 'readily obtainable' will be critical to many derecognition decisions. This term is not defined but, in the absence of a clear definition, it is likely that a series of, potentially inconsistent, 'bright line' criteria will evolve through market practice - making this a very rules-based determination. It should be noted that whether an asset is 'readily obtainable' is not a simple matter of fact and that different market participants may have a different view whether or not a specific asset meets this definition.
37. The suggestion in AG52E(b) that a contractual prohibition on disposing of an asset may not prevent the practical ability to sell test from being met is confusing and is likely to create significant application issues. We suggest that this should be removed.

#### **Question 6—Accounting for retained interests**

**Do you agree with the proposed accounting (both recognition and measurement) for an interest retained in a financial asset or a group of financial assets in a transfer that qualifies for derecognition (for a retained interest in a financial asset or group of financial assets, see paragraph 21A; for an interest in a financial asset or group of financial assets retained indirectly through an entity, see paragraph 22A)? If not, why? What would you propose instead, and why.**

***(Note: The accounting for a retained interest in a financial asset or group of financial assets that is proposed in paragraph 21A is not a change from IAS 39. However, the guidance for an interest in a financial asset or group of financial assets retained indirectly through an entity as proposed in paragraph 22A is new.)***

38. We are content with the accounting proposed in paragraph 21A for a directly retained interest. However as set out in 4.1 above, we oppose the accounting proposed in paragraph 22A for an interest retained indirectly through an entity. We do not believe it is theoretically sound to track an asset into an entity that you do not control. Moreover, we do not believe that such a requirement can be made consistently operational, given the problems of obtaining the required information. It is also unclear how the example in AG52L(d) relates to paragraph 22A. AG52L(d) suggests that when the transferor purchases a subordinated interest in the transferee, the transferred asset cannot be derecognised, although paragraph 22 suggests that such a transfer can qualify for derecognition. It is also not clear whether assets transferred to parties where the transferor owns a subordinated interest (whether a controlling stake or not) would ever qualify for derecognition.

#### **Question 7—Approach to derecognition of financial assets**

**Having gone through the steps/tests of the proposed approach to derecognition of financial assets (Questions 1–6), do you agree that the**

**proposed approach as a whole should be established as the new approach for determining the derecognition of financial assets? If not, why? Do you believe that the alternative approach set out in the alternative views should be established as the new derecognition approach instead, and, if so, why? If not, why? What alternative approach would you propose instead, and why.**

39. We do not agree that the proposed approach is suitable for determining the derecognition of financial assets, for the reasons set out in the answers to questions 1 to 6 above. As we state in paragraphs 5 to 7 above, we do not necessarily believe that the derecognition requirements of IAS 39 need to be replaced. If the Board is determined to mandate a new approach, we believe that the alternative approach might provide a better basis. We set out some preliminary ideas in the Appendix about how this approach might be made operational. However, we emphasise that in the time available we have not been able to develop the model thoroughly. We trust that the Board will carry out its own work in this area and re-expose and field-test the revised proposals.

#### **Question 8—Interaction between consolidation and derecognition**

**In December 2008, the Board issued an exposure draft ED 10 *Consolidated Financial Statements*. As noted in paragraphs BC28 and BC29, the Board believes that its proposed approach to derecognition of financial assets in this exposure draft is similar to the approach proposed in ED 10 (albeit derecognition is applied at the level of assets and liabilities, whereas consolidation is assessed at the entity level).**

**Do you agree that the proposed derecognition and consolidation approaches are compatible? If not, why? Should the Board consider any other aspects of the proposed approaches to derecognition and consolidation before it finalises the exposure drafts? If so, which ones, and why? If the Board were to consider adopting the alternative approach, do you believe that that approach would be compatible with the proposed consolidation approach.**

40. We agree that the proposed derecognition and consolidation approaches are theoretically consistent, in so far as they are both based on the notion of control. However, we question whether it is appropriate to draw any conclusions about the compatibility of the two approaches from this notional similarity, because the application of the control principle is different in each case. There is clearly a potential difference, as implied in the ED, in using the concept of control over (separable) assets and liabilities for derecognition and over an entity as a whole for consolidation.
41. We can see some inconsistencies between the two approaches to control. For example, under the proposed approach in this ED, control has passed to the transferee as long as the transferee has the practical ability to transfer the asset for its own benefit. Whether the transferee has the power to affect the returns associated with the transferred asset is not relevant, while this is a requirement for control under ED 10. Also, as noted in 13A above, control under ED 10 would be unaffected by whether the interest held in the entity is readily obtainable in the market or not, while this can be critical for the control assessment under the approach in this ED.
42. We believe that compatibility can only be assessed empirically, by testing the interaction in different circumstances, particularly in relation to SPEs, to see if the results are consistent and sensible.

### **Question 9—Derecognition of financial liabilities**

**Do you agree with the proposed amendments to the principle for derecognition of financial liabilities in paragraph 39A? If not, why? How would you propose to amend that principle instead, and why.**

43. The amendments to the derecognition principle for liabilities do not seem substantive. We note that AG62 also has not been substantively changed. In practice, there is some uncertainty over whether at least a 10 per cent difference between the discounted present value of the remaining cash flows of the financial liability under the original terms compared to the discounted present value of the cash flows under the renegotiated terms is meant to be an example of the terms being substantially different or a rule for determining whether the terms are substantially different. We do not support bright line rules in accounting standards and so believe this should be merely an example. Since the standard is being amended, it would be useful if the example was either removed or the wording clarified.

### **Question 10—Transition**

**Do you agree with the proposed amendments to the transition guidance in paragraphs 106 and 107? If not, why? How would you propose to amend that guidance instead, and why.**

44. We suggest that the transition to any new derecognition requirements should be consistent with that adopted for the previous change with the basic rule being prospective application with the option to adopt from an earlier date of the entity's choosing provided all transactions from that date are treated consistently.
45. The current drafting in paragraph 107 does not achieve this. It is not clear what 'that date' is in the last sentence, is it the date the entity has elected to apply the amendments or is it the date specified in paragraph 106, which is the date of mandatory adoption of the revision?
46. We also have concerns about the transitional provisions proposed in paragraph 44H of IFRS 7 in respect of disclosure requirements. These provisions require disclosures for assets previously transferred but which were not derecognised (but which would be derecognised under the new guidance) and for assets previously transferred that were derecognised (but which would not be derecognised under the new guidance). In our view, the work that will be required to make these disclosures will be akin to that which would be required to apply retrospectively the full derecognition requirements. In particular, it will be difficult, if not impossible, to identify assets representing continuing involvement in assets previously derecognised. In our view the costs of this exercise must exceed the benefits as the disclosures are unlikely to be understandable. We believe these requirements should be deleted.

### **Question 11—Disclosures**

**Do you agree with the proposed amendments to IFRS 7? If not, why? How would you propose to amend those requirements instead, and why.**

47. The objectives of the disclosure requirements as set out in paragraph BC96 are that users should be able to:

- (a) understand the relationship between transferred financial assets that are not derecognised and associated liabilities; and
- (b) evaluate the nature of and risks associated with the entity's continuing involvement in derecognised financial assets.

We broadly support these objectives, although we believe that the overriding principle should be that users should be able to evaluate the risks associated with all financial instruments.

- 48. We do not believe that introducing a sub-set of risk-based disclosures in IFRS 7 for assets and liabilities subject to the derecognition standard would be of significant benefit to users. The Basis for Conclusions signally fails to identify any specific benefits these disclosures would confer on users. Indeed, we are concerned that the disclosures could actually lead to confusing information - for example, where a reporting entity has a continuing involvement that is perfectly hedged by a derivative that is only captured by the wider IFRS 7 disclosures.
- 49. We also emphasise that any benefits must be considered in the context of the significant practical difficulties that preparers would face in obtaining this sub-set of information. The potentially enormous number of disclosable transactions will often be recorded across many systems, which are unlikely to be configured to capture information to the required level of detail. We suggest that the IASB should field-test the requirements in order to establish whether the disclosed information would actually be of value to users, and to address the real concerns of preparers.
- 50. We are also concerned that the proposed disclosure requirements for continuing involvements are in excess of and inconsistent with the current IFRS 7 requirements. If the Board believes that these new proposals are an improvement on the existing requirements, then they should be considered as part of an overall review of IFRS 7 rather than considered specifically in relation to a sub-set of involvements.
- 51. In our view, if the derecognition principle and the resulting accounting is sound, then there should be no need for a raft of additional disclosures. We agree that where assets and liabilities are subject to some kind of encumbrance or expose the transferor to some kind of risks, appropriate disclosure is necessary. The excessive detail of the disclosures as proposed may actually hide essential information. We believe that the existing provisions of IFRS 7 are sufficient, and the Board should explore this option.

## **DETAILED POINTS**

- 52. In addition to the above more general comments, we also wish to highlight the following more detailed points:
  - (a) Paragraph 42B – Where the assets subject to a financing transaction are measured at amortised cost and the resulting liability is also at amortised cost, it is not clear what the purpose of separately disclosing the fair value of the assets and liabilities would be, for example, for a single debt factoring arrangement.
  - (b) Paragraph 42D(c) & (g) – Disclosing the maximum exposure to loss and sensitivity analysis may misstate the risks if related hedges are taken into account. While this issue arises more generally for risk disclosures, it is

highlighted in this instance since the disclosure is only about a sub-set of involvements

- (c) Paragraph 42D(d) – We do not believe the requirement to disclose the fair value of the derecognised assets will provide any further meaningful information to users, if the reporting entity has disclosed the fair value of its continuing involvement and maximum exposure to loss. It is likely that a reporting entity will not maintain a valuation for all the assets in which it has only a small involvement and that obtaining such data will potentially be onerous. If a reporting entity itself has no use for the valuation, then we are unsure of what benefit this information will provide to users.
- (d) Paragraph 42D(e) & (f) – These disclosures are inconsistent with the current requirements of IFRS 7 which were modified to recognise the difficulties in determining undiscounted cash flows and contractual maturities of derivatives. As per our general comments above, we believe these inconsistencies should be included within an overall review of IFRS 7.
- (e) Paragraph 42D(h) – In order for preparers to provide qualitative information to supplement any quantitative disclosures, further reasoning as to why the specific quantitative information is useful and relevant to users of financial statements is required. It is unclear whether the application guidance given in B33, which seems to be based on structured credit vehicles, is implying that users are likely to be specifically interested in these.
- (f) Paragraph 42E(a) & (b) – We are unsure how this disclosure could be granular enough in order for the information to be meaningful, yet aggregated enough that the information is not confusing to users. These figures would also only be meaningful if they take into account related hedges.
- (g) Paragraph 42E(c) – We do not believe this disclosure is required if the results produced by the derecognition model are seen as robust by users. If the board believe this disclosure does provide useful information, then the reason why should be discussed in the Basis for Conclusions and the meaning of ‘transfer activity’ needs to be included in the guidance.
- (h) Paragraph 42E(c) – *Practical Application* - It would be extremely difficult for global financial institutions who trade across many different regions and systems to monitor the level of transfer activity where they retain a continuing involvement. Also, total activity is largely driven by client demands and can be seasonal. For example, activity in financial markets is generally lower during December. In any case, without a definition of ‘the period within the reporting period’ in terms of the number of days, weeks or months to be considered, it will be impossible to produce in a meaningful or consistent manner. However, it is also unclear whether the purpose of the disclosure is to capture this seasonality or derecognition transactions just before year-end that result in significant gains or losses. If it is the latter, then these may not be captured by looking at total transfer activity.



## **APPENDIX: APPLICATION OF THE ALTERNATIVE APPROACH**

The alternative view is, as we noted in our response to question 2, arguably more principles-based than the view proposed in the exposure draft. We would like to note that we agree that a component that can be derecognised can comprise a disproportionate share of cash flows, as discussed in paragraph AV12.

However, we see two significant problems with the alternative view.

The first is that it would result in the derecognition of transfers with repurchase agreements and similar transactions. Our view is that in the case where the transferor has access to substantially the same cash flows resulting from the asset before and after the transaction then the transferor has in substance retained control of the asset. This is the case whether or not the transferee can sell the asset. We believe that this is also how the market views transactions such as repos and stock lending.

The second problem is that the alternative view does not adequately address the subsequent classification and measurement of the remaining pieces of financial instruments. The implication from the approach (at paragraph AV25) may be that any retained interest or new contractual rights would be measured at fair value at transaction date and subsequently fair valued through income. We do not think this approach would be consistent with a classification and measurement approach that otherwise prohibits reclassification because it would facilitate the ability to choose, at any time, to transfer insignificant portions of an instrument carried at amortised cost which would effectively result in the revaluation of the entire remaining instrument at its fair value. Even if reclassification is permitted for subsequent measurement, we do not believe that it is appropriate to recognise gains on components of an asset that have not been sold and should not be derecognised. It could also be used to crystallise unrealised gains and losses on instruments classified as available for sale if the category remains after the revision to IAS 39.

Any approach to derecognition will need to be reviewed against the final approach to classification and measurement. Therefore, at this stage in the development of the replacement of IAS 39 it is difficult to be definitive. For example, the approach outlined below to address this issue may not work if an AFS category continues to exist. However, we have the following suggestions to help make the alternative view operational:

As a principle, transfers that result in the transferee having access to substantially the same cash flows before and after the transfer should not result in derecognition. For example, a transfer with a repurchase agreement between the transferee and transferor should not result in derecognition. Even if the transferee can onward sell the asset and even if the asset is readily available, we believe that the transferor has retained control of the asset in terms of having access to substantially the same cash flows.

We have used the word substantially. We recognise that application of this word will require judgement but this seems necessary for the practical application of the principle.

A further principle is that the derecognition of a component of a financial instrument does not result in derecognition of all of the original instrument and recognition of new financial instruments. If we accept the view that a financial asset is a bundle of contractual rights and/or contractual obligations and that transfer transactions unbundle those and rebundle them in different ways, it follows that derecognition of a component should not change the classification of the remaining component or bundle of components, unless the transaction changes the nature of these components. For example, if a loan was carried at amortised cost before the transfer, the retained component should continue to be carried at amortised cost after the transfer and should not be measured at its fair value, unless the

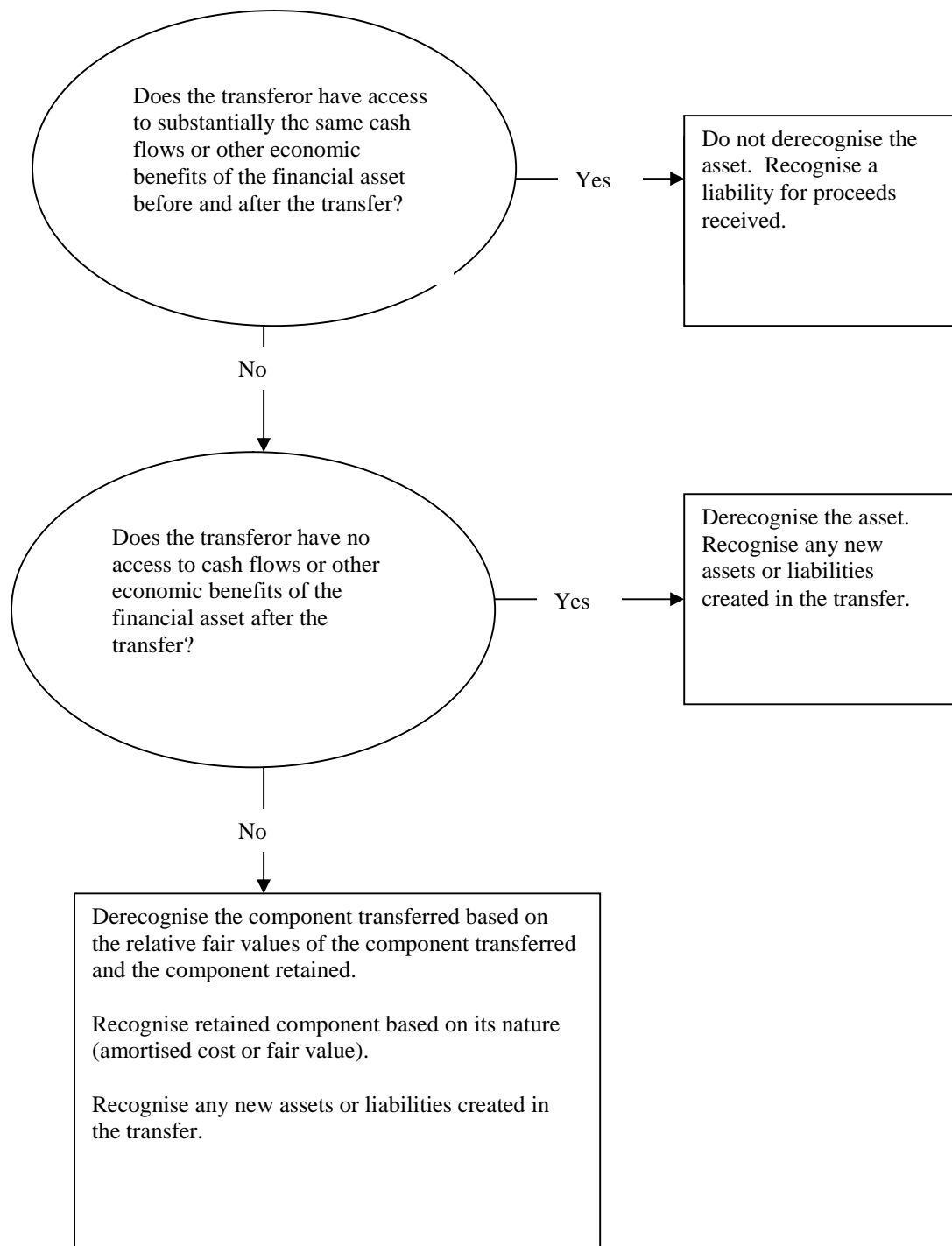
remeasurement is necessary because the retained interest does not meet the classification requirements of the original at amortised cost category. Otherwise, this would be akin to permitting reclassification, which current discussions on the classification and measurement expos.

On the other hand, it may be that the remaining component would not qualify to be carried at amortised cost. In such a case our view is that it should be classified at fair value. For example, if an entity sold the rights to the first 90 per cent of the cash flows of a loan, the remaining bundle of rights, the right to the final 10 per cent of cash flows, would probably meet the definition of a derivative on a standalone basis. In this case, the 'first' 90 per cent transferred should be derecognised and the remaining 10 per cent of cash flows should be reclassified from an asset carried at amortised cost to a derivative measured at fair value.

For an instrument that is carried at fair value prior to a transfer, derecognition of only the portion transferred will not change the measurement of the portion retained (i.e. this would continue to be carried at fair value after the sale).

Our initial view is that the separation of the portion derecognised and the portion retained should be done based on their relative fair values at transaction date. We believe this approach would work whether the remaining portion continues to be carried at amortised cost or at fair value. Such an approach would also result in no gain or loss being recognised on the retained portion which we consider is preferable to recognising gains and losses when the nature of the remaining financial instrument is unchanged.

The resulting decision tree would be as follows:



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