Accounting Standards Board

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Sir David Tweedie
Chairman
International Accounting Standards Board
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22 April 2010

Dear David

I am writing to you on behalf of the UK Accounting Standards Board (ASB). We have been following the IASB's debate on derecognition closely and, in light of the recent Valukas report on Lehman Brothers, I would like to make you aware of our significant concerns about the direction of travel on that project.

We note that IASB has prioritised the derecognition project as a crisis related project and that one of the G20 recommendations on the crisis related accounting issues was that both the IASB and the FASB should review their accounting for off-balance sheet instruments. We believe this recommendation was driven by the comments by investors that they had not been aware of the extent of off-balance sheet activity prior to the commencement of the credit crisis. We read this not as a request for simplification of the derecognition models but more as a call to make them more robust and less susceptible to structuring.

We believe that the fundamental question to be answered before finalising the derecognition criteria is what should be presented on the face of the balance sheet: the current contractual rights and obligations or a fair representation of the risks to which the entity is exposed? Once this question is answered then the other linked issues of what can or cannot be derecognised, the level of income recognition (upon derecognition of a financial asset) and the potential for the use of the derecognition model as a means for reclassification can be answered.

As we see it, in developing the alternative model in the ED the IASB appears to have focused on control as the key criterion as to whether an entity should derecognise a financial asset or not. This implies to us that the IASB has decided that it considers the presentation of the current contractual rights and obligations on the face of the balance sheet as the superior approach to derecognition. However, given the current risks and rewards overlay in IAS 39, the IASB's proposed model is likely to fundamentally change the "landscape" for reporting of financial assets under IFRS, with a different picture of the balance sheet than that presented currently. We believe this will lead to inconsistent and counterintuitive results as well as increasing structuring possibilities. In particular, we are concerned that the IASB's model, by following the legal form so closely, is likely to lead to derecognition of more financial assets than is currently permitted under IAS 39.

We note that you have made an exception to the principle for repo transactions. We are concerned that exceptions to the principle imply underlying problems with the principle itself.

We do not believe we are alone in our concerns. We have examined the comment letters the IASB received on its ED on derecognition, issued in March 2009, and have come to the conclusion that most of the IASB's constituents were content with the performance of the current IAS 39 model during the recent credit crisis. A large number of those who expressed a preference for the alternative model did so with the proviso that the earnings management potential of the proposals will be addressed and that some element of risk and rewards filters will be incorporated within the model to ensure the true economics of underlying transactions were presented fairly on the balance sheet. In particular, the response from the CFA Institute[1] was clear in its preference for the inclusion of a risks and rewards filter in any derecognition model.

We think it is important that any weaknesses in the current derecognition requirements in IAS 39 are clearly identified; any proposals on derecognition must be given adequate Board time to ensure full discussion of the issues as well as consideration of any unintended consequences; and the resulting ED includes detailed examples of application of the proposals. We are concerned that, given the number of items on the Boards agenda, the ED may be published without these steps being completed.

We believe that these alternative proposals on derecognition, based on the control model, would increase the scope for financial engineering. Therefore, we would reiterate our recommendations, made in our response on the proposals in the derecognition ED[2], that in the short term the IASB should focus on addressing

[1] The CFA Institute response to the IASB ED can be found at the following link http://www.iasb.org/Current+Projects/IASB+Projects/Derecognition/Exposure+Draft+and+Comment+Letters/Comment+Letters/CL99.htm

[2] A copy of the ASB response can found at the IASB website by following this link http://www.iasb.org/Current+Projects/IASB+Projects/Derecognition/Exposure+Draft+and+Comment+Letters/Comment+Letters/CL14.htm or at the ASB website under the 'Other Publications' tab

weaknesses in the disclosure requirements for financial instruments to ensure investors are made fully aware of the risks taken by the entity, both on and off-balance sheet. If the IASB still wants further improvements to the derecognition requirements, it should undertake a longer term project that fully considers the various aspects we mention above.

Should you have any queries on the above please do not hesitate to contact me on 020 7492 2434 or Seema Jamil-O'Neill on 020 7492 2422.

Yours sincerely

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