Accounting Standards Board

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Dear Christian

IASB Exposure Draft *Derecognition*

1. This letter sets out the comments of the UK Accounting Standards Board (ASB) on the above Exposure Draft (ED), which proposes a revised derecognition model for financial instruments.

2. Our detailed comments on the questions asked in the Invitation to Comment (ITC) section of the ED are set out in the Appendix to this letter. The ASB has a number of concerns with the proposals. These are outlined below, but in summary:

    - we are concerned that the proposals in the ED do not address the crisis-related concerns raised with the existing derecognition model in IAS 39, which in our view relate to disclosures (paragraphs 3 to 10 below);
    - the proposals do not articulate a clear principle for the derecognition of financial assets, which should be linked to a consideration of the purpose of the balance sheet and should be consistent with the IASB's work on other projects, for example consolidations and leasing (paragraphs 11 to 13);
    - we do not agree that the existing risks and rewards tests should be replaced by a test to determine continuing involvement (paragraphs 14 to 17);
    - we are concerned that testing for control on the basis of the transferee's practical ability to transfer for its own benefit will be difficult to apply (paragraph 18); and
    - 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 (paragraphs 19 to 21).

The problems with the derecognition requirements of IAS 39

3. The ASB believes that the IASB's focus should be on the crisis-related amendments to accounting and disclosure requirements for financial instruments. As such we are concerned that the changes proposed to the IFRS derecognition requirements for financial instruments go beyond those requested by the Financial Stability Forum (FSF) and the G20.

4. The IASB, in its introduction to the ED, notes that the derecognition requirements in IAS 39 are complex and internally inconsistent as they combine elements of various derecognition concepts (risks and rewards, control and continuing involvement). The ASB agrees that some aspects of IAS 39, including the current derecognition requirements are rules-based. As such, we would welcome a more principles based approach that allows entities to apply the requirements consistently across the board and which simplifies the accounting for financial instruments.

5. However, in our view the main deficiency identified in accounting in this area as a result of the current credit crisis is in relation to the disclosure requirements, which have been seen to be inadequate in informing users of the nature and extent of risks undertaken by entities both on and off-balance sheet.

6. We note that some regulators have also called for improvements to and convergence of accounting requirements in this area. In particular, the Turner Report in the UK and the de Larosière Report in Europe have drawn attention to the recent rise in structures being permitted off-balance sheet treatment when the ultimate risk in those structures was still borne by the originator (often banks) or that the originator ended up providing so much support to those structures that it, in effect, bore most of the risk. These reports as well as the FSF criticised the accounting for permitting off-balance sheet treatment of these structures and for not providing the users with adequate disclosures that highlighted the nature and extent of the risks being taken by these entities.

7. We are not convinced that the changes to the derecognition model proposed in the ED represent an improvement on the current requirements in IAS 39 or are sufficient to counter the criticisms levelled at the derecognition model of IAS 39. In particular, the new model (by expanding the definition of a transfer and removing the risks and rewards test) appears to lead to more, rather than less, derecognition of financial assets and is likely to result in less transparent and counter-intuitive accounting solutions for certain financing arrangements (e.g. the proposals on the treatment of repo transactions) and more complex structured transactions. We are not certain how permitting even more derecognition than is currently the case addresses the concerns raised about the off-balance sheet structures mentioned above.

8. We would, therefore, recommend that the IASB focuses, in the first instance, on streamlining of disclosure requirements in this area so that users are aware of the actual economic risks taken by the reporting entity. We provide some examples of disclosures in our response to question 11 in the appendix to this letter that we believe would enhance the information content currently included in financial reporting in this area.

9. We recommend that the IASB should then consider the alternative model we have incorporated in our answer to question 7 in the appendix to this letter, as the starting point to a derecognition model that would provide decision useful information to users.

10. We would also recommend that the IASB perform extensive field testing of any changes they propose to the requirements of IAS 39 which takes into account that companies other than banks are required to comply with its requirements.

Principle for derecognition of financial assets

11. In order to arrive at a principle for derecognition we believe it is important to discuss the role of the balance sheet[1] 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, which takes a components approach and in doing so has increased the possibility of a financial asset being derecognised.

12. Further, there was a prospect of aligning the principle for derecognition with that proposed in ED 10 for consolidations. However, the two approaches proposed by the IASB have two very different starting points: the consolidation approach in ED 10 requires a review of the transaction as a whole, the derecognition approach in this ED looks to account for the individual components of a transaction undertaken by an entity. This means that the consolidation approach is more flexible in potentially accommodating the myriad of differing types of consolidations, including structured entities. By contrast, the derecognition requirements set out in this ED look at individual assets and liabilities and by not referring to the risks and rewards of the transaction are liable to omitting the economic substance of a transaction. Additionally, as the requirements are constructed as a set of

[1] Referred to in the IASB's literature as the Statement of Financial Position

rules, it is possible that certain counter-intuitive accounting treatments will arise on certain more complex transactions.

13. We also believe that the proposals in this ED are not in line with IASB's proposals in the leasing discussions. We believe that if applied to leasing transactions the proposals in this ED would lead to the net position being reported on operating leases, which is counter to the decisions by the IASB so far in this area. We can identify no reason why the two approaches should be inconsistent.

Implication of removal of reference to risks and rewards

14. The current IAS 39 derecognition model is applied as follows:
    i. review whether substantially all risks and rewards have been transferred;
    ii. if transfer of risk and rewards is unclear then undertake an assessment of control; and then
    iii. consider continuing involvement in the transferred item by the reporting entity.

15. The proposed derecognition model in the ED is likely to be applied as follows:
    i. an assessment of control of asset by the entity by referring to the contractual cash flows;
    ii. consider continuing involvement;
    iii. if continuing involvement then consider if transferee has the practical ability to transfer asset for its own benefit.

16. The IASB has removed consideration of the transfer of substantially all risks and rewards on the basis that it is too complex to combine elements of several derecognition concepts. It should be noted that the control model based on contractual cash flows is a useful starting point for straight-forward financial instruments. However, problems arise when the more complex transactions, such as securitisations and credit derivatives, are being accounted for. In these cases, the control requirements must be accompanied by the risks and rewards tool for coping with the complexity inherent within the structures. This test enables a review of the economic substance of the transaction as a whole rather than looking to the individual components and the contractual cash flows therein.

17. The IASB has replaced this risks and rewards test with more extensive disclosure for financial instruments that have been derecognised but in which the entity retains a continuing involvement. However, as mentioned above, we do not believe that extending the number of financial assets that are derecognised deals adequately with the recommendations in the Turner and de Larosière Reports. In addition, some of the disclosures proposed may add to the confusion for users of financial statements.

Transferee's practical ability to transfer for its own benefit

18. We are concerned that this test will be difficult for reporting entities to comply with. The initial problems arise in reporting entities having to access information about the transferee that it may not easily have access to. There are additional problems with this approach which are set out below.

 i) *'Without additional restrictions'* – This requirement would force entities to differentiate between convertible bonds that are identical in substance but differ in how the conversion option is legally setup (already part of the bond then not a restriction on practical ability to transfer but if written as a separate call option i.e. an additional contract then there is a restriction). Similarly, repos which are a financing activity will be accounted for as if the entity has sold the asset and acquired a liability in its place. We fundamentally disagree with this approach to accounting for financing activities. This would also mean that the accounting for the derecognition of a financial asset will be different to that for factoring of debts or hire purchase agreements.

 ii) *Factors to consider in assessing 'practical ability to transfer'*- there are a number of factors outlined in the application guidance (AG52E). However, the most significant relates to 'market for the asset' which is fungible. As has been the case recently such a market can disappear overnight leading to changes to how entities account for assets previously derecognised. Such a change in the market would lead to a change in the practical ability to transfer however, the application guidance notes that no reassessment is permitted in such cases (see below).

 iii) *Reassessment of the 'practical ability to transfer' test* – Reassessment is permitted if a transfer does not qualify for derecognition. A previously derecognised asset cannot be re-recognised if conditions subsequently change and the transferee loses the practical ability to transfer for its own benefit (AG52F-G). So if a reporting entity is supporting a SIV (initially derecognised) more extensively as a result of a liquidity crisis than it was originally set up to do, we are unclear as to how it will show this changed relationship in its financial statements under this proposal? This rule appears to be similar to those in US GAAP on such reassessments. Our understanding was that the US requirements in this area were criticised for their inflexibility in the face of changing economic conditions. We are therefore uncertain as to why the IASB is considering importing much criticised accounting requirements into IFRS.

Alternative Approach

19. We are concerned that the alternative derecognition model put forward in the ED is similar to the proposed model in taking a components approach. However, it additionally requires the entity derecognise an asset when it sells a small proportion of it and to recognise the remaining portion as a new asset, recognised at its fair value.

20. As mentioned above, we are against the balance sheet providing information that provides only the net position of what may be an asset and a liability with very different underlying characteristics. As such, we believe that grossing up of the balance sheet is the most appropriate presentation to ensure that users have sufficiently detailed information content for it to be decision useful.

21. Given that the alternative approach implies that the figures presented in the balance sheet would be netted into smaller and smaller portions of the original financial assets we are strongly against it being implemented into IFRS. We would refer you to our response to question 7 which details an alternative approach to derecognition which we believe should form the starting point for the IASB's derecognition proposals for financial instruments.

If you would like to discuss any of the comments made above then please contact Seema Jamil-O'Neill on 020 7492 2422 or myself on 020 7492 2434.

Yours sincerely

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Appendix: Responses to Questions asked by the IASB

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?

1) We agree that under the proposals included in the ED that the determination of the item to be evaluated for derecognition and the assessment of continuing involvement should be made at the level of the reporting entity.

2) However, we also believe that before this step can be taken there should be an overall consideration of the purpose and role of the balance sheet as a primary statement. Such deliberations would enable the IASB to set out a clear principle on which the derecognition of assets and liabilities should be undertaken.

3) In particular, we believe that in order to achieve the objective of financial reporting, i.e. providing decision useful information to users in their capacity as owners, the balance sheet must report the effect of transactions undertaken by the entity during the accounting period. In order to achieve this objective the balance sheet must reflect the risks taken by the entity by presenting the resulting assets and liabilities on its balance sheet.

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.)*

4) Although we agree with the IASB that most of the criteria proposed in paragraph 16A are the same as those in IAS 39 we are concerned about two aspects of the proposals – (i) the inclusion of "the performance of the part retained does not depend on the performance of the part transferred" when referring to cash flows arising from a part of a financial asset and (ii) the potential linkage to the definition of an asset in the Framework.

5) We believe that the inclusion of "the performance of the part retained does not depend on the performance of the part transferred" when referring to cash flows arising from a part of a financial asset, goes beyond the current requirements in IAS 39 and has not been explained in the ED. We do not agree that the performance of a part of a financial asset retained will always be independent of the part transferred. For example, if an entity transfers a bond but retains the interest strip we are unclear as to whether the entity will be permitted to

derecognise the whole bond (principal and interest strips) as the performance of the interest strip depends on the quantum of the principal transferred. We believe the IASB needs to consider this issue further before making a final decision.

6) Another additional piece of guidance included in the ED is around the treatment of interest rate swaps. The ED states (AG 41A) that "for a transfer of a part of a financial instrument that can be an asset or a liability over its life, the Asset is the entire instrument". It then goes on to note that for a transfer of a receive leg of an interest rate swap the Asset is the swap. The reason given is that the two legs of the swap would have to meet the criteria for derecognition for a financial asset as well as those for a financial liability. However, if the entity did not treat the cash flows from the two legs as netted it does not then follow that swap would need to meet the criteria for derecognition for a financial asset as well as those for a financial liability. We believe that the above guidance is an exception to the requirements set out in paragraph 16A of the ED and would suggest that the IASB consider some field testing of this proposal and then consider the proposals in the ED in light of the results of such field testing.

7) Furthermore, when discussing groups of financial assets, the proposals in the ED have been simplified. IAS 39 currently requires these to be a "group of <u>similar</u> financial assets" if they are to meet the definition of an asset evaluated for derecognition. The proposals in the ED have removed the reference to "similar" thus simplifying the requirements overall. However, AG43A in the ED requires that for a transfer of a part of a group of financial assets, the Asset is the part transferred only if it meets the conditions in paragraph 16A and "none of the assets in the group is an instrument that can be an asset or a liability over its life." Again, this appears to be rule-making that has little relevance to the requirements in paragraph 16A. We believe that this requirement is a further corollary to the requirements in AG41A. If that requirement was amended as a result of the field testing suggested above then similar changes would be required to this rule.

8) We are also concerned that by defining the unit of account for derecognition here as 'the Asset' some confusion is liable between this and an asset as defined in the Framework. The Asset as defined in paragraph 16A is a subset of the asset defined in the framework and makes no reference to control by the entity or arising from past transactions (as included in the current Framework definition). We would advise the IASB to amend the name of this unit of account to something that does not result in such confusion. A possible way of looking at it is to refer to the unit of account as "the financial asset to be assessed for derecognition". Although not a punchy name at least it avoids misinterpretation as a different asset.

9) Having said the above, we believe that the requirements in paragraph 16A can be dealt with in a far simpler way than that proposed in the ED. Firstly, we would advise the IASB to incorporate the definition included at the end of paragraph 16A into the definitions section of the standard (not tag it on to this paragraph). We believe the following would be an adequate definition of 'the Asset' proposed in this ED:

The term 'the Asset' refers to: either a financial asset (or a group of financial assets) in its entirety; or a part of a financial asset (or a part of a group of financial assets) only if that part comprises specifically identified cash flows or a proportionate share of the cash flows from that financial asset. If the Asset comprises part of a financial asset (or a part of a group of financial assets) and there are two or more transferees, no transferee is required to have a proportionate share of the cash flows from the asset (or the group of financial assets) provided that the transferring entity has a proportionate share.

10) Secondly, by amending paragraph 17A as follows the remainder of paragraph 16A can then be deleted:

An entity shall derecognise the Asset <u>(as defined in paragraph 9 of this standard)</u> if…

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?

11) The definition of a transfer in the ED is set out as a clear principle that would require a reporting entity to consider the economic substance of a transaction undertaken or as BC38 of the ED puts it " the proposed definition ensures that irrespective of their form, qualifying transactions will be assessed for derecognition". This appears to be an attempt to replace the complex and difficult to implement rules on pass-through transfers currently included in IAS 39. As noted in our answer to question 1 above, the ASB agrees that replacing rules with a principles-based approach is the desirable way forward.

12) However, in doing so, the IASB states that it has defined 'transfer' broadly. This would imply that many more transactions will be subjected to the derecognition test, making it even more crucial that the test is robust. This increase in number of transactions being considered for derecognition can also lead to some additional items being derecognised. In this respect, we note that repos, for example, are one type of transaction where the underlying asset will be derecognised as a result of the proposals in the ED. We are fundamentally against a financing transaction, such as a repo, being treated in such a way and would not consider this an improvement on the requirements currently set out in IAS 39. Such counter-intuitive results would provide further structuring opportunities when the IASB has been specifically charged by the G20 and FSF to attempt to limit them in future.

13) The ASB would recommend that, prior to finalising the proposals in the ED, the IASB considers them carefully to ensure that unintended consequences are properly dealt with prior to finalising the proposals.

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?

The 'Continuing involvement' filter

14) Under the current requirements of IAS 39 a transfer is subjected to a risks and rewards test which enables reporting entities to consider whether it should derecognise an asset. The ED proposes to replace this test with a continuing involvement test. Under this new test if a transferor does not have continuing involvement in the transferred asset then it shall derecognise the asset. Thus, making this test crucial to the derecognition process.

15) Paragraph 18A of the ED notes that a transferor has no continuing involvement in the Asset if it "neither retains any contractual rights or obligations inherent in the Asset nor obtains any new contractual rights or obligations relating to the Asset". If the transferor has no continuing involvement then per paragraph 17A (b) the entity shall derecognise the Asset. This proposed approach in the ED is significantly different to the current role of continuing involvement in IAS 39. Currently, IAS 39 gives primacy to the risks and rewards test to determine if an entity has retained control of an asset. It then requires entities to apply the continuing involvement test to consider what part of the asset the entity should continue to recognise where a transfer has meant that some risks and rewards of ownership are transferred but the entity retains control.

16) The ASB is concerned that the principles-based risks and rewards approach to derecognition is being replaced with a much narrower, contractual cash flow-based continuing involvement approach. We believe that such a change would have a significant impact on the current accounting for financial assets and are alarmed at the consequences for accounting for financial assets if the notion of risks and rewards is removed in its entirety.

17) Taking the example of a repo transaction, as noted in our answer to question 3 above this type of transaction is financing in nature. Essentially, it involves an entity transferring a liquid debt instrument (E.g. a bond) to another entity for a set period of time in exchange of cash with a forward repurchase agreement at the present value of the cash received. If looked at beyond the contract, the risks inherent in the security are fundamentally different to the cash received. Under the risks and rewards approach, this transaction means that the transferor has retained substantially all the risks and rewards of ownership of the security and would therefore continue to recognise the debt instrument on its balance sheet but will also recognise the financing transaction, cash received and the related liability. Thus providing the users with information on its ownership of the security as well as the fact that it has a related cash asset and a future liability.

18) However, under the proposed model the entity would have transferred all the contractual rights and obligations inherent in the debt instrument without obtaining any new rights and obligations related to it. It would therefore, treat

the debt instrument as having been sold and derecognise the asset. In its place, it will recognise the cash received and the forward. As noted above, we believe this approach is fundamentally flawed and is a completely undesirable outcome of these new proposals that should be avoided at all costs.

19) We firmly believe that the risks and rewards model is more robust in that it would require the entity to take all the risks and rewards of ownership into account when considering whether an entity should derecognise an asset. We note that although in putting together the proposals the IASB has attempted to delete all references to risks and rewards, it continues to mention these when justifying the inclusion of new rules in the proposals. We believe that this is due to the essential nature of the risks and rewards notion to the consideration by an entity of control and hence derecognition of any asset, but especially financial assets.

20) A further issue we believe the IASB should consider is the impact of this change on the accounting for transactions that are currently outside the scope of IAS 39, e.g. hire purchase agreements and leasing transactions which have direct parallels with the accounting for repos.

Exceptions made to 'continuing involvement'

21) Paragraph 18A of the ED sets out that there are a number of exceptions to what constitutes continuing involvement. These include:

  - Normal representations and warranties
  - Retention of the right to service the Asset in a fiduciary or agency relationship
  - 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.

22) Under the proposals in the ED the existence of the above conditions does not give rise to continuing involvement and therefore the transferor is free to derecognise the associated asset provided it meets the other tests.

23) However, some of these exceptions appear to permit derecognition of financial assets in areas that under the current IAS 39 requirements would indicate retention of some risks and rewards by the transferor. Indeed, the rationale given by the IASB for making these exclusions is that the transfer would not have qualified for derecognition because it would have failed the subsequent 'practical ability to transfer' test. We believe that this indicates the incomplete nature of the new requirements that additional rules are required to remove conditions that would otherwise have been considered to give rise to continuing involvement.

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?

24) The ED states that the 'practical ability to transfer' test is applied in cases where the reporting entity is deemed to have transferred the Asset but retains some continuing involvement in it. In such cases, paragraph 17A (c) of the ED sets out that an entity may derecognise the Asset if the transferee has the practical ability to transfer the Asset for its own benefit. The IASB's rationale for including this test is that the entity with the asset is the one that can use it as it wishes, so an entity is able to give control of an asset to a third party only if the entity itself has that control. In BC48 of the ED states that "if the transferee is free and able to transfer a financial asset in any of these ways, the transferee can obtain the economic benefits. To the extent that the transferee can restrict others' access to those benefits (ie if it is entitled to receive and keep for itself the proceeds from any such potential subsequent transfer), the transferee controls the economic benefits of the asset."

25) The control test in the ED sets out a number of constraints, including: whether the transferee has control of the Asset and whether it is able to transfer the asset for its own benefit (as mentioned above); and the fact that the transferred asset is actively traded in the market, which would indicate in many cases that the transferee has the practical ability to transfer for its own benefit.

26) As noted in the question, other than the 'for the transferee's own benefit' supplement the actual test already exists in IAS 39. However, it should be noted that over and above this change the context in which this test is now being considered has changed significantly. Under the current requirements of IAS 39, 'the practical ability to transfer' test exists within the context of reviewing the risks and rewards retained by the transferor and would be one, but not the only, factor that would indicate whether it has handed over control and should therefore derecognise the asset. By contrast, the ED proposes that this be the only test that indicates lack of control. This change in context places enormous pressure on a test that is simplistic in its approach to what constitutes control of an asset, i.e. the ability to sell it on.

27) There are certain other limitations inherent in this test that makes it less practicable than originally appears. For example, an actively traded Asset is treated differently to one that is not actively traded. So actively traded instruments are easily transferred whilst those that are inactively traded will hardly ever be transferred. These are discussed in more detail below.

a) *'Without additional restrictions'* – This requirement would force entities to differentiate between convertible bonds that are identical in substance but differ in how the conversion option is legally setup (already part of the bond then not a restriction on practical ability to transfer but if written as a separate call option i.e. an additional contract then there is a restriction). Similarly, repos which are a financing activity will be accounted for as if the entity has sold the asset and acquired a liability in its place. We fundamentally disagree with this approach to accounting for financing activities. This would also mean that the accounting for the derecognition of a financial asset will be different to that for factoring of debts or hire purchase agreements.

b) *Factors to consider in assessing 'practical ability to transfer'*- there are a number of factors outlined in the application guidance (AG52E). However, the most significant relates to 'market for the asset' which is fungible. As has been the case recently such a market can disappear overnight leading to changes to how entities account for assets previously derecognised. Such a change in the market would lead to a change in the practical ability to transfer however, the application guidance notes that no reassessment is permitted in such cases (see below).

c) *Reassessment of the 'practical ability to transfer' test* – Reassessment is permitted if a transfer does not qualify for derecognition. But once derecognised an asset is not re-recognised if conditions subsequently change resulting in the transferee no longer having the practical ability to transfer for its own benefit (AG52F-G). So if a reporting entity is supporting a SIV (initially derecognised) more extensively as a result of a liquidity crisis than it was originally set up to do, we are unclear as to how it will show this changed relationship in its financial statements under this proposal? This rule appears to be similar to those in US GAAP on such reassessments. Our understanding was that the US requirements in this area were criticised for their inflexibility in the face of changing economic conditions. We are therefore uncertain as to why the IASB is considering importing much criticised accounting requirements into IFRS.

28) We believe that the above rules are likely to result in structuring opportunities that are not currently available to under IAS 39. In particular, differentiating 'practical ability to transfer' on the basis of the existence of a market and whether or not options are imbedded in the legal contract but then disallowing reversals has the potential for inconsistent application of the requirements to financial assets that are similar in their economic substance but have different legal set ups.

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.)

29) Yes, we agree with the ED's proposals for accounting for an interest retained in a financial asset or a group of financial assets in a transfer that qualifies for derecognition. We note that the Alternative View includes a concern that guidance for an interest in a financial asset (or group of financial assets) retained indirectly through an entity might not be operational. It states that the transferor may not have access to the information about all the assets and liabilities in the transferee. We agree that this issue should be considered further, in particular, if the required split in paragraph 22A is impracticable.

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?

30) No, we do not agree that the proposed approach to derecognition of financial assets is sufficiently robust to be established as the new approach for determining the derecognition of financial assets. We also disagree with the alternative approach in the ED. As we understand it, it takes a similar components approach to derecognition but additionally requires that whenever a part transfer of the financial instrument occurs a new asset would be recognised representing the part that is retained by the entity. This re-recognised part would then be measured at its fair value. We see this as a significant weakness with the alternative approach as at its best it would permit entities to reclassify assets from amortised cost to fair through profit or loss and vice-versa.

31) We are concerned that IASB is missing an opportunity to review the underlying principle on which it permits the accounting for financial instruments. The current credit crisis has provided valuable insights into the shortcomings of the requirements of IAS 39. In particular, it has been clearly demonstrated by recent events that the complex, rule based requirements of both IAS 39 and under US GAAP have encouraged the use of financial engineering with the sole aim of

establishing structures that amongst other things permitted entities to show financing transactions as off-balance sheet arrangements.

32) The ASB believes that it is important to consider the economics of a transaction i.e. the purpose it was undertaken by the company (e.g. to move risk off-balance sheet, to save tax, access new investor base, etc) when accounting for it. As it stands, the proposed approach in the ED limits reporting entities to taking a components-only approach to accounting for the assets and liabilities arising from the transaction. By focusing on the contractual cash flows (and with no references to the risks and rewards retained or transferred) when determining control of the transferred asset the proposed approach is likely to result in reporting entities not accounting for the substance of the transaction as a whole but instead for individual components in isolation.

An alternative to the derecognition proposals in the ED:

33) As noted in our answer to question 1, the ASB believes that before setting out the requirements for derecognition of financial instruments there needs be an overall consideration of the purpose and role of the balance sheet as a primary statement. Such deliberations would enable the IASB to set out a clear principle on which the derecognition of assets and liabilities should be undertaken.

34) In our view, to achieve the objective of financial reporting the balance sheet must report the effect of transactions undertaken by the entity during the accounting period. Therefore, the balance sheet must reflect the risks taken by the entity by presenting the resulting assets and liabilities on its balance sheet.

35) We think that the IASB should lead the accounting in this area by requiring that reporting entities first consider the transaction to ensure its substance is captured and that the correct assets and liabilities are recognised or derecognised. Such a requirement would ensure that all reporting entities comply with the same overarching principle of accounting for the substance of the transaction. There could then be specific requirements that ensure that recognition and derecognition of financial instruments is in line with this overarching principle.

36) So, in the ASB's view, accounting for a transaction, and the resulting assets and liabilities, will begin by first considering the substance of the transaction – who controls the assets and liabilities arising from the transaction. This would entail the consideration of both contractual rights and obligations, a review of the ability of the entity to restrict the access of others to the assets, and consideration of the ability to direct the financial and operating policies if a group of assets is transferred to a new entity.

37) It is then followed by the entity considering whether recognition/ derecognition is triggered for the assets and liabilities. This assessment may be clear-cut for instruments where the contractual cash flows are unambiguous. However, for instruments where there is structuring involved or the cash flows are less certain it may be possible to review the continuing involvement by considering the risks and rewards inherent in the transaction.

38) Derecognition would only be permitted if there is no recourse to the transferor for losses (excluding normal warranties) and the transferor does not benefit from an improvement in the condition of the transferred 'Asset'. It may be possible to limit derecognition of a financial asset to the extent that the entity has passed on the relevant risks and benefits to a third party. However, under such conditions we would anticipate disclosure that clarifies the extent of the entity's exposure to the underlying assets and liabilities.

39) The above model is not complete in that it does not address all the possible issues that may arise from the ambiguous transactions mentioned above. However, we believe that this model will only permit derecognition of financial assets to the extent that an entity has passed on most of the risks and rewards of ownership to a third party. In the event that an entity does not meet this test, we believe that it is correct that it accounts for the maximum possible exposure to the risks arising from a transaction but then discloses where these are mitigated by transferring some of the risks and benefits to third parties.

40) Accounting for financial transactions in this way will ensure that users are aware of
    - the possible mitigation of risks on the balance sheet (e.g. transfer of loans to third parties via a securitisation), but also
    - the new risks arising from the transaction (e.g. counterparty risk, liquidity risk).

41) In proposing the above, we have not given full consideration to the asset definition and the unit of account. However, we believe that these are important issues that must be considered prior to any approach to derecognition of financial assets can be finalised.

42) We would also recommend that the IASB looks at the model in the UK standard FRS 5, as originally issued in April 1994. Although some elements of that standard are slightly out of date we believe that it contains a principles-based approach to derecognition that is relevant for financial instruments and as well as other transactions undertaken by entities that trigger derecogniotion of assets from the balance sheet.

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?

43) The ASB believes that the approach to consolidation and derecognition of financial instruments should be broadly similar as they deal with similar issues – both consider the control by the reporting entity of an item and both result in movements on the balance sheet.

44) We do not believe that the proposed derecognition approach in the ED is in line with the consolidation approach in ED10. The difference between the two noted in the question i.e. that consolidation is assessed at the entity level whilst derecognition is applied at the level of the assets and liabilities is a significant enough difference for the two not to be similar. The main reason is that the consolidation approach is a top-down approach which considers the transaction undertaken by the entity and then proposes the accounting treatment. By contrast, the derecognition approach by operating at the asset and liability approach is a bottom-up approach which attempts to show the impact on the balance sheet of a transaction by focusing entirely on the resulting components.

45) Furthermore, the consolidation approach by starting at the top enables entities to consider the accounting implications of a wider set of transactions than just the most straight forwards types. Subject to the changes to the model as suggested in our comment letter dated 18 March 2009, we believe that ED10 has the potential for providing satisfactory accounting solutions based in the economics of the transactions for both subsidiaries acquired in the normal course of business as well as structured entities. Furthermore, a definition of control which incorporates the notion of variability of returns (in essence a risk and rewards principle) is more suitable when assessing control of structured entities.

46) This cannot be said for the proposed approach to derecognition, which provides component-level solutions (rules) and then has to deal with structures by way of exceptions to those rules. To bring the derecognition model into line with the ED 10 model on consolidation we believe that the IASB would need to begin at the transaction level and then apply the control principle, supplemented with a risks and rewards test to establish the resulting assets and liabilities and their treatment.

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?

47) We agree with the proposed amendments to the principle for derecognition of financial liabilities and note that it is unlikely to affect the substance of the existing requirements.

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?

48) We agree with the ED's proposals of prospective application of the standard it is based on the cost implications for preparers and that hindsight might affect the measurement of past transactions.

49) However, prospective application raises the issue of grandfathered transactions and how changes to these will be accounted for by reporting entity, i.e. in accordance with the old rules or in accordance with the new requirements. The ASB would not support accounting for changes to the grandfathered transactions under the old rules as that creates inconsistency within the financial statements of the reporting entity.

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?

50) The disclosure requirements surrounding the existing IFRS derecognition requirements have been identified by the FSF and G20 as needing work. In particular these need to be clarified to ensure users are able to understand the nature and extent of risks undertaken by the reporting entity both on and off-balance sheet.

51) Although the disclosures proposed in the ED are likely to provide information that would enable users to make assessments as noted above, the ASB is concerned that the disclosures for transferred financial assets that are derecognised but in which an entity has continuing involvement are far more extensive than those for assets that have not been derecognised. In particular, we are unsure as to what the following requirements add:

    i) to disclose the undiscounted cash outflows to repurchase derecognised financial assets showing the remaining contractual maturities of the entity's continuing involvement (IFRS 7 paragraph 42D (e)) (although this appears to be a fix for the ED's proposed approach to accounting for assets under repo transactions), and

ii) a sensitivity analysis showing the possible effect on the fair value of the continuing involvement of changes in the relevant risk variables that were reasonably possible on the reporting date (IFRS 7 paragraph 42D (g)).

52) We would recommend that the IASB considers giving higher priority to qualitative disclosures under 42C-D that clearly articulate the risks related to any off-balance sheet transactions in which the reporting entity has had involvements. This would mean that information would be given on the quantum of the associated assets and liabilities as set out in the IASB ED and also on the legal set up of the structures.

53) For example disclosures for SIVs or securitisations may include information about: the events that trigger defaults; the legal clauses that lead to structures being automatically wound up e.g. when assets fall below a certain threshold or the SIV's credit rating declines; the impact on the entity's equity/debt ratio as a result of setting up the SIVs; any ongoing support provided to the SIV by the entity; puts held by investors in the notes issued by the SIV and events that lead to these being exercised; and the reporting entity's underlying motivation in setting up the structures e.g. balance sheet management or arbitrage purposes.