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Le Président

JFL/DC

N°49

Paris, 28th July 2009

IASB
30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Re : Exposure Draft "Derecognition – proposed amendments to IAS 39 and IFRS 7"

Dear Sir or Madam,

I am writing on behalf of the Conseil National de la Comptabilité (CNC) to express our views on the above-mentioned Exposure Draft.

The IASB initiated its project on derecognition of financial assets and liabilities because of the perceived complexity of the current requirements and the resulting difficulty in applying them in practice. In response to the global financial crisis and following the conclusions of the G20 and the recommendations of the Financial Stability Forum, the IASB accelerated its project work and decided to proceed directly to the publication of an exposure draft.

1- The CNC is not convinced that such a deep and fundamental revision of the IAS 39 derecognition approach is useful in the short term.

- Although we understand that US GAAP provisions on derecognition and consolidtion have been highly criticised during the financial crisis, we wonder whether current IAS 39 provisions need to be changed in the short term. While we agree that the current approach uses different derecognition concepts, we believe that the current IAS 39 model did not show the same weaknesses as those shown by US GAAP. The CNC believes however that supplementary disclosures on off balance sheet and risk exposures should be improved or complemented.

- Equally, the CNC regrets that the IASB focuses mainly on reducing complexity. As already expressed in our comment letter to DP Reducing complexity[1] for instance, the CNC considers that "accounting for financial instruments is by nature a complicated subject" and that "it remains vital to give priority to the relevance of the accounting treatment".

2- Additionally, the CNC believes that the ED, as drafted, does not represent an improvement over the existing standard. Even, it anticipates that the amendments proposed by this ED may lead to unintended and even inappropriate accounting consequences. Hence, the CNC is strongly against moving towards the proposed approach. The main concerns regarding the proposed approach in the ED are as follows:

- the proposed approach does not include a test to evaluate the extent of risks and rewards retained but analyses instead whether the transferor has kept a continuing involvement in the transferred asset. This requirement is similar to a risks and rewards test with a threshold at zero and may lead to inaccurate accounting treatment. For instance, the CNC strongly disagrees with the conclusion that liquid financial assets should be derecognised when an entity enters into repo transactions since this would be inconsistent with the economic substance of the transaction, i.e. a secured borrowing. The CNC also disagrees with the conclusion that illiquid financial assets for which almost all risks and rewards have been transferred to the transferee should not be derecognised (for instance, trade receivables securitisations). The CNC believes that removing the risks and rewards test from the derecognition decision tree would lead to inappropriate accounting consequences (e.g. compared to the current standard, more liquid financial assets would be derecognised with unrealised gains or losses recycled into P&L and less illiquid financial assets would be able to meet the new derecognition principles), which could be difficult to understand by preparers and users (see Q3 & Q4).

- the proposed approach extends the definition of transfer to liabilities linked to assets (see Q3). For instance, we understand that a wide part of contracts issued by the insurance industry and unit-linked to mutual funds could then be derecognised. We wonder whether this was what the Board has in mind.

- the proposed approach is presented by the Board to be based on control. However, the derecognition trigger is based on the transferee's ability to dispose of the asset and not on the effective control of the transferor over the transferred asset. We believe that focusing on the transferee's point of view is not necessarily the appropriate way to assess control for the reporting entity (see Q5). The proposed approach will result in many situations in reflecting in the transferor's balance sheet assets, which are no longer controlled by the transferor (especially in situations where a continuing involvement has been retained – even very small – and the asset is not liquid). We think this outcome contradicts the underlying principle of this approach as described in the basis for conclusion (BC2-BC14).

- additionally, the CNC notes that, through the assessment of the practical ability to transfer the asset, the degree of liquidity of the asset becomes a crucial criterion of the derecognition test. We are concerned that liquidity/obtainability of an asset is playing such a prominent role in assessing whether assets are still controlled by the reporting entity and fail to see what the conceptual basis for such an approach is (see Q5). Besides and more particularly in the current context of illiquidity in the markets, we are concerned that the ED does not require a re-assessment of the derecognition of financial assets in the case where markets become illiquid since it may lead to inappropriate outcomes.

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[1] CNC's comment letter to DP Reducing Complexity in Reporting Financial Instrument (18 September 2008)

3- Finally, the CNC also disagrees with the alternative approach that better suits to a full fair value measurement model which is a model to which the CNC is strongly opposed.

For these reasons, the CNC would recommend the IASB to:

- postpone a fundamental revision of the derecognition principles in IAS 39 and work on a long term project to find a converged approach with US GAAP;
- maintain the existing derecognition principles in IAS 39 and focus on practical difficulties related to the current approach[2] and improve disclosures.

However, were the IASB to decide to pursue the proposed amendments, we would recommend to replace the continuing involvement step in the ED by the existing tests on risks and rewards in IAS 39 in order to capture situations where :

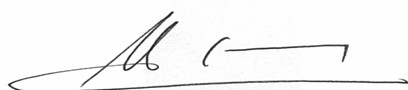
- the reporting entity has transferred substantially all risks and rewards (derecognition would apply, in the case of trade receivables factoring arrangements for instance) or
- it has retained substantially all risks and rewards (no derecognition permitted, in the case of repo transactions for instance).

Regardless of the model finally adopted by the Board, the CNC would recommend that the derecognition approach should be assessed in relation to the consolidation principles (ED 10). We have concerns that the consistency between the derecognition and consolidation principles has not yet been (and will not be) assessed through practical examples and field testing.

Detailed comments are provided in the Appendix I to this letter.

We hope you find these comments useful and would be pleased to provide any further information you might require.

Yours sincerely,



Jean-François Lepetit

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[2] practical difficulties identified by IFRIC regarding the transfer of loans together with financial guarantees obtained and the conditions attached to transfer related to the existence and value of transferred asset.

Appendix I

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?

At first sight, it seems logical to apply consolidation principles before evaluating items for derecognition since it enables to capture all transactions linked to the transfer made by entities within a consolidated Group.

However, this leads to analyse entities for consolidation based on their "legally-owned" assets and liabilities (i.e. before applying derecognition principles). Could the Board confirm this is what it has in mind?

This question raises also the issue of the consistency between the derecognition and consolidation principles (see question 8). We would recommend the Board to add guidance and practical examples illustrating the application of the derecognition and consolidation principles on common transactions involving SPEs.

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.)

We understand that the definition of portions of assets that can be assessed for derecognition are very similar to current IAS 39 requirements. Since the CNC is in favour of not making fundamental changes to the current approach, we agree with the criteria proposed with the following remarks:

- Clarity is needed in the following transaction: in the case of a transfer of loans/receivables together with financial guarantees obtained, how should the loan portfolio be analysed for derecognition (i.e. with or without the financial guarantees)? If the loan/receivables portfolio is analysed separately from the guarantees for derecognition, how should the transfer of the financial guarantees be analysed? [see issues raised by IFRIC update November 2006]
- We understand that AG42A would prevent a reporting entity from assessing a transfer of a group of dissimilar financial assets by regrouping transferred items with similar characteristics (currency, ...). However, we believe that it would be appropriate to allow the assessment of the derecognition principles on a subgroup basis for example when specific contractual features apply only to a specific subgroup. For instance, we believe that a Euro-denominated loan portfolio included in a multi-currencies-denominated loan portfolio should not be prevented from derecognition by a Euro functional currency entity because of the retention of the foreign currency risk (related to non-euro loans) by the transferor. That is why, we would recommend to state "can be evaluated for derecognition as a group" instead of "*shall* be evaluated [...]" in AG42A of the ED.

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?

The CNC believes that the definition of transfer is too broad and we are not clear how to apply this notion in practice since it is not clear from the examples provided in the Application Guidance of the ED how they do reconcile with the definition of transfer provided in the ED.

Specifically:

- It is not clear how a 'provision of collateral' is a transfer. If provision is merely the referencing of collateral we believe this should not be a transfer. However, if an entity provides another entity with collateral or provision of a collateral with a right of "re-use", that the entity has immediate and unrestricted access to, for example cash collateral, we agree this should be considered a transfer that is subject to assessment for derecognition. Equally, we would expect foreclosure of collateral to be a transfer.
- According to AG45A, "an entity treats the issue of debt or equity instruments as a transfer of specific financial assets of that entity if, according to the terms of the instruments, the entity has agreed to remit to the holders some or all of the cash flows of those assets (this guidance applies <u>irrespective of whether the certificates provide the holders with an interest in the entity or in the assets of that entity</u>)". We understand that this AG could result in all SPVs issuing pari passu beneficial interests or mutual funds becoming "empty shells" by derecognising both its assets and liabilities. As a consequence, a lot of financial liabilities currently in the balance sheet of banks or insurance companies (financial asset linked notes, minority interests in mutual funds consolidated by an entity, contracts issued by insurance companies and unit-linked to mutual funds) could then be derecognised. Is it what the Board has in mind? If it is, we wonder whether the presentation of a proportionate share in the transferred assets in the transferee's balance sheet would fairly represent the transferee's control on and involvement in these assets.
- The definition of transfer is based on passing "economic benefits". However, this notion is not clearly defined in the ED. Clarity is needed as to whether 'economic benefits' extend to benefits such as voting rights, subscription rights, both which are likely to be inherent in the contractual terms of the transferred asset. We understand from the examples in the AG they are not. We would recommend the Board to explain the rationale for excluding voting rights from the definition of economic benefits.

We recommend that the definition of transfer be strengthened : we are troubled by some aspects of the application guidance which seem to include principles (in some aspects, similar to a "weakened" pass through) in the examples. We believe that clear principles must be included in the main paragraphs, the application guidance adding only some precisions. Moreover, we consider that some further explanations or illustrations of arrangements that are considered 'transfers' would be beneficial as preparers will be transitioning from a very strict definition of a pass-through transaction to a much broader definition of a transfer.

Specifically, AG44A refers to "passing or agreeing to pass the cash flows or other economic benefits" which does not seem consistent with the examples developed in AG52L. In particular, should a transaction consisting in issuing a note contractually linked to a financial asset meet all of the four conditions described in AG52L(g) in order to meet the definition of a transfer ? In other words, we do not understand to which extent a financial liability issued should be linked to a financial asset in order to meet the definition of a transfer. More precisely:

- It is unclear whether instruments that achieve a transfer of <u>only the economic risks</u> associated with an asset should be considered a transfer of that asset. For example, if an entity enters into physically settled forward sale contract on an asset it had recognised (or even a net settled forward), is the asset considered transferred? Similarly, is the portion of floating rate interest cash flows on a debt instrument considered transferred if the entity enters into a floating to

fixed interest rate swap? We believe the above examples should not be considered transfers but as currently drafted this is ambiguous.

- Although the pass-through arrangements have disappeared from the ED, it seems that the notion of transfer as considered by the Board is quite similar (see example in appendix II). But it is unclear whether more specific criteria are needed, particularly concerning:
    1. Security interest?
    2. Legal isolation?
    3. Delay to pass through?
    4. Other…?

  We note that in the Q&A session during the Webcast on 27 May 2009, the Staff clarified the underlying principle that the transferor should not be able to transfer the economic benefits twice. Hence, even though there is no legal transfer, the transferor should be prohibited from having access to the economic benefits underlying the asset.

Finally, as developed in Question 5, we are concerned that the notion of "transfer" as proposed in paragraph 9 is not the same as the one used in paragraph 17A(c) to qualify the ability of the transferee to transfer the asset (please refer to question 5).

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?

We agree that if a transfer results in no continuing involvement then the asset should be entirely derecognized.

However, the CNC believes that replacing the existing risks and rewards tests in IAS 39 by a continuing involvement test is quite similar to a risk and rewards test with a threshold at zero and may lead to inappropriate accounting treatments since:

- it would prevent derecognition for transfers of almost all risks and rewards (e.g. 99.9% of risks and rewards) for illiquid financial assets (such as receivables); and
- it would not prevent derecognition for transfers of liquid financial assets with a retention of all the risks and rewards (e.g. repo agreements on readily obtainable securities)

The CNC strongly disagrees with the derecognition of financials assets subject to repo transactions which would be inconsistent with the economic substance of the transaction, i.e. a secured borrowing and with the retention in the balance sheet of illiquid financial assets for which almost all risks and rewards have been transferred. The CNC believes that removing the risks and rewards test from the derecognition decision tree would lead to inappropriate consequences (e.g. compared to the current standard, more liquid financial assets would be derecognised with unrealised gains or losses recycled into P&L and less illiquid financial assets would be able to meet the new derecognition principles), which would be difficult to understand by preparers and users.

The CNC is in favor of keeping a risks and rewards test in a derecognition decision tree in order to deal with the substance of some transactions and obtain proper accounting treatment in these cases (e.g. repo transactions, securitisation transactions involving the transfer of substantially all the risks and rewards).

Additionally, we have the following remarks:
- Similar to our response to Q3 we are unsure whether the retention of voting rights inherent in a transferred asset is a continuing involvement. Para 18A refers to "contractual rights or obligations inherent in the Asset", of which voting rights are contractual rights. As the definition of a transfer refers to "economic rights" as opposed to "contractual rights" we suspect the reference in paragraph 18A should be "contractual economic rights". The standard should make this clearer.

- We disagree that a transaction that requires or permits the transferor to buy the transferred asset at future fair value is not continuing involvement. The arrangement is not a 'clean' sale, i.e. the transferor maintains involvement in the asset. In these circumstances, the derecognition should be based on the practical ability to transfer the financial asset.

- Para 18A states that a transferor has no continuing involvement "if, as part of the transfer, it neither retains any of the *contractual rights* or obligations inherent in the Asset nor obtains any new *contractual rights* or obligations relating to the Asset." *[emphasis added]* Retaining or obtaining contractual rights would appear on the face of it to prohibit a transaction that previously met the pass-through tests in the current requirements in IAS 39 ever being deemed 'no continuing involvement' (under 17A(b)) as in a pass-through the contractual rights of the original asset are always retained by the transferor. If a transferor passed all cash flows with respect to the Asset to the eventual recipient(s) without material delay we do not believe this should be regarded as continuing involvement. We note that para AG52L(g) contains an illustration of a pass-through of an investment in shares and states "Entity A has no continuing involvement…" which appears to be consistent with the way we understand the ED proposals, but the words as currently drafted in para 18A do not appear to reflect this.

- Para 18A(b) does not consider the servicing of the asset as a continuing involvement provided certain conditions are met. Servicing is a key component for certain financial assets such as loans/receivables and generally remains with the transferor due to the commercial relationship that exists between the debtor and the transferor. It would be beneficial if there was a clear principle which supported the approach followed by the ED. We assume the basis for this treatment is that the transferor is not receiving cash flows to retain for its own benefit, rather receiving them and in combination servicing those cash flows for the benefit of others. Additionally, we note that the agency circumstances identified in ED 10 consolidation (B4) and in the derecognition ED (AG49A) are not identical. We would recommend that the notion of agent be reviewed consistently with other standards mentioning it and to ask for comment on this issue.

- The ED is not clear on whether conditions attached to a transfer and relating to the existence and value of the transferred asset[3], such as guarantees covering credit notes issued at the discretion of the transferor for commercial relationship reasons, guarantees covering volume discounts or changes in tax, legal or regulatory requirements or offset arrangements are included in the "normal representations and warranties" exception in paragraph 18A(a). Sales of trade receivables typically include specific guarantees provided by the transferor on "non-financial risks", that always remains with the transferor. These may be, in addition to the guarantees covering any credit notes issued for any reason, the risk that the existence of the receivable be challenged by the debtor in situations of bad performance of the transferor (on the service rendered or the goods delivered, often called "Technical dilution"), the risks arising from subsequent services rendered by the transferor... In such situations, the transfer of the receivable could be invalidated through a legal action or by way of offset against a credit note, volume discount…. It is currently unclear whether the "normal representation and warranties" of paragraph 18A could exclude this type of risk.

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[3] See conditional transfers of financial assets in IASB Agenda Paper 13B September 2006

- An entity may transfer a loan and enter into a plain vanilla swap with the transferee with the same notional amount. The ED is not clear whether this swap constitutes a continuing involvement in the loan [see current IAS 39 AG 51(p) & (q)]

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?

The CNC is highly concerned by the idea that the control of an asset is mainly driven by the obtainability/liquidity of an asset. While we agree that the obtainability is a factor to be taken into account when determining control, we believe this is only one among others.

Moreover, contrary to the current IAS 39 decision tree, the ability to transfer is playing a key role in the proposed decision tree, which is not acceptable for us (i.e. any transferred asset that is liquid will be derecognised, irrespective of the level of continuing involvement).

The proposed approach is presented by the Board to be based on control. However, the derecognition trigger is based on the transferee's ability to dispose of the asset (i.e. on the liquidity of the asset) and not on the effective control of the transferor over the transferred asset. We believe that focusing on the transferee's point of view is not necessarily the appropriate way to assess control for the reporting entity. The proposed approach will result in many situations in reflecting assets in the transferor's balance sheet, which are no longer controlled by the transferor (especially in situations where a continuing involvement has been retained – even very small – and the asset is not liquid). We think this outcome contradicts the underlying principle of this approach as described in the basis for conclusions (BC2-BC14).

Additionally, we have the following remarks:

- The ED uses the word "transfer" to assess control at this stage of the decision tree but it seems that the Board wants to define "ability to transfer" only as "ability to dispose of" (see AG52A and following paragraphs), which is not consistent with the definition of transfer used in other parts of the ED. We encourage the Board to clarify this point or to use another word than "transfer" at this stage of the decision tree.

- Paragraph AG52B & C should be clearer as to whether 'without additional restrictions' is referring to restrictions that are 'additional' to a 'clean sale' (i.e. a sale without any restrictions) or something else.

- Moreover, the ED should clarify whether the "ability to transfer" applies to the original assets transferred or to the asset representing cash flows or economic benefits of the original assets (an equity-linked note for instance).

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

- We wonder what the Board has in mind in the sentence "if the transferor cannot <u>unreasonably</u> withhold its consent, the transferee has the practical ability to transfer the asset unilaterally" (AG52A). We believe this notion is not precisely defined and could lead to divergent interpretations in practice.

- Also, it would be helpful to state whether servicing is deemed an "additional restriction" in AG52B & C. If the transferee can transfer the asset but retain a servicing right, say, because the cash flows on the asset it would transfer are dependent on receiving cash flows under a servicing arrangement with the original transferor, then would the need to include a servicing right prohibit the transferee ever to be able to transfer for its own benefit (under 17A(c))?

- We wonder if using "actively traded on an accessible market" (ED paragraph AG52E (b)) instead of "traded in an active market" as indicated in the current IAS 39 (AG42) could have unexpected impacts in practice.

- The ED is not clear on whether the strike of physically settled options must be taken into account in order to determine if the transferee has the practical ability to transfer the asset. For instance, deeply out-of-the-money options could be seen as not economically constraining the transferee's ability to dispose of a non-readily obtainable asset.

- We identify inconsistencies between example AG52L(d) and AG52L(e) : the former explains that only "because of the transferor's retained interest [i.e. subordinated interest], the transferee does not have the practical ability to transfer the Asset to an unrelated third party for its own benefit" whereas the latter explains that in the case of a transfer of a financial asset with a credit guarantee, the practical ability to transfer condition depends on whether the asset is readily obtainable or not. We do not understand why this last condition is not considered at all in the first example? Moreover, in the second example, qualifying for derecognition if the asset is readily obtainable is questionable as a financial guarantee usually imposes to hold the underlying asset (and to actually incur a loss to obtain compensation).

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.)

We acknowledge that the treatment of retained interest remains the same before and after the proposed amendment.

While we agree with this general principle, we have the following remarks:
- In the case where derecognition is applied to a part of a financial asset (i.e. specifically identified cash flows or a fully proportionate share of cash flows) paragraph 21A requires the carrying amount of the part of the asset to be derecognised based on the relative fair value of the part transferred and the part retained. We consider this is appropriate in the case of a transfer of a fully proportionate share of cash flows as the consideration received is equal to the fair value of the proportion of cash flows acquired by the transferee. We also believe this approach is appropriate where the asset is measured at fair value (whether through profit or loss or other comprehensive income). We question whether this technique is appropriate in the case of derecognition of specifically identified cash flows. If the cash flows are by definition 'specifically identifiable' we believe it should be required that the transferor derecognises the specifically identified part of the carrying value when the asset is measured at amortised cost. We also consider it more appropriate as it retains the proportion of the amortised cost measurement of the retained interest at the date of transfer unaffected, whereas the proposed approach in the ED has the effect of revaluing the retained interest for fair value movements since initial recognition and may also need the effective interest rate to be updated to avoid a residual balance being retained at maturity of the part of the instrument that was not subject to derecognition.

- Furthermore, we believe where amounts in OCI relate to either all, or none, or a combination thereof, of the specifically identified cash flows subject to derecognition, that the amount reclassified to profit or loss from OCI should be specific to only those specifically identified cash flows derecognised. A reclassification based on a relative fair value basis would result in part of the amount in OCI being, in our view, inappropriately recycled to profit or loss.

- Paragraph 23A requires that if an asset is not derecognised the proceeds received are recognised as a financial liability. This does not differ from the existing standard. However, what remains is a lack of guidance as to how to measure that financial liability. In the case of failed derecognition, the ED is not clear on how the transferor should measure the liability that arises.

- In addition, the ED provides no guidance on the measurement of the transferred asset when the asset fails derecognition. It can be assumed therefore that the measurement of the asset remains unaffected. In the current standard this is generally regarded as acceptable as the transferor retained substantially all of the risks and rewards of ownership. However, has the Board considered whether retaining the existing measurement for the transferred asset is appropriate in all cases where the transferred assets fails to be derecognised? For example, an entity transfers an asset that is measured at fair value and concurrently enters into a physically settled written put option with the transferee. Therefore, the transferor retains the downside fair value below the put strike price, but transfers the upside fair value above the strike price. Assuming the written put economically constrains the transferee then derecognition will not be achieved for the transferor. Is it still appropriate for the transferor to fair value both the up and downside when the exposure following the transfer is only the downside? The same question applies in the case of a transferred asset measured at fair value when the transferor retains a purchased call option and therefore is only exposed to the upside fair value above the strike price of the call option where the asset is not readily obtainable in the market and therefore the transferor continues to control the transferred asset.

- The ED has removed the guidance in paragraph AG49 in the existing standard. This guidance stated that derivatives that are an impediment to achieving derecognition are not recognised as to do so would be double-counting. This guidance is still relevant when a transferred asset fails derecognition and therefore we suggest it should be retained.

- We are concerned about the guidance related to an interest in a financial asset retained indirectly through an entity. The split accounting treatment proposed could be burdensome in practice and we believe that the information needed to achieve this requirement might be difficult to obtain since the interest will be held in non controlled entities.

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?

Proposed approach :

The proposed approach concerns us and as a consequence the CNC is not in favour of moving towards the proposed approach without significant amendments (see overall comments).

In particular, we have the following concerns :

- The withdrawal of the substantial risks & rewards test. This leads to the derecognition of readily obtainable financial assets whereas the transferor retains all the risks and rewards of this asset. Derecognition of assets in the case of sale and repurchase agreements ('repo') will create inappropriate recycling of unrealised gains or losses in P&L and is contrary to the substance of the transaction, i.e. a secured loan. Moreover, it will prevent from derecognising illiquid financial assets for which almost all risks and rewards are transferred ;
- The *de facto* prohibition to enter into repurchase transaction for HTM securities as long as current IAS 39 is still applicable ;
- The key role given to the liquidity/obtainability of an asset (aggravated by the absence of reassessment of the derecognition in case of markets becoming illiquid): even when significant continuing involvement is retained in a transferred asset, assets readily obtainable in a market would be derecognised ;
- Using the transferee's point of view to assess the transfer of control ;
- The divergence with US GAAP (including the revision project of FAS 140) ;
- Interaction between ED Derecognition and ED 10 consolidation (see Q8).

Alternative approach:

The alternative approach is more conceptual but would be difficult to apply in practice and would result in more transactions involving liquid financial assets meeting the derecognition criteria than under the current IAS 39 approach, which is not what constituents expect in the short term.

Moreover, we have concerns about the "P&L management" that this approach would allow by requiring the recognition of a gain/loss based on the whole asset even if a small portion is transferred. This approach is obviously consistent with a full fair value measurement model but this is a model to which the CNC is clearly opposed.

Hence, the CNC is not in favour of establishing a new derecognition approach based on the alternative view as currently designed.

Overall:

While we agree that the current approach uses different derecognition concepts, it has demonstrated its robustness in the past and has not resulted in financial assets unduly posted off-balance sheet and vice-versa. The CNC concluded that the ED, as drafted, does not represent an improvement over the existing standard. Moreover, the amendments proposed by this ED may lead to unintended and even inappropriate consequences (see Q4).

The real issue is what is the purpose of financial statements. What must be presented on the face of the balance sheet: current rights and obligations or a fair representation of the risks to which an entity is exposed ? From our point of view, the IASB must first answer this question before moving to a revision of derecognition principles in IAS 39. The CNC considers that the IASB has not provided strong enough elements on this issue to support such a deep change in derecognition principles.

However, if the IASB decided to pursue the proposed amendment, we would recommend replacing the continuing involvement step in the ED by the existing test on risks and rewards in IAS 39. This would avoid entities from inappropriate accounting treatment for certain transactions (e.g. repo and securitisation / factoring arrangements of illiquid financial assets).

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 onsider 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?

We are concerned about the inconsistency between the definition of control in ED 10 Consolidated financial statements, based on power and returns together and the definition of control in the derecognition ED based only on the ability for the transferee to sell the acquired asset. For example, derecognition will be mainly driven by the obtainability/liquidity of an asset whereas this factor is not taken into account for consolidation purposes.

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?

We agree that the proposals are broadly similar with the existing guidance in IAS 39 but it is not clear enough why these incremental changes represent an improvement to financial reporting.

We understand that the proposed amendment to the principles for derecognition of financial liabilities aims at aligning it with the definition of a liability in the framework. At first sight, we do not expect the proposed amendments to the main principles for derecognition of financial instruments (paragraph 39A) and the corresponding amendment to IFRS 4 to have significant impact in practice.

However, we expect more impacts from the derecognition principles applied to financial liabilities associated/linked with financial assets (par 40A) [See Q3].

Moreover, we have the following remarks:

- We believe para 41A(b) and 42A(b) should be clarified. This clarification should ensure that the liability is extinguished at its then fair value, reflecting the value of the liability given up. Currently, there are divergent views on whether the issue of equity as extinguishment of a financial liability should be at fair value or carrying value.

- In the case where a debt for debt exchange/modification is not treated as derecognition, guidance should be included that clarifies that no gain/loss will arise.

- The Board should explain the rationale for recognising transaction costs in profit & loss (paragraph 42B) when a debt is significantly modified since, otherwise, new debt instruments are initially recognised at fair value plus transaction costs.

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?

The CNC agrees with the proposed transition guidance, which requires applying the amendments prospectively. This provision is similar to past practice regarding application of derecognition principles such as IFRS 1 First-time adoption of IFRS for instance. Moreover, it will avoid costly restatements of past transactions.

However, the CNC disagrees with the requirement in paragraph 44H (added in IFRS 7) which requires to disclose information about past transactions as if the amendment was applied retrospectively without grandfathering. This requirement is very burdensome and it could be difficult to obtain information on past transactions meeting derecognition according to IAS 39 (revised 2003) and that would not have been derecognised according to the proposed amendment.

Furthermore, the following clarifications are needed:

- Paragraph 107 allows entities to pick a date earlier than the date specified in paragraph 106 to apply the amendments. The ED refers to this as 'prospective application', even though it relates to transactions in the past, which we assume means that the standard is applied to transactions on or after that date without restatement of comparative periods (unless of course the date chosen is in the comparative period). We consider the paragraph could be clearer in this respect.

- If an asset was partially derecognised under the continuing involvement approach and the entity chose not to back-date the effective date to transactions that occurred before the date the continuing involvement transaction took place, it is not clear to us whether the measurement of the continuing involvement asset and associated liability will remain unaffected following the adoption of the new standard. We will presume it would. However, the standard is not clear, as the asset is neither recognised nor derecognised, rather it is partially derecognised to the extent of the transferor's continuing involvement. We note that the continuing involvement measurement paragraphs will have been deleted from IAS 39 upon introduction of the new standard on derecognition.

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?

The CNC considers that the recent financial crisis has shown the utility for the users of financial statements to obtain disclosures on "off-balance sheet items".

However, the CNC is not convinced of the usefulness of all disclosures asked by the ED, especially for derecognised financial assets with continuing involvement.

Requiring too many detailed disclosures gives the impression that the Board is willing to provide enough information to enable users to restate the entity's financial statements. The CNC believes this consideration should not drive disclosure requirements.

Moreover, some proposed disclosures for derecognised financial assets with continuing involvement are redundant with other disclosures already required by IFRS 7. For instance, the maximum exposure to loss from its continuing involvement (paragraph 42D(c)) and sensitivity analysis (paragraph 42D(g)) are already disclosed through disclosures asked from paragraph 31 to paragraph 42 regarding "nature and extent arising from financial instruments". We do not see why a particular focus should be made on financial instruments related to the transferred financial assets instead of "stand alone" financial instruments. Both have similar risks exposures.

The CNC is extremely concerned about the volume and degree of details of proposed disclosure for which the costs to provide such information exceed the benefits for users (for instance maturity analysis of undiscounted cash flows to repurchase transferred assets or information related to the greatest transfer activity period (paragraph 42E(c)).

The CNC considers that disclosures must be led by principles instead of checklist. The IASB must, first of all, clearly define what are the objectives of information to be provided to users. If the disclosure principle consists in enabling users to restate the balance sheet with less derecognition than in the proposed approach, the IASB must clearly explains this. In the contrary, the IASB should find what kind of information (about risks for instance) is needed instead of providing a detailed and wide list of data to disclose.

Judgement must be applied in order to determine which information to disclose. Hence, the CNC believes that the Board should specify that "it is the reporting entity who decides, in the light of circumstances and significance, how much detail it provides to satisfy the requirement of this IFRS and the disclosure objective in paragraphs 42C and B" (similarly to paragraph B31 of the ED 10 Consolidated Financial Statements[4]).

Lastly, we note that there are no disclosures for financial liabilities that fail derecognition. We consider it may be useful for users to understand if during the period the entity had a modification or exchange of a financial liability with an existing lender. In particular, disclosure of the revised effective interest rate immediately following and immediately preceding the date of the modification or exchange will provide the user with the amount of gain/loss that is effectively being spread over future periods as opposed to being recognised at the date of the modification or exchange

[4] ED10 paragraph B31 : A reporting entity decides, in the light of its circumstances, how much detail it provides to satisfy the requirements of this [draft] IFRS, how much emphasis it places on different aspects of the equirements and how it aggregates information to display the overall picture without combining information with different characteristics. It is necessary to strike a balance between burdening financial statements with excessive detail that may not assist users of financial statements and obscuring important information as a result of too much aggregation

Appendix 2

Notion of "Transfer"

Example

Entity A holds an investment in Entity B (classified as an AFS).

Entity A contracts a Total Return Swap (TRS) on Entity B shares with Entity C, whereby:

1. Entity A transfers all interim cash-flows received on the shares (dividends);
2. Entity A physically delivers the shares at maturity;
3. Payment occurs on delivery.
4. The contract does not specify that Entity A must hold the shares during the life of the TRS.

Question

Has Entity A transferred Entity B's shares?

- The definition of a "transfer" is provided by paragraph 9 IAS 39, which states:

> ***"A transfer takes place when one party passes, or agrees to pass, to another party some or all of the economic benefits underlying one or more of its assets****. The term 'transfer' is used broadly to include all forms of sale, assignment, provision of collateral, sacrifice of benefits, distribution and other exchange. (A transfer does not necessarily result in derecognition.)"*

Therefore, there is a transfer if Entity A passes through (or agrees to pass) the cash flows or other economic benefits underlying the asset.

- AG44A adds, as an example:

"(…) For example, an entity might obtain a loan that it must repay (both principal and interest) only from proceeds generated by a specified asset in which ***the lender has a security interest*** *(or by the transfer of the asset itself) and then only to the extent that the asset generates sufficient funds."*

- AG52L(g) also adds an example where:

"(…) (i) ***Entity C has a security interest in the shares*** *that Entity A holds in Entity B;*

(ii) Entity C agrees to look to only the cash flows from those shares for repayment of the note (ie Entity C has no recourse against Entity A);

(iii) Entity A is obliged to pass to Entity C all cash flows it receives from its 10 per cent investment in Entity B; and

(iv) Entity A is prohibited from selling the shares without the approval of Entity C."

In this example, it is concluded that transfer has occurred.

Conclusion

In the example, Entity C does not have a "security interest" in the asset (shares of Entity B). Therefore, we understand from AG44A and AG52L(g) that the transaction does not qualify as a "transfer".

Analysis

This example raises the question of what specific criteria should be met to conclude that there is a transfer:

- As mentioned above, both AG44A and AG52L(g) refer to an entity having a "security interest" in the asset.
  - Is the existence of a "security interest" a pre-requisite to the existence of a "transfer"?
  - If so, how should it be defined?

- BC24(b) states that *"(…) A major difference between the proposed amendment to SFAS 140 and the proposed approach in the exposure draft is that the former requires that transferred financial assets have been isolated from the transferor, any of its consolidated affiliates and its creditors, even in bankruptcy.* ***The approach proposed in this exposure draft does not require such a test****. (…)"*

  BC38 states that *"(…) The Board believes that the proposed definition ensures that irrespective of their form, qualifying transactions will be assessed for derecognition. For example,* ***a non-recourse loan*** *in which an entity repays the principal and interest of the loan only from proceeds generated by the specific asset it finances (or by the transfer of the item itself) and then only to the extent that the asset generates sufficient funds is in effect a transfer of the securing financial asset that has to be evaluated for whether it qualifies for derecognition."*

- Finally, AG45A refers to a "beneficial interest" and states: *"Similarly, an entity treats the issue of debt or equity instruments (****beneficial interests****) as a transfer of specific financial assets of that entity if, according to the terms of the instruments, the entity has agreed to remit to the holders some or all of the cash flows of those assets (this guidance applies irrespective of whether the certificates provide the holders with an interest in the entity or in the assets of that entity)."*

Although the pass-through arrangements have disappeared from the ED, it seems that the notion of transfer as considered by the Board is quite similar. But more specific criteria are needed, particularly concerning:

1. Security interest?
2. Legal isolation?
3. Delay to pass through?
4. Other.

Nota Bene

In the Q&A session during the Webcast on 27 May 2009, the Staff clarified the underlying principle, that the transferor should not be able to transfer the economic benefits twice. Hence, even though there is no legal transfer, the transferor should be prohibited to have access to the economic benefits underlying the asset.

Subsidiary question: transferee's practical ability to transfer the asset

Being admitted that the existence of a "transfer" actually supposes the existence of a "security interest": how should the practical ability of the transferee to transfer the asset for its own benefit be analysed when the transferor retains some risks and rewards?

- Is the "practical ability to transfer" the capacity for the buyer to settle with another party a contract mirroring its contract with the seller?

- Or is it the capacity to sell the asset or "subrogate" another party in its rights and obligations?