Project	**Derecognition**
Topic	**Feedback on the alternative approach in the *Derecognition* exposure draft**

Introduction

1. This paper summarises the comments the IASB received on the alternative approach to derecognition of financial assets set out in the *Derecognition* exposure draft (ED).

2. Typically, the alternative views section of an ED lays out the reasons of the Board members who disagree with the proposals in the ED. The *Derecognition* ED was different in that regard in that the alternative views not only stated the reasons for the dissenting Board members' disagreement with the proposed approach but also described in some detail the approach that they would favour as the new derecognition model for financial assets. One reason for this was that a significant number of the Board opposed the proposed approach.

3. This paper is structured as follows:

    (a) G**eneral observations** identified from the feedback on the alternative approach (these observations should help the Board assess whether there is support for the alternative approach)

    (b) S**pecific merits** of and **specific concerns** about the alternative approach that were identified by constituents

General observations

4. **Respondents who objected to the alternative approach.** The respondents who objected to the alternative approach generally did so because they disagreed with its focus on 'control' as the sole (or the appropriate) determinant for derecognition of financial assets. They believed that disregarding 'risks and rewards' in the derecognition analysis would leave to an undue emphasis on (contractual) form over substance and thus would lead to less than faithful representation of some transactions, and would thereby result in inappropriate gain or loss recognition. For example, some respondents argued:

   - *We do not think that the alternative approach outlined in the ED would be acceptable, as we do not believe it would provide users with decision-useful information. […]*

     In order to arrive at a principle for derecognition we believe it is important to discuss the role of the balance sheet as a primary financial statement and what it is trying to portray. In our view, the balance sheet should portray the risks undertaken by the business and the resulting assets and liabilities. We would expect the balance sheet to provide information that is rich enough in its presentation and information content to enable the users of financial reports to make decisions in their capacity as users. This would mean that the balance sheet must report the effect of transactions undertaken by the entity during the accounting period and reflect the risks taken by the entity. This would result, in most cases, in gross assets and liabilities being recognised on balance sheet. This would also mean that the derecognition approach will be significantly different to that presented in the ED [including the alternative approach], which takes a components approach and in doing so has increased the possibility of a financial asset being derecognised. (CL14)

   - *[We are] of the view that, as both [the proposed and alternative] approaches permit derecognition without applying a more overt risks and rewards analysis, they both could lead to earlier removal of assets from balance sheets at present, and more significantly, to the inclusion of 'non-substantive' gains and losses in the income statement. Therefore, [we are] of the view that it is important to continue to have a risks and rewards consideration in any derecognition analysis. (CL101)*

5. Some respondents were also concerned about replacing the current derecognition model in IAS 39 with an approach that comparatively would result in more financial assets being derecognised (this criticism was also raised in the context of the proposed approach). For example:

   - *It can be questioned if it is appropriate in the current crisis climate to make derecognition 'easier'. In a way this is counterintuitive since one may expect more severe derecognition requirements. (CL94)*

6. Respondents not in favour of the alternative approach also noted some other reasons for their objection to that approach, such as expansion of fair value measurements and with that an increase in complexity in the financial statements (see section 'Specific concerns about the alternative approach' for a detailed analysis).

7. **Respondents who favoured the alternative approach.** Many respondents expressed support for the alternative approach (see Paper 16D for a statistical analysis of the comments received on the ED). Such respondents generally viewed the alternative approach as principle-based and consistent with the *Framework*. They also believed that the alternative approach would resolve the 'stickiness' issue and would be much simpler to apply in practice.

8. Some thought the Board should adopt the alternative approach, as described in the ED (ie without any modification), as the new derecognition model for financial assets. For example:

   - *[We] believe that the alternative approach is more consistent with the definition of an asset and can be applied more consistently in practice. [We] agree with the reasoning set forth in paragraph AV-1 through AV-16. (CL46)*
   - *[We favour the alternative view expressed by the five dissenting Board members. […] We consider the time has come for the derecognition rules to align with the recognition rules – ownership history should not affect whether different parties with the same exposure apply different accounting treatments. (CL58)*
   - *The alternative approach results in a more reasonable presentation of the rights and obligations retained by the transferor. As per IAS 1, an asset is a resource controlled by the enterprise and from which economic benefits are expected to*

flow to the enterprise. It is better synchronised and consistent with this fundamental principle. Additionally, the alternative approach focuses more on the economic impact of the transfer than on the transaction itself, resulting in more effective financial reporting. (CL79)

9. Others agreed that the alternative approach should form *the basis* for a new derecognition model for financial assets but suggested some modifications to disallow recognition of gains or losses if only a small portion of a financial asset is transferred or to treat transactions involving repurchase agreements, securities lendings and provision of collateral as financings. For example:

- *Our preferred approach is closer to the alternative approach with the significant difference that if a transferor retains control over certain rights to cash flows under the transferred asset that those cash flows are not included in the derecognition assessment, i.e. they continue to be recognised. (CL36)*

- *At a conceptual level, we prefer the Alternative View. This model is superior to the proposed model […]. [T]he Alternative View […] results in derecognition of financial assets transferred in a repo transaction, contrary to the business model of banks that use repo arrangements for financing purposes. Since the continued recognition of the asset subject to the repo, together with a liability reflecting the entity's obligation to repurchase the asset, would more closely mirror the substance of these arrangements as collateralised borrowings, we would not object to an exception to exclude repos from the proposed derecognition requirements, perhaps in the form of an amendment to the definition of a transfer as to explicitly exclude assets subject to a repurchase obligation. (CL105)*

10. **The alternative approach as a possible long-term solution.** A large proportion of respondents who preferred that the IASB focus on improving the disclosure requirements in IFRS 7 *in the short-term* also stated that in the longer term the IASB could use the alternative approach as a starting point for developing a replacement derecognition guidance. For example:

- *Rather than proceed with the [proposed approach] on a fast-track timetable we suggest it would be better to:*

    (i) address the concerns raised by the Financial Stability Forum and others by focusing on short term improvements to disclosure requirements

(ii) maintain the existing model [in IAS 39] in large part, while considering making limited improvements to address known application issues (including possible removal of the 'continued recognition to the extent of continuing involvement' outcome)

(iii) carry out further work on the alternative approach with a view to developing this as a possible longer-term replacement for the existing model. (CL7)

- *[We are] not in favour of the development from this ED of a standard based on the proposed approach or the Alternative Approach. In our view, the standard developed from this ED should be one that involves a limited number of incremental changes to the derecognition model in existing IFRS.*

  We would nevertheless encourage the IASB to continue its work on finding a better model. The Alternative Approach might be a good starting point for that work. (CL47)

11. Some respondents also suggested that the IASB should not change the current derecognition in model in IAS 39. However, if the IASB did anything at all, they recommended that it start with the alternative approach. For example:

- *We believe that the current model is well understood and applied by most constituents and results in an accounting treatment that is consistent with the economics of a transaction.*

  If retaining the current model is not possible, we see merits in the alternative approach where an asset is derecognised when the transferor has no continuing involvement in it or when the transferor has relinquished control. (CL22)

- *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. (CL53)*

12. **Need for re-exposure of any proposals based on the alternative approach and convergence.** Some believed that the alternative approach was not described in sufficient detail (ie no application guidance and basis for conclusions) and that to the extent the Board decided to move forward with the approach (with or without modifications), the Board should re-expose that approach. They believed that re-exposure would also help with assessing the interaction of the alternative approach with other aspects of the IAS 39 project

(eg classification and measurement) and other IASB projects (leasing and revenue recognition) and also with achieving a converged derecognition standard between the IASB and FASB. For example:

- *We can see [the alternative approach] 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. (CL53)*
- *We prefer and strongly encourage the Board to adopt the Alternative Approach because of its simplicity, its consistency with a control model and because it is better aligned with the Framework in respect of reporting only those assets and liabilities in the balance sheet which meet their respective definitions. However, before adopting the Alternative Approach we believe that the Board should re-expose it, addressing specifically the accounting for gains on sales, transition, disclosures, and draft application guidance applying the Alternative Approach to specific transactions. We strongly believe that re-exposure of a new draft is required for such a fundamental standard. (CL77)*
- *[W]e believe that the best way to proceed is for the Board to further develop the alternative view articulated in ED 2009/3. [W]e recommend that the IASB complete the development of the alternative view and expose it concurrently with the FASB with an abbreviated comment period of 60 days. A converged final standard could then be developed jointly and released during 2010. (CL106)*

13. **Summary.** Clearly some constituents were opposed to the alternative approach, mainly because they disagreed with risks and rewards not being part of the derecognition assessment. However many more constituents expressed support for the alternative approach (with or without modifications). In addition, a

significant number of respondents expressed support for the alternative approach as a possible solution in the longer-term.

Specific merits of alternative approach

14. The respondents who favoured the alternative approach to be adopted as the guidance for derecognition of financial assets (either now or in the longer term) liked that approach for the same reasons as set out in the alternative views on the proposed approach in the ED. That is, these respondents commented that the alternative approach:

- was principle-based (eg the alternative approach does not arbitrarily create a rule for what portion of a financial asset transferred qualifies as an appropriate unit of account to be assessed for derecognition and thus whether such portion ultimately can get derecognised)
- was a single concept (control) as opposed to a mix of concepts (ie control with a risks and rewards overlay)
- would result in the recognition of assets and liabilities that would be consistent with the *Framework*
- would result in faithful representation of the transferor's and transferee's contractual rights and obligations (which would include reflecting the risks and uncertainties the transferor remains exposed to after the transfer in the measurement of those contractual rights and obligations)
- would resolve the 'stickiness' issue (ie two entities with identical contractual rights and obligations would account for those rights and obligations consistently, irrespective of how they obtained them)
- was consistent with the derecognition principle for financial liabilities. For example, an entity that has written a guarantee on a financial liability it transferred would derecognise the liability and recognise the guarantee as a new liability. Similarly, an entity that has written a guarantee on a

financial asset it transferred would derecognise the asset and recognise the guarantee as a liability.

- was consistent with the way participants in the financial markets structure financial instruments to manage risk and hence would reflect the economics of the market place
- in light of the above reasons, would be much simpler to apply in practice.

15. Some examples of feedback about the merits of the alternative approach were:

- *The proposed approach defines a portion of an asset in an arbitrary way. The proposed approach uses that arbitrary mechanism to portray risk exposure rather than measurement. The alternative approach appropriately uses measurement to reflect an entity's risk exposures. It is similar to the approach used for derivatives for which risk exposures are portrayed through measurement rather than recognition. […] Measurement is the appropriate manner for dealing with uncertainty and risk inherent in a particular asset; recognising fictional assets and liabilities is not. Notional risk exposures can be disclosed in the footnotes to the financial statements. […]*

  We believe that the existing paradigm has its roots in an era in which risk and uncertainty could not be adequately captured through measurement and disclosures. Now is the time to challenge that paradigm, not reaffirm it without question. (CL45)

- *[The alternative] approach is more appealing because it does focus within the principles of control and is not tainted by elements of a risks and rewards filter, nor constrained by rules to determine the unit of account. It also does not narrowly view control from the perspective of what the transferee can or cannot do with the asset. Consequently, the alternative view does not encounter some of the issues noted in the proposed approach.*

  Since the alternative approach does not require an entity to evaluate how the entity got to a particular economic position, similar economic situations are account[ed] for in a similar manner. Simply put, a seller would derecognise what they believe they have sold, in sync with what the purchaser believes what they have bought. This has the benefit of being much simpler to apply in practice. More importantly, the model more appropriately aligns the accounting back to the fundamental definition of an asset and liability under the Framework than under the proposed approach. (CL97)

Specific concerns about alternative approach

16. The main concerns raised in respect of the alternative approach were:

    - Misleading representation of some transactions
    - Opportunity for earnings management
    - Expansion of fair value measurement
    - Purpose of statement of financial position and the elements within it
    - Transfer definition
    - Lack of convergence with US GAAP
    - Inconsistent derecognition principles with consolidation project and other IASB projects dealing with nonfinancial items (revenue recognition and leasing)

17. In the following paragraphs, we focused on the first four of the issues listed above. Please refer to Paper 16A (comments on proposed approach) for a summary of the remaining issues.

Misleading representation of some transactions

Repurchase and sale ('repo') and securities lendings

18. Applying the alternative approach to transactions involving repurchase agreements and securities lendings would result in the derecognition of the financial asset involved and the recognition of a forward derivative (the proposed approach in the ED would yield the same outcome if the asset was readily obtainable).

19. Many respondents disagreed with this accounting outcome. They noted that, irrespective of their legal form, repos and securities lendings are both commercially and economically financing transactions and should be reported as such in the financial statements. For example:

    - *[R]epo transactions are widely used by banks in some Europe in order to secure borrowings, among which borrowings from central banks. Under such financing* *arrangements, the transferor retain substantially all the risks and rewards of the transferred assets, but those financing arrangements often include other features (transferor's right to proceed to exchange of assets at any time during the arrangement, transferor's right to receive any coupon…) that further demonstrate the transferor's control of the transferred assets.*

The difference between a repo and a pledged borrowing (where the asset is pledged to the counterparty in guarantee of a loan) is more a question of legal form than of economic substance: repos give the lender an easier legal access to the benefits of the guarantee in the event of bankruptcy (no need to go to court to obtain ownership of the collateral). There would be some inconsistency and a real lack of comparability if those two comparable types of financing arrangements were accounted for differently, leading to a derecognition of the transferred asset in one case and not in the other.

Some view the repo as to be equivalent to a sale combined with a standalone forward and explain that after the transfer entities that are obliged to a repurchase agreement should account for the transaction as a standalone forward. However, in practice and in substance, repurchase agreements after transfer of assets are generally not equivalent to standalone forwards: the initial price of a standalone forward would be generally zero, whereas the implicit price of the forward of a repo is - approximately – equal to the haircut (excess of value of the collateral over the loan) less the difference between the return on the assets and the transferor's cost of funding. Consequently, it is not adequate to separate the transfer from the repurchase agreement when assessing the accounting treatment to apply to repo transactions.

In substance, repos are secured borrowings. We note that the money lender bears a risk on the transferred asset which is purely equivalent to the risk borne by any lender in the value of a pledge, and has control of a loan granted to the transferor, of which credit risk reflects the value of the assets "transferred". As used to secure borrowings, repos transactions create significant liabilities that need to be reported in banks' statements of financial position and to be measured as financing liabilities which is amortised cost. […]

Consequently, we strongly disagree with the derecognition of financials assets subject to repo transactions […] as it would be inconsistent with the economic substance of the transaction. Repos are a valid example that illustrate the need to keep the risks and rewards test in the derecognition decision tree in order to avoid unattended consequences which would be difficult to understand by *preparers and users (both in the statement of financial position where liabilities would be underestimated and in the income statement where inappropriate volatility would be shown). (CL88)*

20. Respondents cited a number of reasons for why they believed repos and securities lendings were in substance financings, with the main reason probably being that the transferor remains exposed to substantially all of the risks and rewards of the transferred financial asset.

21. To address this concern some advocated that similar to the current model in IAS 39, a transfer of a financial asset should first have to go through a 'risks and rewards' test before applying the control test of the alternative approach. For example:

- *A key weakness in the proposals is the derecognition of an asset even when the transferor retains substantial risks and rewards of that asset, e.g. the derecognition of repo transactions. We recommend that own benefits and exposure to risks be integrated into the control principle, since control without risks and rewards indicates rather an agency relationship than beneficiary control. (CL94)*
- *On balance, the alternative approach is more persuasive than the proposed approach and merits further consideration when developing a robust and sustainable standard for the complex topic of derecognition. We are concerned about the removal of the 'risks and rewards' approach to derecognition and believe that the focus on 'control' is too simplistic and may risk the creation of structuring opportunities to avoid 'control'. (CL98)*

22. Other respondents suggested amending the 'transfer' definition to scope out repos and securities lendings from the derecognition requirements. For example:

- *We […] recommend that the definition of a transfer should be amended to exclude the delivery of a financial asset (or substantially the same asset) that the entity is required to repurchase in the future so that these transactions can continue to be accounted for as secured financings. (CL61)*
- *On balance, we believe that [repurchase, securities lending and similar] collateralised financing transactions should be reflected as such on the balance sheet, and that the final standard should either (a) define "transfer" so as to*

exclude collateralised financing transactions or (b) contain an exception from the general principles so that collateralised financing transactions are more accurately reflected on the balance sheet. (CL70)

- *[We] think that the provision of collateral […] should not be included, since collateral is provided as a credit enhancement of a borrowing in line with the usual current business models of many financial institutions. In that respect we propose that linked transactions are considered substantially being one transaction for the definition of 'transfer'. This would result in a situation where transactions in which the transferred or substantially same asset is required to be returned should not lead to derecognition and would not meet the transfer definition. (CL94)*

23. Finally, others supported the introduction of the 'effective control' concept in FASB Statement No. 166 either in the transfer definition or as a separate derecognition test.

'Empty' SPEs and unit-linked insurance and investment contracts

24. Some respondents asked for clarification whether the alternative approach would cause special purpose entities that are set up to purchase financial assets and distribute to note holders and other interest holders (eg trustee, servicer, guarantor) all the cash flows that those assets generate not to recognise those assets and the corresponding liabilities (in which case the entities would be 'empty'). They believe that such an outcome would be inconsistent with the views of the stake holders of special purpose entities (after all, the assets in which they invested must be somewhere!) and would also render the consolidation standard (and proposals in ED 10) meaningless.

- *The example provided in paragraph AG52L(g)iii, of a note that is contractually linked to shares, indicates that if all the cash flows are passed through to the other entity, control of the asset has been lost. An extension of this example is when an SPE passes on all cash flows to its note holders, the transaction is a transfer as defined […] and as transferring the rights to cash flows is akin to transferring the asset itself, provided the AG49A provisions for an agency or fiduciary relationship are met, the SPE will not recognise the assets it manages or the related liability to the note holders. In this situation the SPE is in substance acting as an agent for the note holders. If this analysis is correct it* *would mean that many investment vehicles such as certain investment funds would report an 'empty' statement of financial position. Guidance on this matter would be helpful, to clarify if this is an appropriate analysis. (CL71)*

- *It is very common that SPEs are structured so that ultimately no cashflows are retained by the SPE and note holders receive all of the cashflows of the assets held by the entity. In this case the SPE has no continuing involvement in the assets transferred to it as all the cashflows are re-distributed to note holders through the waterfall structure. Application of paragraph BC81 to such SPEs will seem to result in the SPE reporting zero balance sheet. This is not only counter-intuitive, but will be confusing to the investors relying on financial statements submitted by such entities.*

  Further, such derecognition of the assets by the SPE will not necessarily result in the recognition of those assets by the investors in the notes as often investors will be multiple, disparate parties. This may cause the assets transferred to such an SPE to "disappear" as they will not be recognized by the original transferor, the SPE or the note-holders. (CL106)

25. Similar to the concern about 'empty' special purpose entities, others were concerned that the alternative approach might cause entities to derecognise (or not to recognise in the first place) the assets and liabilities related to unit-linked insurance and investment contracts.

- *[A]pplying the derecognition principles to assets backing insurance and investment products […] could result in many assets held by insurers in a fiduciary capacity being derecognised and much valuable information being lost from the balance sheet. This would not reflect the economic substance of our underlying business. Furthermore a key part of an insurer's business is to manage policyholders' funds; how well this is achieved is useful information in predicting future success as a business. It would not be helpful to users if this information was lost as a consequence of holding these assets off balance sheet. We also note that is it not clear from the ED whether the related liability would be derecognised if financial assets backing insurance and investment products were derecognised. (CL65)*
- *Another major concern is that the new proposed rules (including the alternative approach) could be interpreted in a manner that may lead to the derecognition of a significant portion of many insurers' investment assets. Such a situation could occur, for example, when unit-linked insurance and investment contracts are*

entered into. The policy is issued by the insurer and is usually valued by reference to a pool of ring fenced assets. Based on both the proposed and alternative approaches, these assets could be regarded as a 'transfer' without any continuing involvement that would lead to a derecognition of these assets.

This would result in a situation that the unit-linked assets would be derecognised and the associated insurance liability would still be recognised. In order to avoid such mismatch, in our view it is required that the assets are kept on the books of the reporting entity when the obligation to transfer the rights of the asset's cash flows represents a liability out of the scope of the financial instruments standards (e.g. an insurance liability under IFRS 4). (CL87)

Opportunities for earnings management

26. The alternative approach requires that in a transfer of a portion of a financial asset the transferor derecognise the asset in its entirety and recognise the portion retained and initially measure it at fair value. The basis for this measurement is that the portion retained is in nature different from the financial asset recognised before the transfer. As a result the alternative approach recognises the 'transformation' of the nature of the previously recognised asset into something new by treating the retained portion as a new asset (hence, the requirement to initially measure it at fair value).

27. Many respondents did not support measuring the retained portion at fair value. They were concerned that an entity could sell only a small portion of a financial asset carried at amortised cost and trigger a gain or loss on the entire financial asset as opposed to only on the portion transferred.

- *[W]e are concerned that [the Alternative View] results in gain or loss recognition in the income statement on a financial asset in its entirety even though there has been no change in its rights to some of the underlying cash flows of that asset. While selective gain recognition is possible today through wash sales of assets traded in an active market, the Alternative View would extend the recognition of such gains to illiquid assets. (CL61)*
- *Notwithstanding [the fact that it is much simpler to implement than both current IAS 39 requirements and the proposed approach], the alternative approach has the weakness that it provides an opportunity for earnings management. This is the case when a transfer results in derecognition of an asset that is measured at*

amortised cost. Subsequent to the derecognition, upon 'reacquisition', the asset is recognised at fair value. Thus, the difference between its previous carrying amount and its fair value is recognised in profit or loss. An example that illustrates this weakness is as follows: A sale of a one per cent proportionate interest in a loan, which is measured at amortised cost, would require the 99 per cent retained interest to be measured at fair value upon 'reacquisition' […] In summary, we tend to favour the alternative approach if this counterintuitive result could be corrected. (CL87)

28. Some also expressed the view that the retained portion is not necessarily a 'different' asset from that recognised before the transfer. For example, if the portion retained is a proportionate share of the cash flows of the financial asset previously recognised, the transferor is exposed to the same nature/type of risks and rewards of the asset as the transferee, albeit in a different proportion. In this instance, those respondents would treat the retained part as a part of the previously recognised asset and thus would allow for gain or loss recognition on only the part transferred. However, if the portion retained was disproportionate, then it would qualify as a 'different' asset to which a different measurement attribute would have to be applied.

- *[We] recommend that the IASB explore ways that the alternative view could be implemented with safeguards to prevent abuse. [We] recommend IASB consider adding provisions to the alternative approach that require the instruments received back in an exchange be demonstratively distinct from the assets derecognised in terms of risk. (CL9)*
- *[We are] of the opinion that the alternative approach leads to an appropriate outcome in cases of transferring disproportionate shares of the cash flows from financial assets, because the retained parts have different risk profiles and thus represent new assets (or liabilities) to be recognised at fair value. A weakness of the approach is seen in cases where only a small proportionate share (e.g. 1% or 2%) of the cash flows from a financial asset is transferred and the financial asset is carried at amortised cost in the financial statements. Derecognising the 'old' asset and recognising the 'new' asset (representing 99% or 98% of the 'old' asset) at fair value offers structuring opportunities. A suggestion to avoid this problem would be to incorporate 'the Asset' test from the proposed approach in the ED into the alternative approach. Therefore, in the example mentioned, the*

derecognition test would only be applied on the 1% or 2% transferred cash flows while the retained part is still carried at cost. (CL11)

- *[T]he model outlined in the Alternative View allows gain or loss recognition on the whole asset even if the transferor's retained interest in the underlying cash flows is substantially unchanged. One way to address this would be to require the transferor to assess the extent to which its exposure to those cash flows has changed in such a way as to change the measurement basis of the retained asset. Therefore we propose that, where the cash flows underlying its retained interest in the financial asset are substantially generated by the transferred asset, and the retained interest qualifies for amortised cost measurement, no gain or loss should be recognised relating to the retained interest. The carrying amount of the transferred asset would be allocated between the retained interest and the other assets and liabilities received based on the relative fair values. However, where the retained interest is one that would be carried subsequently at fair value or is not substantially generated by the transferred asset, this revision would recognise that the transaction has resulted in a substantial change in the entity's exposure to the rights and obligations associated with the underlying cash flows and a gain or loss would be recognised on initial recognition of the retained interest. Since this issue arises from the existence of a mixed attribute measurement model for financial assets, its significance will depend on the final outcome of the Board's deliberations on the classification and measurement of financial statements. (CL61)*

29. Other respondents argued that any retained portion of a financial asset is part of that 'old' asset because irrespective of how the cash flows are allocated between the retained and transferred parts (ie whether proportionately or disproportionally), it is the underlying 'old' asset that generates those cash flows. Stated differently, because the unit of account according to the alternative approach is the cash flows of a financial asset, any cash flows that a transferor has not transferred and surrendered control over (ie those it retained) by default must be part of the 'old' asset. Because the cash flows the transferor has retained are part of the 'old' asset, they must be measured using the same measurement attribute as the one applied to the previously recognised 'whole' asset.

- *Where the entity transfers an asset and as part of the transfer arrangement retains an interest in the cash flows of the asset, the transferred asset shall be assessed as the net interest in the cash flows that are transferred. For example, if an instrument that contains a contractual right to cash flows of CU100 is transferred and the transferor retains a right to receive 10% of cash flows from the asset, then the transfer is 90% of all cash flows. An interest of CU10 is part of the asset that will continue to be recognised and the classification or measurement of it will not change. Similarly, if the retained interest is the first CU10 of cash flows on the asset then the transferred asset is the right to all cash flows on the asset after the first CU10 of cash flows are retained by the transferor. The transferor's interest in a disproportionate share of cash flows of CU10 is part of the original asset and therefore is not subject to derecognition or a change in its classification or measurement at the date of transfer. (CL36)*

30. Some respondents suggested that one way to address the earnings manipulation issue would be to require that a transferor measure subsequently any retained interests in a financial assets at fair value through profit or loss.

- *One […] potential mitigant to concerns over earnings management would be to require any financial assets recognised through continuing involvement to be fair valued through the income statement in subsequent periods. (CL77)*

31. Finally, others recommended to defer any gain recognised on the transferred portion of a financial asset that qualified for derecognition.

- *Under the Board's new proposal on classification and measurement of financial instruments, we believe that such situations would not occur because business models resulting in the sale of assets in securisations would require such assets to be carried at fair value. While not optimal, day-one gains on interests held might be deferred consistent with the Board's proposal on fair value measurement in conjunction with IAS 39. (CL45)*

Expansion of fair value measurement

32. The alternative approach requires that the retained portion of a financial asset and any other assets or liabilities created in a transfer that qualifies for derecognition initially be measured at fair value.

33. Because the alternative approach will likely result in more transfers qualifying for derecognition, some are concerned that the requirement to measure any new

assets or liabilities obtained or incurred in connection with a transfer at fair value will significantly expand the use of fair value and with that the complexity involved in determining such value, and would thus decrease the reliability of items recognised in the statement of financial position.

- *The alternative view of the dissenting Board members has conceptual merit. It is simple and achieves similar accounting results for similar transactions, irrespective of the starting point. However, it would likely create more complex instruments requiring valuation models to determine fair value and so is likely to increase, rather than reduce, the complexity in measuring and reporting financial instruments. It would result in an increase in complex components of financial instruments being recognised in the balance sheet and might make it more difficult for users to understand the information on financial instruments reported in the financial statements. (CL37)*
- *We moreover consider that the alternative approach will transform a derecognition issue into a valuation issue: first, it will be difficult to fair value some assets in order to record the gain or loss resulting from their derecognition; then, it will be even more difficult to fair value portions of them to record the new asset. (CL44)*

34. Others seemed to be concerned that the alternative approach is an all fair value measurement basis through the back door. They argued that the Board might require that any new assets or liabilities obtained or incurred in connection with a transfer be measured at fair value not only initially but also subsequently, in which case any changes in fair value would have to be recognised in profit or loss. (This concern was also widely expressed during our outreach efforts).

- *It is critical for the Board to consider the interplay of the Alternative View and the proposals in the Exposure Draft, Financial Instruments: Classification and Measurement. We believe that many interests retained by the transferor should qualify for amortised cost accounting going forward, and are concerned that the Board may decide to require ongoing fair value accounting for all retained interests regardless of the characteristics and business model that applies to those interests. (CL70)*
- *[The] alternative approach obviously appears to be much more consistent with a full fair value principle and as far as we are strongly opposed to such a single*

measurement model at fair value we are neither in favour of the alternative approach. (CL88)

35. Some preferred that the classification alternatives that were currently available in IAS 39 or that would be available according to the proposals in the exposure draft *Classification and Measurement of Financial Instruments* be made available to a transferor that obtained or incurred a new asset or liability in connection with a transfer of a financial asset that qualified for derecognition.

- *We believe that, for the alternative approach, the recognition and measurement of retained interest could follow the proposed requirements that will be set out in the Board's forthcoming exposure draft on IAS 39: Classification and Measurement. That is, any concern that the Board may have regarding "selective application of fair value and an opportunity for earnings management" will be alleviated if the measurement attribute for the transferred asset and the interest retained is consistently applied. (CL 42)*

Purpose of statement of financial position and the elements within it

36. Some respondents believe that a broader debate about the purpose of the statement of financial statements and elements within is warranted.

37. Those respondents suggested (or at least their response implied) that the statement of financial position should reflect the risks an entity was exposed to (rather than or in addition to the contractual rights and obligations entered into by the entity). They argued that the focus should be on the substance of arrangements rather than on their contractual/legal form. So for a repo transaction where the transferor was exposed to all of the risks (and rewards) of the transferred asset, it should report that asset as its own even though the repo might be structured as a sale coupled with a forward.

- *The basic question is about the purpose of financial repurchasing statements. What must be presented on the balance sheets: the current rights and obligations or a fair representation of the risks to which an entity is exposed? As already explained, we do not support the notion of control as it is presented in the ED. We support a risks and rewards approach. […]*

  As a consequence we have concerns about the derecognition of readily obtainable financial assets whereas the transferor retains all the risks and *rewards of these assets. Derecognition of assets in case of sale and repurchase agreement will create inappropriate recycling of unrealised gain or loss in P&L for instruments that are not accounted for at fair value through P&L. This is contrary to the substance of the transaction, i.e. a collateralised loan, meaning that […] the IASB should, at a minimum, create an exception for standard repurchase agreements and similar transactions. (CL68)*