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Sir David Tweedie
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International Accounting Standards Board
30 Cannon Street
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Dear Sir David,

On behalf of the Austrian Financial Reporting and Auditing Committee (AFRAC), the privately organised standard-setting body for financial reporting and auditing standards in Austria, I appreciate the opportunity to comment on the Exposure Draft ED/2009/3 *Derecognition – Proposed amendments to IAS 39 und IFRS 7*. Principal authors of this comment letter were Peter Bitzyk, David Grünberger, Heiner Klein, Michael Laminger, Andreas Rauter, Ernst Schönhuber and Roland Nessmann.

General remarks

We see the present ED as part of the general process of revision of IAS 39, intended to lead to the development of a new standard: on the one hand, to restore confidence in IFRS measurement and disclosure of financial instruments, which has been shaken by the financial markets crisis, and on the other to result in a globally accepted, uniform regulation.

This ED attempts to base the recognition and hence also the derecognition of financial instruments on the principle of control. As a matter of principle, we welcome a principles-based simplification of IAS 39. But in our opinion this goal will not be achieved with the present ED:

1. Derecognition is in theory to be based on the principle of control, but in our opinion the intention is frustrated in practice by the excessively wide definition of transfer with respect to finan-

cial instruments (e.g., any granting of a security interest). For instance, we see no theoretical difference between borrowing secured by a mortgage on real property, where there is no transfer of the property at the time the mortgage is granted, and borrowings secured on a financial instrument "readily obtainable … in an active market", which results in transfer and derecognition of the financial instrument at the time the security is granted. In our view, therefore, the accounting treatment should be the same.

2. In addition to the fact that the specification of an "active market" in the view of both IASB and FASB requires a "professional judgement", which is not capable of clear and uniform definition, there is then also the problem that derecognition is dependent on which courses of action are in practice available to the acquirer. A consequence of this is that the derecognition of a financial instrument depends on anentity's estimate of the options potentially available to another entity. In our view, this is a conceptual mistake, and will certainly not result in the desired reduction in complexity as compared with the existing regulatory framework. For example, it is questionable whether any call options that counterparties may have as one of their possible alternative courses of action should be taken into account. In this respect, we believe that the existing risk and rewards approach in IAS 39 provides a more consistent and practical solution.

3. Although the alternative approach could in our view result in some simplification, it is not yet explained in sufficient detail for a conclusive comparison with the ED or IAS 39 to be possible.

4. In applying IAS 39 in the past, the existence and subsequent treatment of a continuing involvement was considered a difficult problem, and usually avoided by appropriate formulation of agreements: the ED does not solve this problem.

Our comments should therefore be seen in the light of these general remarks: we believe that this ED is not yet sufficiently developed for it to serve – in combination with the subsequent projects in relation to IAS 39 and other standards needing revision – as an effective measure for the avoidance of future financial crises, while at the same time contributing to a user-friendly reduction in the complexity of accounting for financial instruments.

Specific comments

Q1. *Assessment of 'the Asset' and 'continuing involvement' at reporting entity level*

We agree.

Q2. *Determination of 'the Asset' to be assessed for derecognition*

We agree that derecognition rules should be applied to financial assets as a whole, groups of financial assets or a proportionate share of the respective cash flows. However, we see an inconsistency in the first sentence of paragraph 16A (similar inconsistency in paragraph AG39A):

"An entity applies paragraphs 17A and 18A to 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 (or that group of financial assets) (ie the performance of the part retained does not depend on the performance of the part transferred, and vice versa)."

The words "*the performance of the part retained does not depend on the performance of the part transferred, and vice versa*" are not currently included in IAS 39.16. It is unclear whether they only relate to "*a proportionate share*" or also to "*specifically identified cash flows*". If the words are related to "*specifically identified cash flows*", the word "ie" would be misleading, as independent performance would then be a defining (limiting) element and not just a mere consequence. According to paragraph BC35, the board wishes to prohibit derecognition of "a right to *any* cash flows" irrespective of interdependencies. Furthermore, the term "*specifically identified cash flows*" needs at least some definition. We would therefore suggest the following wording:

"An entity applies paragraphs 17A and 18A to a part of a financial asset (or a part of a group of financial assets) only if the performance of the part retained does not depend on the performance of the part transferred (and vice versa) and the part transferred comprises specifically identified cash flows or a proportionate share of the cash flows from that financial asset (or that group of financial assets)."

In practice, interdependent parts of cash flows would hardly qualify for derecognition for the purposes of the subsequent steps in the ED procedure: interdependencies create a continuing involvement and parts of cash flows are, per se, usually not readily obtainable on the market.

Q3. *Definition of 'transfer'*

The acknowledgement in BC38 that not all transfers lead to derecognition is to be welcomed, but the definition has been made too broad (see also *General remarks*). What needs to be made clear is whether in the case of the issue of debt or equity instruments or other beneficial interests to refinance a securitisation vehicle, where the vehicle passes all the cash flows of its financial assets to the transferee (as described in BC 39), the transfer really entails the derecognition of the assets by the securitisation vehicle.

If it does, one consequence could be that where a bank transfers toxic securities to such a securitisation vehicle or special purpose entity (SPE), there would be no continuing involvement of the bank, so that even if the SPE was included in consolidation the toxic securities would no longer be disclosed.

The financial statements of acquirers of such debt or equity instruments, however, show only a receivable from an SPE, without any requirement to disclose the underlying risks on the toxic securities.

Furthermore, acquirers have no control over the cash flows from the toxic securities, because acquirers benefit from or are dependent on the actions of the legal owner of the securities (the SPE). Acquirers have the risks and rewards from the toxic assets, but they have no control, in the sense of the ability to dispose over the assets, so that in our view the control principle has been given up in favour of a risks and rewards approach.

Q4. *Determination of 'continuing involvement'*

In principle we agree with paragraph 17A(b), but from our point of view there are a number of open issues.

1. Question with respect to paragraph 18A: what is the meaning of "contractual right or obligation" in this context? Does it mean
   - a contractual right to cash flows, or
   - an obligation to make payments, or
   - exclusive legal ownership?

2. In our view paragraph 18A(c) should be removed. It proposes that there should be no continuing involvement by a transferor where there are: *"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."* This proposal mainly reflects the risks and rewards approach and not the control approach. Derecognition requires the transferee to be able to transfer the Asset for its own benefit

(paragraph AG51A). The contracts given in paragraph 18A(c) might still enable the transferor to exercise control over the transferred Asset as outlined in paragraph AG52L(b) if the Asset is not readily obtainable. If the IASB chooses the control approach, it should follow it consistently.

Q5. *'Practical ability to transfer for own benefit' test*

1. In particular, we see a problem with the ability to transfer a financial asset without transferring risk: it would permit (and require) an entity to recognise gains and losses on available-for-sale securities transferred under repurchase agreements, and would similarly permit reclassifications and application of the fair value option through the use of short-term repurchase agreements (wash sales) that, arguably, have little or no substance.

2. Even if the conceptual problem above can be resolved, there are additional difficulties: what does "readily obtainable" mean? If it is really the same as "traded in an active market" this term should be used instead – with all problems discussed above of determining when a market is active.

3. If that is not what is meant, we see the need for clarification, as mentioned in our general remarks: should a transferee's call options really influence the accounting treatment by the transferor?

4. Paragraph AG52L(d) we see as a problem in its own right. If it is to be so construed that any equity interest at all is to be a bar to the derecognition of a transferred asset, then demergers of subsidiaries will in future no longer be possible, because the asset being transferred will continue to be recognised in the balance sheet. If this is what is intended, then this should be clearly stated. In our view, derecognition of an asset should only be prohibited where there are special contractual provisions, such as profit and loss pooling agreements, applicable at least to the assets transferred. In the light of this provision, there should also be a clear ruling on the problem of contributions in kind to special purpose vehicles (SPEs) that finance themselves by issuing participation certificates, so that there is no consolidation requirement for such SPEs where their assets have already been derecognised under this provision.

Q6. *Accounting for retained interests*

We agree to the extent that is largely paragraph 21A that is concerned. But derecognition always involves realisation of profit or loss. The acquisition cost of a retained interest for the purposes of paragraph 22A has to be treated separately from this question.

Q7. *Approach to derecognition of financial assets*

For the problems of the proposed measurement approach, see our answers to questions 1–6 above; particularly the concepts "transfer" and the "practical ability to transfer for own benefit test" need to be more narrowly defined in order to avoid unintended consequences. The alternative approach, in our view, can not at present be assessed as a consistent whole, but only as a set of individual issues.

Q8. *Interaction between consolidation and derecognition*

To the extent that it is clearly recognised that approaches and measurement are always to be applied at the level of the individual reporting entity (i.e., individual or consolidated financial statements), we agree. We also agree that the control approach should be applied consistently for both derecognition and consolidation.

In individual financial statements, however, derecognition rules for transfers to subsidiaries should be relaxed. Otherwise, the distinction between consolidated and individual financial statements will be blurred. One of the purposes of consolidated financial statements to make clear the exposures on assets transferred to subsidiaries. If equity interests were to prevent derecognition in general, this would jeopardise the purpose of separate financial statements and the concept of separate reporting entities (cf. paragraph AV15). Therefore, the notion of the "transferee's own benefit" should be limited to cases where the transferee is the sole beneficiary (paragraph AG52L(d)).

Another problem area is the relationship between SIC 12 and the derecognition provisions. As explained in the answer to Q3, we are concerned that the application of the proposed regulations could lead to a bank hiving off toxic securities into an SPE or security vehicle and financing the vehicle with participation rights or special liabilities linked to the securities in question, so that the toxic securities were no longer recognised in any financial statements.

Q9. *Derecognition of financial liabilities*

We agree.

Q10. *Transition*

We agree.

Q11. Disclosures

On the disclosure requirements, our comments are as follows:

1. In paragraph 42D(g) the sensitivity analysis should be restricted to market risk.

Please do not hesitate to contact me if you wish to discuss any aspect of our comment letter in more detail.

Kind regards,

Romuald Bertl
Chairman