IASB Meeting | Agenda reference **16A**

Staff Paper | Date **Sept. 2009**

Project **Derecognition**

Topic **Feedback on the proposed approach in the *Derecognition* exposure draft**

Introduction

1. The purpose of this paper is to provide the Board with a summary of the comments received on the questions posed in the Exposure Draft *Derecognition* (the ED), as well as suggestions and issues raised in relation to the proposed approach in the ED. The ED was published in March 2009 and the comment period ended on 31 July 2009. We received 118 comment letters.

2. Analysis of the comments on the alternative approach in the ED will be discussed separately in Paper 16B.

3. This paper is not a comprehensive list of the comments. The staff will provide more detailed analysis at each Board meeting depending on the approach that will be selected by the Board.

General comments

4. Respondents generally supported the objective of reducing complexity in accounting for transfer of financial assets. Some preferred that the Board enhance the disclosure requirements to address the issues identified during the global financial crisis and the recommendations by the Financial Stability Board (FSB) in the short term but to develop a replacement guidance (if need be) in the long term.

5. Except for a few respondents, respondents generally did not agree with the proposed approach in the ED to be adopted as the new approach to derecognition of financial assets. Some of those respondents suggest that the Board retain the current 'risks and rewards' model (unchanged) with some

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improvements in disclosure requirements. The comments on the proposed approach as a whole are addressed in detail in the section that follows the summary of the specific comments.

Comments on the specific questions posted in the ED

Assessment of 'the Asset' and 'continuing involvement' at reporting entity level

6. Respondents in general agreed with the ED 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.

7. However, some respondents indicated that 'reporting entity' concept was not sufficiently defined or addressed in IFRSs or the *Framework* to be a robust basis for this assessment.

> The reporting entity notion is not discussed in any detail in IFRS at the moment, and the recent Framework Discussion Paper on the subject was very tentative on a number of important issues. It could be argued therefore that it is premature to base so much significance in this ED on the notion. (CL#47)

8. Some respondents suggested that the final standard should provide further guidance for a typical securitisation transaction, in particular, whether the consolidation analysis should assume that transfers to a securitisation vehicle meet the derecognition criteria (ie the assets transferred are the assets of the vehicle) before assessing who consolidates the vehicle.

> ...we note that paragraph 15A states "an entity first consolidates all subsidiaries in accordance with IAS 27 and SIC-12 *Consolidation—Special Purpose Entities* and then applies [IAS 39 derecognition principles] to the resulting group." That sentence implies that the transferor should first assess whether to consolidate a securitisation or similar entity, *before* concluding whether the transfer of financial assets to that entity qualifies for derecognition (in other words, before assessing whether the securitisation entity owns the transferred financial asset or has a receivable from the transferor for accounting purposes. We recommend that the final standard provide guidance for securitisation and similar transactions on whether the consolidation analysis should assume the transferred financial assets qualify for derecognition. The ordering of the analysis can be critical in determining whether a specific entity should be consolidated. (CL#70)

9. Paragraph AG47A of the ED discusses a situation where a subsidiary transfers to a third party an asset, in which the parent of the subsidiary has a continuing involvement. AG47A further explains that the subsidiary does not include the

parent's involvement in the assessment in its stand-alone financial statements but the parent would take into account its continuing involvement in assessing the transaction in its consolidated financial statements. Hence some respondents questioned if symmetric accounting between a transferor and a transferee will always be possible under the proposed approach.

> [Applying the guidance in the ED about considering, in the consolidated financial statements, a parent's continuing involvement in a financial asset transferred by its subsidiary,] may result in the asset being derecognised in the subsidiary's account, but not in the consolidated accounts. Given that a transferee applies symmetric accounting, then it is unclear whether the third party should recognise the asset, given the different derecognition results between the subsidiary's stand-alone accounts and consolidated group accounts. (CL#33)

Determination of 'the Asset' to be assessed for derecognition

10. The ED (paragraph 16A) proposes that a part of a financial asset (or a group of financial assets) can be 'the Asset' to be assessed for derecognition only if that part comprises specifically identified cash flows or a proportionate share of the cash flows from that financial asset.

11. While some respondents who are in favour of the current requirements supported the criteria in paragraph 16A (on the basis that they are similar to those in IAS 39), many respondents disagreed with the criteria for the following reasons:

    (a) Even though the ED claims to be based on a single concept 'control', it essentially introduces a 'risks and rewards' concept into the derecognition model through the definition of the Asset (ie, by precluding disproportionate (eg, subordinated) cash flows from being treated as the Asset).

    (b) The criteria in the ED are merely a set of rules and there is no clear conceptual basis for it. The concern over risks related to transferred assets (BC35 of the ED) should not be addressed by the arbitrary line to identify the unit of account for derecognition.

    (c) The criteria introduce a unit of account which is not consistent with IAS 39 itself, although the criteria are the same as required under the current IAS 39 guidance on derecognition.

    (d) Disproportionate cash flows of a financial asset *are* identifiable cash flows (the transferor and transferee know which cash flows they have contracted for). Thus, the alternative view's characterisation of the 'Asset' (ie, *any* cash flows from a financial asset can be assessed for derecognition) is more

consistent with the 'control concept' in the context of a financial asset (ie, the right to cash flows from the asset).

(e) Although the criteria are similar to those in the existing IAS 39, their implication as a whole in combination with other tests in the proposed approach is significantly different.

> Although paragraph 16A is similar to the existing requirements in IAS 39, its impact is that, unlike under the existing rules, all transfers of disproportionate interests will fail to qualify for derecognition unless the transferee has the practical ability to transfer the entire asset for its own benefit. (CL#37)

12. Furthermore, some respondents were concerned that the new phrase added to the criteria '*ie the performance of the part retained does not depend on the performance of the part transferred, and vice versa*' may contradict the criteria for the Asset.

> ...the ED permits derecognition of interest-only strips that not only represent a disproportionate share of the cashflows, but are also linked to performance of the original instrument, i.e. the principal repayments. (CL#106)

13. Some respondents questioned to what extent the Board intended to retain the criteria unchanged because some of the words in the existing criteria were omitted without a clear explanation in the ED, such as:

(a) Interest rate strips (as an example of specifically identified cash flows)

(b) The adjective 'similar' (in a group of assets), and

(c) Paragraph 16(a)(iii) of the existing IAS 39 which corresponds to a fully proportionate share of specifically identified cash flows.

Definition of 'transfer'

14. Respondents in general supported the principle that all transactions that are economically transfers of financial assets should be assessed for derecognition irrespective of their form.

15. However, many respondents commented that the proposed definition of transfer was too broad. They believe that the broad definition in combination with other derecognition tests (applied later in the decision tree), under the proposed approach, would lead to inappropriate accounting outcomes for some transactions.

16. For example, many respondents noted that repos and securities lending transactions would result in the underlying financial assets being derecognised

even though such transactions are viewed commercially and economically as financing transactions. To account for repos and securities lendings as financings, some suggested excluding them explicitly from the definition of transfer.

17. In addition, many commented that the scope of the definition should be clarified. They raised several questions/concerns, for example:

    (a) Does the definition encompass transactions such as provision of collateral and a total return swap (TRS)?

    (b) Do normal hedges constitute a transfer?

    (c) Does the 'economic benefit' include voting rights? This notion is not clearly defined in the ED.

    (d) What does 'agree to pass' mean? It raises questions regarding the point in time at which the derecognition test is to be performed.

    (e) Does the Board really intend that SPVs which distribute all the cash flows from their assets by issuing beneficial interests become 'empty shells'?

    (f) Does the sale of units in an insurance fund (unit-linked insurance and investments), in which the insurer has contracted to pass on to the policyholder the economic benefits of the underlying linked investments, constitute a 'transfer'?

> ... under the provisions of the ED, the accounting treatment of unit-linked contracts issued by insurance companies is unclear to us:
>
> - an insurance company recognizes first contractual liabilities resulting from unit-linked contracts and then backs these liabilities through investments in financial assets matching their commitments whereas,
>
> - guidance provided in paragaphs AG52 L, AG 52 F and AG 52 G establishes a link between the derecognition of assets and liabilities whereby the derecognition of the asset leads to derecognising the corresponding liability.
>
> [We] note that the accounting treatment of unit-linked contracts is to be addressed within the project IFRS 4 phase II included in the IASB's work plan for October 2009 and was already addressed in the discussion paper.
>
> We would like to draw your attention to the fact that the proposed model for derecognition could pre-empt future decisions to be taken within the IFRS 4 phase II project. A strict interpretation of the proposed derecognition approach may lead to derecognize assets and liabilities related to unit-linked contracts from the balance sheet. In our opinion, a revised standard on derecognition should not lead to derecognising assets and liabilities related to unit-linked contracts as:

- policy-holders have contractual rights indexed or linked to the cash-flows of the asset and not contractual rights to the cash-flows of the asset;
- even though policy-holders carry the investment risk, the voting rights attached to these assets are not transferred to policy-holders.
- from a legal point of view, policy-holders having invested in a unit-linked contract do not have any preferred right on the assets of the company over other policy-holders. For instance, in failing companies, unit-linked assets are not beyond the reach of the bankruptcy trustee. Under the provisions of the ED revising FAS 140, this would preclude derecognition of assets and liabilities related to unit-linked contracts. (CL#21)

18. Some respondents argued that pass-through requirements that the Board 'purports' to have eliminated from the existing IAS 39 seemed to have been kept in another form by the example in AG52L(g). They suggested those requirements in AG52L(g) should be incorporated in the main body of the standard in light of their practical importance (if that is the Board's intention).

Determination of 'continuing involvement'

Continuing involvement filter

19. Respondents in general agreed with the conclusion of the 'continuing involvement' filter that where there is no continuing involvement with the asset transferred to the transferee, the transferor should derecognise the asset.

20. However, many respondents disagreed with the role or implication of the 'continuing involvement' filter, as drafted in the ED, stating that the 'risks and rewards' approach in IAS 39 has worked well (ie a small exposure to the risks and rewards of a transferred asset should not preclude derecognition) and should therefore not be changed.

21. Below is a summary of some of the comments relating to the risk and rewards filter.

    (a) The ED should not replace the existing 'risks and rewards' filter in IAS 39 by the 'continuing involvement' filter.

    (b) The ED is still based on the 'risks and rewards' approach but now with a threshold at zero. This is contrary to the basic principle of the proposed approach to be based on a single concept of 'control'.

22. Others suggested that the Board should explain the underlying principles for the definition and define what constitutes 'continuing involvement' positively, instead of describing what does not qualify as a continuing involvement.

> [W]e have reservations about the way [the 'continuing involvement' filter] 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 exhaustive list, examples or indicators? The continuing involvement filter should be expressed as a principle. […] (CL#53)
>
> The application guidance has examples of what is or isn't continuing involvement without explanation of the principles applied in reaching that decision. (CL#76)

Exceptions to continuing involvement

23. With regard to the exceptions to 'continuing involvement' set out in paragraph 18A of the ED, some respondents suggested that the exceptions should be clarified or expanded further in order to preclude insignificant or practically reasonable involvement from being treated as 'continuing involvement', which in many cases may lead to a failed sale accounting for the transferred asset.

> 18A: ...*None of the following constitutes continuing involvement:*
>
> *(a) normal representations and warranties relating to fraudulent transfer and concepts of reasonableness, good faith and fair dealings that could invalidate a transfer as a result of legal action;*
>
> *(b) the retention of the right to service the Asset in a fiduciary or agency relationship; or*
>
> *(c) forward, option and other contracts associated with reacquiring the Asset for which the contract (or exercise) price is the fair value of the transferred Asset.*

24. Below are some of the comments on the scope of the exceptions to the continuing involvement definition:

    (a) The conditions described in AG49A (eg, kick out rights) for a servicing contract to be excluded from being counted as 'continuing involvement' are too strict from a practical point of view, particularly for companies who act as originators and servicers of mortgages.

    > [Our] business is as an originator and servicer of mortgages. The bulk of the mortgages originated by [us] are brokered to institutional customers; [we retain] the right to service these mortgages for their term. […] The business

> model for these transactions is to break even on the brokering aspect of the sale and profit from the subsequent servicing activity over the term of the mortgage. […] As such, servicing is not retained to notionally invest in what would be a highly leveraged economic interest in the mortgages sold. Instead it is a business in itself which provides values to our customers and which creates profit for the Company independent of the performance of the underlying mortgages.
>
> To protect these future cash flows, [we have] made the servicing rights effectively non-transferable. In most cases [they are] strictly non-transferable; in other cases, the Investor has the right to transfer to another servicer, but the penalty payable to [us] would be uneconomical for the Investor. The Investor will typically have the right to transfer the mortgage sold to it by [us] to a third party, but will have to (a) obtain [our] consent to such transfer (in [our] capacity as servicer of the mortgage) and (b) ensure that the third party transferee of such mortgage enters into a servicing arrangement with [us] that parallels that which had been in place with the Investor prior to transfer. As such, [we] will be the servicer of that mortgage until its maturity or earlier discharge, except in limited circumstances where the Investor may terminate [us] as servicer for "cause." These facts suggest that the derecognition test described in the last sentence of BC44 would not be met despite what the Company considers a clear transfer of the mortgages risks and rewards.
>
> […]
>
> [The company]'s approach to its servicing business where it precludes Investors from terminating servicing arrangements at random is a prudent one, as it ensures its future revenue streams and compensates [the Company] for losses that result from its origination activities. (CL#2)
>
> The proposed IFRS would conclude that a servicing relationship is "continuing involvement" in the absence of transferee having kick-out rights. Under ED 10, removal rights are one of many facts and circumstances to consider when determining if an agency relationship exists. [We] recommend that IASB conform the language in the Proposed IFRS to the language in ED 10. (CL#9)

(b) Most of factoring transactions would fail to qualify for derecognition.

> ...we think that virtually all non-recourse factoring transactions would fail to qualify for derecognition under the proposed standard, because virtually all of them involve some form of continuing involvement (first loss or late payment guarantee) and the retention of servicing rights by the transferor. We believe such restrictions are far too excessive. (CL#13)

(c) It is unclear if plain vanilla derivatives (eg, an interest rate swap) entered into with the transferee concurrently with the sale of an asset constitute 'continuing involvement'.

> We are concerned about the interpretation of continuing involvement when a transferor sells assets and concurrently enters into with the counterparty a plain-vanilla interest rate swap contract or other derivative arrangement that is not directly related to the transferred asset. (CL#45)

25. Others argued that the ED should distinguish assets in a fiduciary capacity from those under agency relationships so that assets held by insurers in a fiduciary capacity (unit-linked insurance and investments) should not be derecognised.

> An agent is generally required by law or regulation to act in the best interests of the principal, often referred to as in a fiduciary capacity; however assets can be held in a fiduciary capacity without necessarily being the subject of an agency relationship. The key difference being who in fact actually owns the underlying asset...The lack of a clear distinction in the ED between fiduciary and agency relationships means that applying the derecognition principles to assets backing insurance and investment products in this way could result in many assets held by insurers in a fiduciary capacity being derecognised and much valuable information being lost from the balance sheet. (CL#65)

26. Some respondents commented that the fair value exception in paragraph 18A(c) would contradict the existing guidance on reclassification in IAS 39 and enable an entity to manipulate earnings. Others pointed out that the exception was not consistent with the control based approach in the ED.

> The exception made to 'continuing involvement' in paragraph 18A(c) will permit the transferor to derecognise an asset transferred but can repurchase the asset under the forward, option and other contracts. This would lead the entity to recognise a profit or loss. However, paragraph 50 of IAS 39 says that an entity shall not reclassify any instrument into fair value through profit or loss after initial recognition. This existing provision which is a source of strength as a risks and rewards test prevents an entity from recognising profit by transferring a financial asset and obtaining a fair value forward or option relating to the asset transferred which would have a fundamental impact on existing accounting under the provision of paragraph 50 of IAS 39. (CL#5)
>
> ...we note that under 18A(c), a call option at fair value on a non-readily obtainable asset would not constitute continuing involvement and therefore a transfer of an illiquid asset with such a call would likely achieve derecognition. The inability to transfer the asset...could equally apply when the strike is at market. We thus believe this exemption is primarily an exclusion based on a risk and reward model and is not consistent with the supposed control based approach of the ED. (CL#76)

27. Some questioned whether a transfer to a normal entity (ie, not an SPV) in which the transferor holds shares would result in derecognition.

> It is also unclear from the ED whether the transfer of an asset by a parent company to its subsidiary would be derecognised, as the transferor could always be considered to continue to benefit from the asset by virtue of its holding in the equity of the subsidiary. (CL#62)

Practical ability to transfer for own benefit' test

28. Although many of the respondents recognised that the 'practical ability to transfer' test is similar to the existing requirement in IAS 39, they argue that it plays a more central role in the proposed approach. This is because a transfer with some continuing involvement qualifies for derecognition only if it passes this test under the proposed approach, whereas under the existing approach the test is applied after the 'risks and rewards' test and only when the outcome of the risks and rewards test is not conclusive.

29. Many respondents commented that the 'practical ability to transfer' test should not be the primary test. In particular, they disagreed with its implication for repos and securities lending transactions involving readily obtainable assets (see below for a summary of those comments).

Control from the perspective of the transferee

(a) From a practical point of view, it is difficult to expect that the transferor always has sufficient information to assess whether the transferee has the practical ability to transfer the asset. There might be some (eg, regulatory) restrictions unknown to the transferor. In addition, it may not be practical to require the transferor to continuously monitor changes in the liquidity of the asset, for example, for a possible reassessment in the future.

(b) The ability of beneficial interest holders in a securitisation transaction to dispose of their interest in the vehicle should be taken into account in determining who has control over the asset, as under US GAAP.

> If...each third-party holder of beneficial interests issued by the SPE as a transferee has the right to pledge or exchange the beneficial interest it received without any condition (see SFAS 166, paragraph 9b), it should not preclude the transferee's ability to control the transferred financial asset. (CL#25)

Practical ability to 'transfer' as a determining factor

(a) The ED assumes that the transferee's ability to transfer the asset to a third party should be the sole factor which determines whether the transferee has obtained control (and the transferor has given up control) over the asset. However, the transferee can obtain the economic benefits of (and thus can control) the transferred asset in ways other than through a sale of the asset to a third party (eg, by holding the asset and receiving all the cash flows it generates). Therefore, the assumption in the ED would lead to recognition of an asset, and a liability as a result, which do not meet the definition of these elements in the *Framework*.

(b) It is unclear if the term 'transfer' in the 'practical ability to transfer' test (paragraph 17A(c)) has the same meaning as the term 'transfer' in paragraph 9 which defines the scope of transactions being assessed for derecognition. The Board seems to refer to the former 'transfer' only as the ability to 'dispose of' (AG52A) or 'sell' which would be narrower than the latter.

(c) It is not clear whether the size of the holding of readily obtainable financial assets relative to the trading volume in the market (i.e. blocks) must be taken into account in order to determine if the transferee has the practical ability to transfer the asset.

Emphasis on readily obtainable or not

(a) Assessment of control of an asset should not be driven by the obtainability or liquidity of the asset. The ED has too much emphasis on this specific point.

(b) The definition of 'readily obtainable' and the related guidance 'actively traded on an accessible market' (AG52E(b)) are not clear and therefore the assessment can be highly judgemental. Furthermore, the deviation of the guidance from 'traded in an active market' as stated in the current IAS 39 (AG42) may have unintended consequences in practice.

(c) It seems inappropriate for the Board to conclude that a contractual restriction on the transferee's right to transfer an asset does not necessarily prevent the transferee from having the practical ability to transfer if the asset is readily obtainable. This assumes that the terms of the contract can be ignored.

Accounting for retained interests

30. Respondents in general agreed that, for a transfer of a part of a financial asset, the transferor should account for the part retained 'as part of the financial asset recognised before the transfer' (paragraph 21A, ED).

31. However, many respondents did not agree that the transferor should split the interest purchased between previously recognised and new assets or liabilities in situations where the transferor acquires, as part of the transfer, an investment in a transferee vehicle and the transferee vehicle has also acquired assets/liabilities besides those transferred to it by the transferor (paragraph 22A, ED).

32. Many respondents who did not agree with the provisions of paragraph 22A argued that it was not practical because the information necessary to make the

required split would not be always available to the transferor due to limited involvement with the assets.

> In practice, this information may unreliable or unavailable to the transferor. We strongly disagree with the requirement imposed by paragraph 22A to include information in audited accounts which is obtained on this basis. (CL#92)
>
> ...we question whether the value of such a split for the investors outweighs costs that would be incurred by preparers in complying with this requirement. (CL#106)
>
> We are … concerned that this creates a divergence from US GAAP concerning the accounting basis for retained interests when compared to FAS 166. We believe retained interests should be measured at fair value. (CL#76)

33. Furthermore, some questioned what kind of entities or transactions the Board intended to capture (ie, SPVs or normal operating entities), given that securitisation transactions in general would fail to qualify for derecognition.

> The objective of securitisation being to create a priority order in the waterfall of payments, securitisation vehicles issue disproportionate interests in the securitised portfolios of assets. This combined with the fact that securitisation vehicles are restricted in their right of disposal of the transferred assets leads us to conclude that securitisations in which the transferor has retained an interest would fail derecognition systematically. We therefore do not see in what circumstances paragraph 22A would be used in practice, the issuance of proportionate interests through a securitisation being, in our view, pointless. (CL#13)

Approach to derecognition of financial assets

Proposed approach – Overall assessment

34. As described in 'General Comments' at the beginning of this paper, an overwhelming majority of respondents did not agree that the proposed approach should be established as the new approach for derecognition of financial assets.

35. The reason for disagreeing with the proposal are summarised below:

    (a) There seems to be no need to fundamentally change the current requirements in IAS 39 as the current 'risks and rewards' model has worked well and has not been criticised during the crisis, as opposed to the derecognition model in the US.

    (b) The concerns raised by the FSB and others may be better addressed by enhancing disclosures.

    (c) The proposed approach, which is a mixture of 'control' and 'risks and rewards', does not reduce complexity in accounting for transfers of financial

assets and would therefore not result in a significant improvement to financial reporting.

(d) The ED adopts an 'all or nothing' approach and the outcomes under the approach for repos, securities lending and most of securitisations and factoring transactions do not reflect the economic substance of these transactions.

(e) There remain significant differences between the proposal in the ED and SFAS166. The Board should work more closely with the FASB towards a converged approach.

36. Meanwhile, some of the respondents suggested modified approaches as a possible way forward. Those include:

(a) An approach closer to the alternative approach (but if the transferor retains control over some rights to cash flow, those cash flows should not be included in the assessment of derecognition)

(b) A model similar to the existing model in IAS 39, with elimination of the continuing involvement accounting (the most challenging part of the current requirements in practice).

37. Many respondents suggested that the Board should conduct thorough field tests on the impact of changes to the current IAS 39, whichever approach is taken.

Comments on repo transactions

38. The majority of the respondents expressed strong concerns on the proposed treatment for repo transactions involving readily obtainable assets. For example, many argued that:

(a) The proposed accounting does not reflect the economic substance of the transaction as a secured borrowing.

(b) The current accounting has not been criticised even during the recent crisis period.

(c) Profit or loss recognised as a result would affect behaviour of financial institutions adversely, which may have unintended consequences on the financial markets in light of the importance of the transaction as a main source of funding.

> If profit and loss are to be recognized at the time of each transaction, practically nobody would engage in these transactions and market liquidity would dry up. (CL#55)

(d) The current project on classification and measurement of financial instruments should be finalised first since it is likely to influence how the proposed derecognition accounting actually affects the financial statements.

> ...if derecognition standards with the proposed treatment were effective before the new financial instrument standard regulating the classification becomes effective or if [the] HtM category with its tainting rules was not cancelled many banks would face [a] significant problem. (CL#4)

(e) The difference between the proposed approach and SFAS166 is not tolerable.

> Repurchase financings and securitisation transactions are so common and pervasive in financial markets that we believe it is not acceptable for IFRS and US GAAP to reach such inconsistent conclusions. (CL#70)

39. Many respondents commented that the transferor (borrower) retained substantially all risks and rewards on the asset under a repurchase agreement and therefore should not be derecognised. Some argued that a repo transaction can be distinguished from a sale of an asset with a separate forward contract.

> ...as regard repo transactions the transferor has full access to primary cash flows of the transferred asset and therefore in our opinion is in full control of it...The transferee receives only the cash flows connected with the loan which it provided and which is collateralised by the transferred securities. (CL#4)

> Although one could argue that the economics of these arrangements are similar to a sale of the financial asset with a forward repurchase commitment, these transactions differ from a typical forward purchase agreement in that the transferor is (i) paid the interest and dividends from the transferred asset and (ii) assured that the transferred asset will be returned via the provision of collateral that is valued daily and adjusted frequently for changes in the market value of the transferred asset. The transferor is entitled to the collateral should the transferee default. However, the transferee is exposed to the transferor's credit risk on the return of cash (ie the repurchase price), similar to a secured lender in a financing. These provisions are not typical of forward contracts where collateral arrangements generally protect only the fair value of the forward for both counterparties. (CL#61)

40. Those who did not agree with the proposed accounting for repos suggested strongly that the Board should adopt 'risks and rewards' model as currently used in the existing IAS 39, instead of the combination of the 'continuing involvement' test and the 'practical ability to transfer' test, which they believe is the main weakness and the basis for treating repos as sales.

41. Some of the respondents suggested that the following may be possible alternatives for addressing the repo issue if the Board were to proceed with the proposed approach.

(a) Repos and similar transactions should be explicitly excluded from the definition of 'transfer'.

(b) The Board should introduce the 'effective control' concept as in SFAS166[1].

> A significant difference, one that will have substantial impact on reporting entities and related capital requirements, is the treatment of "effective control" via repurchase arrangements. Under the FASB guidance, repurchase agreements are deemed to be effective control and therefore do not qualify for derecognition... (CL#42)

Interaction between consolidation and derecognition

42. While many respondents commented that the consolidation approach and the derecognition approach should be consistent, some noted that it would be desirable but not necessarily essential for the approaches to be consistent as long as the combined accounting faithfully represents the economic substance of a transaction.

43. Those respondents who emphasised the importance of the consistency between the two approaches commented that ED 10 *Consolidated Financial Statements* and the proposed approach to derecognition *appeared* to be similar in that both are based on a 'control' concept.

44. However, they indicated that there were still some significant differences between the two approaches. For example,

> We are concerned about the inconsistency between the definition of control in ED 10..., based on power and returns together and the definition of control in the derecognition ED based only on the ability for the transferee to sell the acquired asset. (CL#27)

> We understand that there is a fundamental difference between how fiduciary (or agency) servicing is defined in ED 10 and this exposure draft. In particular, ED 10 does not require that the entity that receives (pay for) services has the right to terminate the contract. We believe that such a definition is important and should be completely aligned in both final standards. (CL#22)

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[1] Paragraph 9c of SFAS166 includes 'an agreement that both entitles and obligates the transferor to repurchase or redeem them before their maturity' as an example of a transferor's effective control over the transferred financial assets.

Derecognition of financial liabilities

45. Most respondents agreed with the proposed amendments and acknowledged that the changes would not have any fundamental impact on current practice. Many agreed that the proposed amendments would make the derecognition criteria more consistent with the definition of a liability in the *Framework*. Some respondents, however, questioned whether it is necessary for the Board to amend the current requirements, which are generally well understood and not contentious.

46. Many respondents suggested that the Board should delete the 10% test (AG62) which determines if the renegotiated debt instrument is substantially different from the original one. They argue that it is quite a rule-based approach.

47. In addition, others suggested that the Board should take advantage of this opportunity to respond to several known issues which give rise to divergent views in practice under the current IAS 39.

> A final standard should address the accounting for debt-for-equity swaps. We recommend that the difference between the carrying amount of the liability settled upon issuance of equity instruments, and the fair value of the liability (or equity instruments issued if more readily determinable), be recognised in earnings. (CL#70)

> We believe that the Board should specifically differentiate the accounting treatment for unamortised costs and fees included in the carrying amount of the liability and incremental costs and fees incurred. (CL#71)

48. Some respondents commented that the proposed guidance about how restructurings of debt instruments should be accounted for could lead to asymmetric accounting between the borrower and the lender.

> Paragraph 40A addresses that if an entity and a creditor agree to modify substantially the terms of a debt instrument (whether or not as a result of the financial difficulty of the entity), the entity derecognizes the associated financial liability and recognizes a new financial liability. However, paragraph AG84 of IAS 39 addresses that if the terms of a loan, receivable or held-to-maturity investment are renegotiated or otherwise modified because of financial difficulties of the borrower or issuer, impairment is measured using the original effective interest rate before the modification of terms. Therefore, the gain recognized by the debtor will usually be greater than the loss recognized by the creditor. (CL#1)

49. Some noted that the real cause of the asymmetric accounting between the borrower and lender in a restructuring transaction is that the principles proposed for derecognition of financial liabilities are inconsistent with those proposed for

derecognition of financial assets (the staff notes that this criticism also holds true for the current derecognition requirements for financial liabilities and financial assets in IAS 39). Thus, these respondents suggest that the derecognition principles for financial liabilities and those for financial assets should be aligned.

> Our general view is that the approach adopted for the derecognition of financial liabilities should be consistent with that for financial assets. It is not clear whether this is always achieved in the ED.
>
> For example, consider an entity that enters into a non-recourse loan in respect of an owned financial asset. If the terms of the loan were such that the asset would be derecognised, then both the asset and liability would be eliminated. However, it is not clear whether the loan could be derecognised if the liability derecognition rules were applied first as the liability still exists and the presence of the asset does not eliminate the obligation of the entity to perform under the loan. (CL#62)
>
> [We] see no obvious reasons why financial assets and liabilities should be evaluated based on different criteria. Instead we believe that they should be evaluated for derecognition based on the same overarching principles. (CL#103)

Transition

50. Respondents in general supported the proposal to apply the amended requirements prospectively to transactions entered into after the effective date (TBD).

51. However, many expressed strong concerns with paragraph 44H which provides the transition rules for the disclosure (IFRS 7) amendments, suggesting that it has the effect of removing the benefit of the prospective application of the derecognition test (IAS 39).

> ...we do have a concern that paragraph 44H which provides the transition rules for the IFRS 7 amendments, has the effect of removing the benefit of this transition relief by requiring an entity to analyse retrospectively, transactions prior to the effective date in order to assess whether they would not have been derecognized under the new rules (and if so to provide the disclosures in 42C to 42F). (CL#76)

52. Some respondents suggested that the Board should clarify whether early adoption is applied only from the beginning of a fiscal year or from any other selected day.

53. Other respondents suggested that the Board should align the amended date in IFRS 1 to the date of transition, rather than a specific date.

> We encourage the Board to align the amended date in IFRS 1 to the date of transition for countries such as Canada, Brazil and others who will be adopting IFRS for the first time beginning in 2011. (CL#108)

54. Some respondents recommended that the Board should finalise the changes as soon as possible to ensure that first-time adopters are not required to adjust to the revised standard again shortly after.

> We are concerned with the possibility that Canadian entities may be required to change from current Canadian GAAP requirements for derecognition to the existing derecognition requirements in IAS 39 on changeover to IFRSs in 2011, and then the Exposure Draft proposals shortly thereafter...We recommend that the changes be finalized as soon as possible (but not later than the first half of 2010) to enable first-time adopters to assess the implications of the final standard and make informed decisions whether to adopt the proposals early on transition to IFRSs. (CL#73)

55. A few respondents supported retrospective application of new accounting standards ‘in order to preserve the comparability of financial statements’.

Disclosures

56. Respondents in general agreed that the Board should improve disclosure requirements in response to the issues identified during the financial crisis and the recommendations by the FSB and others.

57. However, most of the respondents were concerned that the proposed disclosure requirements in general would be excessive and obscure truly important information for users. Some of them were opposed to the proposed requirements on the basis that such extensive disclosures, which almost enable users to recast the statement of financial position, may give an impression that the Board is not sure whether it has adopted an appropriate approach to derecognition.

58. Many respondents strongly expressed concerns that disclosure requirements were far too extensive for transferred financial assets that are derecognised (but in which an entity has continuing involvement), especially on the fair value of those assets. They commented that it would be impractical to collect the information when the entity’s involvement is insignificant.

> Our general concern is that these proposed requirements would require the reporting entity to obtain significant amounts of data relating to assets that it does not control. Not only would this information be very difficult to obtain in some circumstances but we fail to see how disclosing such information for assets in which the reporting entity has some minor level of continuing involvement could be useful to readers... (CL#106)

59. Others suggested that the Board should first develop a principle, including how information for derecognition should be addressed in IFRS 7.

> ...disclosures must be led by principles instead of checklist. The IASB must, first of all, clearly define what are the objectives of information to be provided to users. (CL#27)

> ... we believe that if the Board finds these disclosures to be an improvement on the existing requirements, they should be considered as part of an overall review of IFRS 7, rather that specifically in relation to subset of transactions. (CL#62)

60. Some respondents suggested that the disclosures for a financial liability that failed derecognition would be useful information.

> We note that there are no disclosures for financial liabilities that fail derecognition. We consider it may be useful for users to understand if during the period the entity had a modification or exchange of a financial liability with an existing lender. (CL#36)

Other issues

Consistency with other projects

61. Some respondents suggested that the Board should ensure that there is consistency between the classification and measurement ED and the derecognition guidance and also consistency in the use of the 'control concept' between this project and the other projects addressing derecognition of non financial assets (such as 'revenue recognition' and 'leases').

> We think that comparison between derecognition of financial assets and non-financial assets would be more beneficial...it is anticipated in the Discussion Paper 'Preliminary Views on Revenue Recognition in Contracts with Customers' that control of inventory could be surrendered even if product warranties or the customer's rights to return the goods are provided...On the other hand, the ED proposes that a sale treatment is precluded in a transfer of a financial asset generally if the transferor makes a guarantee to the transferee or retains subordinated interest in the transferee... (CL#25)

Netting

62. Some respondents in the financial industry suggested that the Board should address the issue of netting of financial instruments which significantly affect comparability of the statement of financial position between financial statements prepared under IFRS and US GAAP.

> The issue of netting financial instruments is not addressed by the Board in this ED; indeed, our understanding is that it is not currently addressed in any financial instruments-related project that is on the technical agenda. We should like to

escalate the sense of urgency and importance of this topic vis-a-vis recognition and presentation of financial instruments as well as, of course, convergence of accounting standards. Divergences in accounting standards for netting financial assets and liabilities, including netting of financial assets with related obligations to return collateral, significantly affect balance sheet comparability and related regulatory capital requirements. The differences in global accounting rules that exist today have created an unlevel playing field that directly impacts the ability of banks to compete effectively on the basis of equal capital, *ceteris paribus*. (CL#42)