EFRAG
European Financial Reporting Advisory Group

X July 2009

International Accounting Standards Board
30 Cannon Street
London
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United Kingdom

DRAFT COMMENT LETTER

Comments should be sent to Commentletter@efrag.org by 9 July 2009

Dear Sir/Madam

Re: Exposure Draft *Derecognition (proposed amendments to IAS 39 & IFRS 7)*

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the Exposure Draft *Derecognition (Proposed amendments to IAS 39 and IFRS 7)*. This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive amendments on the issues.

Our detailed comments on the proposals in the ED are set out in the appendices to this letter but, to summarise:

- We believe that the focus of the IASB's work on derecognition should for the time being be to address the crisis-related issues arising from the existing derecognition model and to make whatever other incremental changes can be made to the existing requirements that will clearly improve the quality of information provided and/or make them easier to apply. It is our understanding that the main crisis-related issues arising from the IFRS existing derecognition model relate to disclosures.

- We think the approach described in the ED as the Alternative Approach goes far beyond the crisis-related issues and incremental changes just described. We are therefore strongly against the Alternative Approach being implemented at this time. In our view, if fundamental changes of that kind are to be made, there needs to be a comprehensive consideration of the issues involved first.

- We believe that a more comprehensive piece of work on derecognition needs to be done that would need to address at a conceptual level such issues as the asset definition, the unit of account, the role of risks and rewards and the purpose of the balance sheet employing a comprehensive debate and field testing.

- We have considered the main differences between the approach proposed in the ED and the existing derecognition requirements. Our major findings are as follows:

- We are not convinced that the proposed new, broader definition of a transfer represents an improvement and are uncomfortable about introducing this change at this stage.

- We are very concerned about the proposal that the existing risks and rewards tests should be replaced by the continuing involvement test. Although we understand the IASB's desire to move away from a model that it believes mixes elements of two completely different derecognition approaches, we do not believe that such major changes should be made via a curtailed consultation process—and without further debate and field-testing—unless it is absolutely necessary in order to address crisis-related issues. We do not think the changes are necessary for that purpose.

- We think that testing for control by focusing on the transferee's practical ability to transfer the transferred asset is a flawed approach. Furthermore, although we accept that that is also the approach in the existing standard, 'the practical ability to transfer' test is much more important in the ED's proposed approach than it is in the existing approach.

- We have some concerns about the proposed new disclosures. We think there are some inconsistencies in the proposed requirements, we are concerned that some seem to be designed to enable users to second guess management, and we are worried that as currently drafted some of the proposed requirements might encourage a checklist mentality.

We hope that you find our comments helpful. If you wish to discuss them further, please do not hesitate to contact Svetlana Boysen, Emmanuel Gagneux or me.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix 1
A general comment on the ED

In our view the focus of the fast-tracked proposals should mainly be disclosure

1 Derecognition is one of the issues that has been identified, as a result of the financial crisis, as in need of urgent review.[1] The IASB is trying to respond in a timely manner and has as a result foregone the discussion paper stage of the project and issued an exposure draft with a shortened comment period.

2 We have been and continue to be strong supporters of the IASB's efforts to deal quickly with crisis-related issues. On the other hand, we also recognise that trying to do things very quickly does have risks. For that reason we generally favour crisis-related issues being identified and dealt with separately from non-crisis-related issues so that the former can be dealt with urgently whilst the latter can be dealt with following full consideration and debate.

3 We think derecognition-related disclosure is a crisis-related issue, because users of financial statements have clearly been surprised at the size of some of the losses that have arisen from some off-balance sheet risks. We agree that this issue needs to be addressed as a matter of priority. However:

(a) although we understand that the US consolidation and derecognition models have been widely criticised during the crisis, we are not aware of similar criticism being levelled at IFRS. For example, although there is no doubt that, from a conceptual point of view, IAS 39's existing approach to derecognition has some significant weaknesses, the ED makes no reference to any crisis-related issues having arisen from such weaknesses;

(b) although we understand that the IASB has been told that the existing approach is giving rise to implementation problems, we are again not aware of any suggestion that this has given rise to particular problems during the crisis; and

(a) although there have been calls for the IASB and FASB to accelerate their convergence work so that high-quality, consistent approaches to derecognition can be achieved, we are not aware of any evidence that the absence of converged derecognition standards has been a major crisis-related issue.

4 So, as we believe that the main crisis-related issue arising from the derecognition requirements concerns disclosure, we think the focus of the proposals being fast-tracked at the moment should be to address those disclosure concerns.

5 We agree that a comprehensive piece of work does need to be carried out in order to address the conceptual and implementation issues arising from the existing derecognition requirements and to develop a high-quality global solution on the subject, but in our view that work should not be rushed. Derecognition is a complex issue and it is very important that any substantial change to the existing approach needs thorough debate and comprehensive field testing. (For example, in our view,

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[1] For example, the Financial Stability Forum stated, in its April 2008 *Report on Enhancing Market and Institutional Resilience* to the G7 Ministers and Central Bank Governors (the FSF Report), that "the IASB should improve the accounting and disclosure standards for off-balance sheet vehicles on an accelerated basis and work with other standard setters toward international convergence."

in order to build a sound foundation for a more principle-based approach to derecognition criteria, further work and debate is required at a conceptual level on issues like the asset definition, the role of risks and rewards and the purpose of the balance sheet.)

6 Having said that, we would in general be supportive of other relatively minor (incremental) changes being made to the existing requirements through the existing fast-track project if they would clearly improve the quality of information provided and/or make the requirements easier to apply.

The Alternative Approach proposes fundamental changes, and more time is needed if fundamental changes are to be made

7 Therefore, to summarise, we think that the only changes that the IASB should be making through this shortened consultative process are changes necessary to address the disclosure weaknesses identified as a result of the crisis and to make other incremental changes that would clearly improve things for users and/or preparers.

8 We believe that the approach described in the ED as the Alternative Approach involves major changes to existing requirements that go far beyond what is necessary to address the crisis-related issues that have arisen. Therefore, although we would be very happy to discuss that approach as a possible long-term way forward, we are strongly against it being implemented at this time without much more extensive debate and consideration than time currently permits.

Appendix 2
EFRAG's responses to questions asked in the invitation to comment

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?

Background notes for EFRAG's constituents

9 *It is not uncommon for a transfer of financial assets to have the affect of spreading out the rights, obligations, risks and rewards of ownership of the asset amongst a number of different companies, some of which are connected in some way. When that is the case, it is important to know at which level the derecognition decision should be taken. Should it for example, be taken at the level of the legal entity, or perhaps at the level of the reporting entity?*

10 *The ED proposes that derecognition decisions should be taken at the reporting entity level. In other words, if the reporting entity is a group, the derecognition tests should be applied in the consolidated financial statements from the perspective of the group as a whole; hence the assessment has to take into account the continuing involvement of any of the subsidiaries of the group, including any subsidiaries that are SPEs, with the transferred asset.*

11 *The existing standard says merely that the derecognition requirements shall be "applied at a consolidated level. Hence, an entity first consolidates all subsidiaries in accordance with IAS 27 and SIC-12* Consolidation—Special Purpose Entities *and then applies [IAS 39's derecognition requirements] to the resulting group."*

EFRAG's comments

12 The reporting entity notion is not discussed in any great detail in IFRS at the moment, and the recent Framework Discussion Paper on the subject was very tentative on a number of important issues. It could be argued therefore that it is premature to base so much significance in this ED on the notion. On the other hand, there is no doubt that a principle on this issue is needed, because the issue can make a big difference to whether and what is derecognised. EFRAG also believes it is logical to apply the tests from the perspective of the reporting entity.

13 Therefore, EFRAG agrees that with the proposal that the derecognition requirements should be applied—and 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.

14 Moreover, while the proposed approach is the same as that required currently by IAS 39, we find that the ED expresses the notion better than existing IAS 39, which seems to assume that the derecognition requirements will be applied only in consolidated financial statements.

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?

Background notes for EFRAG's constituents

15 *Put simply, financial assets are generally bundles of rights to future cash flows. Many transfer transactions involve sub-dividing those rights and transferring some of the rights to one or more counterparties. It is therefore necessary to decide what represents <u>an</u> asset for the purposes of applying the derecognition requirements. Should it, for example, be the whole financial asset held by the transferor? At the other extreme, should any right be treated as an asset for this purpose.*

16 *Paragraph 16A of the proposed approach requires the criteria for derecognition to be applied to part of a financial asset (or a part of a group financial assets) only if that part comprises:*

(a) *specifically identified cash flows, such as principal-only and interest-only strips; or*

(b) *proportionate cash flows from that financial asset, such as 10% of all the cash flows arising from the asset.*

Therefore, if the entity transfers the right to the first €90 of cash flows from an asset, that right will not represent a part of that asset for derecognition purposes (because such a right falls within neither (a) nor (b)). The criteria for derecognition would therefore be applied to the asset in its entirety.

17 *This approach is very similar to the approach in existing IFRS, although slightly different words are used to describe it and some additional guidance has been added.*

18 *An alternative approach would be to allow any right to cash flows to be treated as <u>an</u> asset. Under this approach, the right to the first €90 of cash flows from an asset referred to earlier <u>would</u> represent a part of that asset for derecognition purposes. The criteria for derecognition would therefore be applied to that right only. This is the approach proposed in the Alternative Approach described in the Alternative View section of the ED.*

<u>IASB's reasoning</u>

19 *In paragraphs BC33 and BC34 of the ED, the IASB explains that:*

(a) *financial instruments are made up of contractual rights or contractual obligations that might be financial assets or financial liabilities in their own right,*

(b) *many transfer transactions separate those rights and obligations and then combine them in different ways, usually for a commercial reason, and*

(c) *if financial statements are to give a faithful representation of transactions and events, the derecognition approach (and hence 'the Asset' criteria) adopted needs to reflect the separation and packaging of those rights and obligations.*

20 *The IASB goes on, in BC34, to say that "in its purest form, a part of an asset may be defined as 'the rights and obligations (i.e. assets and liabilities) embedded in that asset'. This would mean that the right to receive any of the cash flows of a financial asset would in itself qualify as an asset that should qualify for derecognition if the derecognition criteria are met". The IASB decided however that defining 'the asset' in that way would have allowed an entity to derecognise a transferred part of an asset even though the part transferred included some of the risks and rewards of the part retained (BC35 of the ED).*

21 *The IASB argues that the approach proposed in the ED also complements the proposals on consolidation because, if the derecognition model were to enable an entity to derecognise assets when it issues disproportionate beneficial interests in them, the requirement to consolidate would be meaningless because there would be no assets in the SPE to consolidate.*

22 *Those IASB members supporting the Alternative Approach ('the Dissenters') argue that the line drawn by the IASB does not have any conceptual basis and is arbitrary. They also argue that, although the IASB claims the approach it is proposing is a control model, it uses the notion of risks and rewards to justify its definition of an asset.*

EFRAG's comments

23 As stated earlier, we would not favour any significant change to the derecognition approach in existing standards unless such change is needed to address a crisis-related issue. And—although we agree with the Dissenters' comment that the proposed approach does not have strong conceptual foundation—we do not think this is an issue that requires an urgent resolution to respond to the financial crisis. Therefore, we favour no significant change being made to the existing requirements at the current time; in other words, we support the approach taken in the ED and we do not support the approach in the Alternative Approach.

24 The ED is also proposing to clarify some application issues that have arsing in practice. We provide our comments on those proposals below.

<u>Proposed changes in the area of the definition of the asset</u>

INTEREST RATE SWAPS

25 We refer to the proposed guidance in paragraph AG41A. The guidance states that, because the swap can be an asset or a liability over its term, if one leg of the swap is transferred, it should not be possible to derecognise that whole swap and recognise instead just the remaining leg. Only if both legs (the receive leg and the pay leg) meet derecognition criteria can the swap be derecognised.

26 We agree that transferring one leg of a swap should not lead to derecognition of that leg and continued recognition of the other leg. However, we are confused by the rationale for this conclusion given in the ED and therefore think it should be clarified.

27 In particular, although the application guidance (paragraph AG41A) seems to argue that the reasoning behind the guidance in paragraph AG41A is that such instruments potentially can be assets or liabilities over their terms, the Basis for Conclusions (paragraph BC36) argues that it is because "the cash flows relating to the asset part of the instrument are likely to be netted with the cash flows relating to the liability part. Accordingly, the 'specifically identified cash flows' from the instrument that would be observable in this case would be net flows, and thus they

would be different from, and less than the cash flows relating to the asset part only." We have several concerns here.

(a) It is confusing for one rationale given in the ED itself and a different one given in the Basis for Conclusions.

(b) There does not seem to be anything in the basic principles set out in paragraph 16A of the ED (which talks about specifically identified cash flows and proportionate shares of the cash flows) that leads to the conclusion that, if an instrument can change from being an asset to being a liability or vice versa, those basic principles should not be applied. Hence, it seems to be a rule. Or maybe it means the principle is not right.

(c) We wonder whether the rationale in the Basis for Conclusions that refers to cash flows that are likely to be netted would have implications for other arrangements that involve netting. For example if Entities A and B owe each other amounts that are subject to a legal right of set off and Entity A transfers its receivables from Entity B to Entity C, we wonder whether the reasoning would have implications for the subsequent accounting.

GROUPS OF FINANCIAL ASSETS

28 We note that when the existing derecognition requirements set out what is an asset in the context of a group of financial assets, they refer to a "group of <u>similar</u> financial assets" [emphasis added]. (See paragraph 16 of the existing standard.) The proposals in the ED, on the other hand, refer only to "a group of financial assets".

29 For example, assume that an entity has debt and equity securities included in a single portfolio and transfers a right to fully proportionate cash flows coming from that portfolio to a third party, under the existing requirements that right would not represent an asset for the purpose of applying derecognition criteria; but, under a strict reading of the ED, it would represent an asset. The Basis for Conclusions makes no reference to this amendment, so we are unsure whether the ED intended there to be a change. This needs to be clarified.

30 Furthermore, although we can understand why a change along these lines might have some appeal—it could be argued that the existing requirements in this area are somewhat simplistic, because mixed portfolios are common—but we are concerned that it would create opportunities to 'structure around' other parts of the derecognition model. Therefore, if it is an intentional change to the existing requirements, we think its implications need to be explored further so it is not a change we support being implemented via this fast-track project.

THE THE PERFORMANCE OF THE PART RETAINED NOT DEPENDING ON THE PERFORMANCE OF THE PART TRANSFERRED

31 Another difference between the existing requirements in this area and the proposals in the ED relates to the words underlined in the below extract from paragraph 16A of the ED:

> 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) <u>(ie the performance of the part retained does not depend on the performance of the part transferred, and vice versa)</u>.

32 We understand that there is some confusion about the meaning of the underlined words. For example, if a financial instrument is split into an interest only strip and principal only strip, the ED clearly intends each strip should qualify as <u>an</u> asset, yet some would argue that the value of an interest only strip <u>is</u> dependent upon the outstanding principal. Perhaps, the reference to the 'performance' rather than 'value' makes a difference here. However, to avoid any confusion, the IASB should be clearer in its reasoning.

<u>A more comprehensive piece of work on this aspect of the derecognition model would be welcome</u>

33 As noted earlier, the existing derecognition requirements are complex and rather rule based. The requirements governing definition of <u>an</u> asset for derecognition purposes requirement are an example of that. Therefore, we would support the IASB to continue its work on developing a robust principle-based approach to the issue.

34 The choice of what can be <u>an</u> item for derecognition analysis is very important because it has a significant effect on how easy or difficult it will be to derecognise assets from the balance sheet and to recognise new assets and what these new assets will be. However, there are significantly different views on the issue. The basis for conclusions in the ED explains that this difference of view goes back to the debate about the unit of account; a subject about which the IFRS literature says little.

35 EFRAG agrees that financial assets are bundles of rights and obligations and that transfer transactions unbundle those rights and obligations and rebundle them in different ways. EFRAG also agrees with much of the criticism levelled at the proposals in the ED (and therefore the existing approach) by the Dissenters. In particular, we agree that the argument advanced in paragraph BC 23 (that, if the alternative approach were adopted, entities would be able to derecognise a transferred part of an asset even though the part transferred included some of the risks and rewards of the part retained) is at best incomplete and perhaps even conceptually flawed, because there is nothing in the Framework or existing IFRS literature that states that an asset's performance cannot be linked to the performance of some other asset. Indeed, that is exactly what a derivative is. In effect, what the IASB is arguing is that there needs to be some sort of notion of separability and, although the Framework's of some standard-setters have suggested that there should be such a notion, it is not mentioned in the IASB's existing Framework.

36 On the other hand, we have significant concerns with the way the Dissenters characterise their approach. These concerns mirror the concerns we had about the requirements in IFRS 3R *Business Combinations* and IAS 27 *Consolidated and Separate Financial Statements* that, when an entity with a controlling interest in a second entity gives up some of its interest and as a result no longer has a controlling interest, the entity shall be deemed to have transferred the whole of its old interest (the controlling interest) and acquiring a new interest (a non-controlling interest). It seems to us that what has actually happened is that a part of the old holding has been transferred and part has been retained.

37 Furthermore, it is important not to lose sight of the fact that financial statements exist to convey information. Financial instruments represent bundles of rights to future cash flows which may have very different risks, and it is important that the derecognition approach used should not allow the resulting balance sheet positions to obscure those risks.

Question 3: Definition of a transfer—Do you agree with the definition of a transfer? If not, why? How would you propose to amend the definition instead, and why?

Background notes for EFRAG's constituents

38 *It is important to understand that, under almost all derecognition literature, a transfer does not necessarily result in derecognition.*[2] *On the other hand, derecognition cannot take place if there has not been a transfer unless the asset has expired or has been lost.*

39 *The existing IAS 39 identifies two ways in which a transfer can be achieved:*

(a) *By passing the contractual rights to receive the cash flows of the financial asset to another party. (We will call this the 'traditional view' of what a transfer entails'.)*

(b) *Through a pass-through arrangement. In other words, by retaining the contractual rights and assuming an obligation to pass on the cash flows of the financial asset under an arrangement that meets certain additional criteria. For example, a transferor that is a trust or SPE may issue beneficial interests in the underlying financial assets to investors but continue to own those financial assets. All the following conditions have to be met to conclude that such an arrangement meets the criteria for a transfer:*

(i) *The transferor has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset ('not a penny more, not a penny less').*

(ii) *The transferor has an obligation to remit any cash flows that it collects on behalf of the eventual recipients without material delay. In addition, the entity is not entitled to reinvest such cash flows, except in cash or cash equivalents during the short settlement period from the collection date to the date of required remittance to the eventual recipients, with any interest earned on such investments being passed to the eventual recipients ('no delay').*

(iii) *The transferor is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.*

We will call this type of transfer a 'pass-through transfer'.

40 *The proposal in the ED is that 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. That includes all forms of sale, assignment, provision of collateral, sacrifice of benefits, distribution and other exchange.*

41 *Paragraphs AG44A and 45A contain the following examples:*

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

[2] On the other hand, the term 'transfer'' is often used differently elsewhere. For example, the IASB's Revenue Recognition DP treats 'transfer' as synonymous with derecognition.

funds. In that case, the entity shall assess for derecognition the loan as a transfer of the securing financial asset.

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).

42 *The Alternative View applies a similar notion of transfer as the approach the ED is proposing.*

EFRAG's comments

43 The IASB explains in the Basis for Conclusions that the proposed definition is broader than the existing definition and will ensure that all transactions that are economically transfers of financial assets should be assessed for derecognition and that, irrespective of their form, qualifying transactions will be assessed for derecognition. While EFRAG supports any attempt to ensure that IFRS focuses more consistently on the substance of transactions rather than their form, we are not aware of any suggestion that the existing definition is the cause of any crisis-related weaknesses.

44 We are also not convinced that the proposed definition achieves the stated objective satisfactorily:

(a) We are not convinced that this proposed amendment will simplify the derecognition requirements and make them easier to apply.

(b) Moreover, broadening the definition of a transfer in the current economic situations does not seem to be the right thing to do in particular due to concerns about lack of information about off balance sheet risks that are considered as one of the underlying causes of the current financial crisis. In particular:

(i) it seems that many more transactions will be treated as involving a transfer. Of course, this does not mean that "many more" assets will be derecognised, but it seems likely to involve at least some additional items being derecognised.

(ii) although the proposed change will simplify the definition of a transfer, more emphasis will be placed on the derecognition tests. The question then becomes whether the derecognition tests can deal satisfactorily with the complexities and produce outcomes that adequately capture the economics of the transaction without creating other complexities. (These issues are the subject of the questions that follow.)

45 Furthermore, we do not think it is clear how the proposed definition of a transfer should be applied in certain situations. In particular:

(a) Our understanding is the phrase "when one party passes, or agrees to pass, to another party some or all of the economic benefits underlying one or more of its asset" was included in the proposed new definition of a transfer to ensure the definition encompasses arrangements that involve an entity agreeing with another party to pass to that party all the flows the entity receives from a specified asset. However, the wording seems also to describe the situation in which an entity holding a debt instrument enters into agreement with a third party to transfer cash receipts from that debt instrument in a year from now. Under the existing pass-through transfer arrangements, the entity is required to pass on the flows received "without material delay". It would appear acceptable now for the entity to hold the flows for an extended period of time before passing them on. This means that the entity's credit risk is an important factor for the party that is the eventual recipient of the flows, and in effect means that, from the entity's perspective, the obligations taken on will not offset the rights to the same degree as under the pass-through transfer provisions. We think these two arrangements are very different in nature and it is not clear to us whether the intention is that both should be treated as transfers under the proposed new definition.

(b) Paragraphs AG44A, AG45A and AG52L contain guidance on how to apply the definition of a transfer. We think this guidance establishes some further criteria for what qualifies as a transfer and what does not. For instance, the wording in the example in paragraph AG52L(f) establishes a criteria that the transferee should be obliged to hold the asset for the arrangement to qualify as a transfer. However, it is not clear how this follows from the proposed definition of transfer. It is also confusing to establish criteria for determining whether something is a transfer in the application guidance through some examples. For example, it is not clear whether those criteria should be applied to other cases that are not addressed in the application guidance.

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?

Background notes for EFRAG's constituents

46 *Under the existing requirements, having established that a transfer of an asset has taken place:*

(a) *the next step is to ask whether the transferor has transferred substantially all the risks and rewards of ownership of that transferred asset (in which case the asset should be derecognised) or whether the transferor has retained substantially all the risks and rewards of ownership of that transferred asset (in which case the transferred asset continues to be recognised and the transaction is treated as a loan);*

(b) *if the answer to both those questions is 'no', the next step is to ask whether the transferor has retained control of the transferred asset. If it has not retained control, the transferred asset is derecognised.*

(c) *If it has retained control, the transferor shall continue to recognise the asset to the extent of its continuing involvement.*

47 *The proposal is that the risks and rewards tests described in (a) should be replaced by a continuing involvement test that means that; if the transferor has no continuing involvement in the transferred asset, it shall derecognise the asset. (We will discuss changes to (b) and (c) in subsequent questions.)*

48 *In other words, although a continuing involvement notion plays a role in the existing derecognition model, that role is fundamentally different from the one it plays in the proposals.*

(a) *Under the existing requirements, the purpose of the test is to determine what part of the asset the entity should continue to recognise in a transfer that has involved some but not all of the risks and rewards inherent in ownership of the transferred asset being transferred but the transferor retaining control of the asset.*

For example, an entity sells a CU 10,000,000 portfolio of receivables to a factor where the average expected losses are 5% and the seller guarantees the first 4% of losses. If the analysis shows that the transfer neither transferred not retained substantially all the risks and rewards of ownership but retained control over the receivables, the continuing involvement test applies and in this case it would result in the transferor recognising an asset of CU 400,000, as that is the maximum amount the entity could be required to repay. The associated liability is measured at that maximum amount plus the fair value of the guarantee (for example, if the fair value of guarantee is C50,000, the liability is C450,000).

(b) *The objective of the continuing involvement test in the proposed model is, we understand, to capture those transfers where it is clear—without the need for further analysis—that the transferor no longer controls transferred assets. If an entity transfers an asset and has no interest whatsoever in the asset's subsequent performance or value (ie no continuing involvement), the transfer is an unconditional, no strings attached sale —and such sales should result in derecognition. The IASB thinks the result is that it will be possible to reach conclusions about many simple types of transaction without needing to apply the more complex practical ability to transfer test.*

49 *The ED is also proposing that the way a continuing involvement is described should also change (compared to the existing test). In existing IAS 39, a transferor's continuing involvement in a transferred asset "is the extent to which it is exposed to changes in the value of the transferred asset". Under the proposals in the ED, a continuing involvement shall involve retaining contractual rights and/or obligations inherent in the asset and/or obtaining new contractual rights and obligations relating to the asset. However, it is proposed that three types of involvement shall be excluded from the continuing involvement definition:*

(a) *normal representations and guarantees;*

(b) *the retention of the right to service the asset in a fiduciary or agency relationship; and*

(c) *a derivative contract associated with reacquiring the asset for which the exercise price is the fair value of the asset.*

50 *The alternative approach does not have a continuing involvement test.*

EFRAG's comments

51 EFRAG has significant reservations about these proposals. We explain those reservations in the paragraphs below.

52 The objective of the continuing involvement test in the proposed model is broadly similar to the objective behind the risk and rewards tests in the existing model. However:

(a) the IASB is proposing to eliminate completely the part of the test that says that, if the transferor has <u>retained</u> substantially all the risks and rewards of ownership of the transferred asset, it shall continue to recognise that asset (and shall treat the transaction as a loan); and

(b) the IASB is proposing to replace the part of the existing model that says that, if the transferor has transferred substantially all the risks and rewards of ownership of the transferred asset, it shall derecognise the asset with a requirement that, if the transferor has no continuing involvement in the transferred asset (in other words, has no interest at all in its future performance), it shall derecognise the asset.

Eliminating the 'substantially all the risks and rewards retained' test

53 The proposed elimination of the 'substantially all the risks and rewards retained' test that is in the existing model could have a fundamental impact on existing accounting. Currently, it is often argued that, if the transferor has retained substantially all the risks and rewards of ownership of the transferred asset, the transfer has changed nothing of substance, so there should be no substantial change in the way it accounts for the transferred asset. However, the ED in effect says that it is wrong to assume that retaining substantially all the risks and rewards of ownership of the transferred asset means that there should be no substantial change in the way the transferred asset is accounted for.

54 There is another way of putting this same issue. Some would argue that the existing model assumes that, if a transferor retains substantially all the risks and rewards of ownership of a transferred asset, it will—by one means or another—still have control of the transferred asset (because an entity will not expose itself to risk of this kind without being able to manage it). The proposed approach puts this assumption to the test; if having substantially all the risks and rewards of ownership goes hand-in-hand with controlling the asset, then omitting the risks and rewards test and relying exclusively on a control test should not make any difference to the outcome. There are two problems with this argument.

(a) The argument that relying exclusively on a control test should not make any difference to the outcome is crucially dependant on the test of control that is being used being a very good test of control. And, as can be seen from our response to question 5, we are not convinced by the test of control the ED proposes.

(b) It is questionable whether it is right to say that an entity will not expose itself to substantially all the risks and rewards inherent in the ownership of a financial asset unless it controls that asset. Business involves taking risks and, involve it is to be hoped that those risks are commensurate with the returns expected and are managed appropriately, that is not the same as saying that entities only bear risks that they can control.

55 Whatever the correct way of looking at this issue, its implications can be illustrated by considering the case of a simple sale-and-repurchase contract.

Entity A owns a listed —and very actively traded—debt instrument with a market price of €100. It enters into an arrangement with Entity B whereby Entity A will transfer the instrument to Entity B is exchange for €100 and 90 days later Entity B will return the instrument to Entity A in return for a payment of €102 (which has a present value of €100). All distributions from the instrument during those 90 days will be collected by Entity B and passed immediately to Entity A.

Although Entity A has transferred the debt instrument to Entity B, it has retained substantially all the risks and rewards of ownership. Therefore, under the existing model it would continue to recognise the debt instrument and would also recognise cash of €100 and a liability of €100. The additional €2 paid will be treated as interest.

Under the proposed model—and the definition of control that will be discussed in the next question—Entity A will be treated as having sold the debt instrument. It will therefore recognise the cash of €100 and a forward.

56 EFRAG does not agree with the proposal that repos of the type described in the preceding paragraph should be treated as sales rather than secured loans.

57 So, this change would have a fundamental impact on existing accounting. However, it does not appear to be addressing a crisis-related weakness identified in the existing derecognition model. Indeed, we understand that many believe that during the crisis the risks and rewards tests in existing IAS 39 have been a source of strength, not weakness. Therefore, we think this is too significant a change to make to the existing model through a fast-track project. Instead, we would encourage the IASB to explore in a more comprehensive manner the role that risks and rewards should have in financial reporting before reaching conclusions on the matter.

<u>Replacing the 'substantially all the risks and rewards have been transferred' test with the continuing involvement test</u>

58 While the 'substantially all the risks and rewards have been transferred' test and the continuing involvement test are in some ways similar, the proposed new test is perhaps tougher than the existing test (because the transferor might have a continuing involvement even if it has transferred substantially all the risks and rewards). As such, we do not have strong objections to this change being made if the IASB thinks it will improve the model. However, it again does not seem to us to be addressing a crisis-related issue and the proposed change is tied up with the whole question of what if any role risks and rewards should have in the derecognition model; a question that we have already said is best tackled in a project that allows more time for comprehensive debate about the fundamental differences of view underlying the different derecognition models.

<u>The meaning of 'a continuing involvement'</u>

59 Both the existing and proposed new descriptions of a 'continuing involvement' cover both the potential exposures that the transferor has retained and any new exposures acquired. However, we are aware that practitioners have encountered quite a lot of implementation issues trying to apply the notion in the existing model and, now that the proposal is that the notion will have a much more central role to play, it seems certain that those issues will become significantly more troublesome. We are concerned that, unless additional material is provided that draws out the key attributes in the context of some of the complex arrangements that can be seen, the inclusion of the continuing involvement test at the centre of the proposed new model could result in considerable diversity in practice. We think that would be very unfortunate at a time when users are looking to develop a better understanding of what is on- and off-balance sheet and why.

<u>Types of involvement excluded from the continuing involvement definition</u>

60 The ED proposes three types of continuing involvement that should be excluded from the continuing involvement definition. They are:

(a) normal representations and guarantees;

(b) the retention of the right to service the asset in a fiduciary or agency relationship; and

(c) a derivative contract associated with reacquiring the asset for which the exercise price is the fair value of the asset.

61 The IASB explains in paragraph BC 41 that some types of involvement in transferred financial assets after the transfer are commonplace and consistent with the ED's 'control of an asset's economic benefits' principle. Therefore, the IASB decided to exclude them from the 'continuing involvement' definition (even though technically they would meet that definition).

62 Our understanding is that the continuing involvement test is intended to be a short-cut; it is designed to save the transferor from having to apply the whole of the derecognition model to reach a conclusion that is obvious from the outset—which is that the transferred asset should be derecognised. In other words, if the continuing involvement test were deleted, the outcome should still be the same. Therefore, the easiest way to test the appropriateness of the exclusions is to consider whether that would indeed be the case. If it would, the exclusions are appropriate; and if it would not, they are not appropriate—or the control test in the ED is in need of some refinement. Yet:

(a) according to paragraph BC42, "the consequence of not providing an exception for normal representations and warranties could have been that many transfers would not have qualified for derecognition (because they might have failed the subsequent 'practical ability to transfer' test), even though the only involvement a transferor would have after the transfer would be those representations and warranties." In other words, the outcome would not have been the same in all cases regardless of whether the continuing involvement test was applied.

(b) similarly, on fiduciary (or agency) servicing, paragraph BC43 states that "if the Board had not made such an exception, many transfers of financial assets to securitisation vehicles would have failed derecognition (because those vehicles are often prohibited from selling the assets or are required to remit the cash flows generated by the assets to the investors in the vehicles, and thus the transfers would not have met the 'practical ability to transfer' test), even though the only role of the transferor after the transfer would be that of an agent that acts on behalf of the vehicles or the investors in the vehicles." In other words, again the outcome would have been different.

(c) if the transferor's only continuing involvement was in the form of, say, a forward repurchase agreement with an exercise equal to the fair value of the transferred asset:

(i) under the continuing involvement test, the transferred asset would be treated as sold and therefore derecognised.

(ii) under the control test proposed in the ED, the existence of the forward would mean that the transferred asset would not be derecognised by the transferor if it is not easily replaceable. The exercise price of the repurchase agreement is completely irrelevant for this purpose.

Thus again the outcome is different.

63 EFRAG concludes from this that something is wrong with the proposed model.

(a) One possibility is that the continuing involvement test is not a short-cut that saves the transferor from having to apply the whole of the derecognition model to reach a conclusion that is obvious from the outset. And, if is the case, the only argument advanced in the ED for having a continuing involvement test is incorrect.

(b) Another possibility is that there is something wrong with the control test proposed in the ED. We will discuss that test under question 5.

(c) Another possibility is that the exemptions are not appropriate and should be omitted from the model.

64 We have two further concerns about the proposed exclusions. The first relates to the reasoning given in the ED for the exemption for forwards, options and contracts associated with reacquiring the transferred asset for which the contract (or exercise) price is the fair value of the transferred asset.

> BC45 The Board concluded that even though a fair value forward or option that a transferor obtains in connection with a transfer of a previously recognised financial asset is a new right relating to the asset transferred and thus would be continuing involvement in accordance with the proposed definition, the transferor in repurchasing the asset under the forward or option is in the same economic position as a third party that purchases the asset from the transferee. As a result, the transferee is able to obtain the full economic benefits of the asset (albeit from the transferor and not a third party), thus meeting the Board's derecognition principle.

As the IASB itself acknowledges, there are many circumstances under both the existing model and the proposed new model where two entities could be in exactly the same economic position but still account for that position differently. Bearing that in mind, it is not clear why the circumstance in described in paragraph BC45 is so objectionable whilst the other circumstances are deemed to be things we can live with, at least for now.

65 Finally, the ED does not seem to discuss whether the proposed list of exemptions is complete, nor whether the exemptions might have some unintended consequences. We have, for example, be wondering whether the exclusion for fair value forwards, options and contracts associated with reacquiring the transferred asset would include contractual credit notes for volume discounts. We have also been wondering how important it is that the exercise price is fair value. For example, we think economically the position would be virtually the same if the repurchase was required to take place at fair value minus a certain fixed amount. These are all issues that need to be further explored if the exclusions are to be retained.

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?

Background notes for EFRAG's constituents

66 *Paragraph 17A(c) proposes that a financial asset shall be derecognised if it has been transferred and, although the transferor still has some form of continuing involvement, the transferee has 'the practical ability to transfer the asset for the transferee's own benefit'. The thinking here is that:*

(a) *whether the transferor has given up control of an asset can be determined by asking whether the transferee now has control of the transferred asset;*

(b) *if a transferee is free and able to do what it likes with a transferred asset, it controls that asset;*

(c) *the main way by which an entity can obtain the economic benefits from a financial asset, the ED argues, is via a transfer of that asset in exchange for other assets, in settlement of a liability or as a distribution to the entity's owners. As a result, an ability to transfer an asset is equivalent to the 'free and able to do what it likes with the asset' test;*

(d) *the words 'practical ability' are needed because, although there can be contractual terms specifying that the asset cannot be sold, if those terms have no effect in practice they should not have an accounting effect either.*

(i) *So, when the transferee has the obligation to return the asset to the transferor (for example through a forward or an option contract), it will be necessary to consider what effect this obligation has on the transferor in practice. For example, if the asset is one of many identical assets that are actively traded, the obligation will generally have little effect because the actual asset currently being held by the transferee is easily replaced. In such circumstances, the obligation does not prevent the transferee from having the practical ability to transfer the asset for the transferee's own benefit.*

(ii) *On the other hand, if the transferred financial assets are not readily available in the market place the transferee does not have the practical ability to transfer the asset (because it may risk to default under its obligation to return the asset if it transferred it, but cannot find it again in the market place).*

The ED defines readily available financial assets as assets that are actively traded on an accessible market if the transferor requires it to be returned.

67 *As the question makes clear, the practical ability to transfer test proposed in the ED is identical to the one in existing IAS 39 except that a reference to the transfer being 'for the transferee's own benefit' has been added. The effect of these words is that that the transferee needs to be able to keep the proceeds from the transfer of the asset for itself. For example, if the transferee has an obligation to pass the consideration received on the transferred asset from the third party to the transferor, it will not have the practical ability to transfer the asset 'for its own benefit'.*

EFRAG's comments

68 EFRAG believes that the 'practical ability to transfer for own benefit' test is flawed as a test of control. We think that this is true for the existing model too. However, the test does not play a central role in the existing approach; under the proposals in

the ED, it <u>would</u> play a central role. We think this greater role will amplify its inadequacy. We explain below why we believe this is the case.

69 First of all, it is worth reminding ourselves that, under the proposals in the ED, the practical ability to transfer test would be applied only when there has been a transfer but the transferor continues to have some sort of continuing involvement in the transferred asset. The ED mentions that users usually seem to support an approach that would not permit derecognition of a part of the financial asset when the transferor retains substantial risks of ownership of the underlying asset. Indeed, in such circumstances net cash flows and the underlying gross exposures could involve fundamentally different risks. In our view this raises some fundamental questions, including:

(a) on which risks should the balance sheet focus in order to provide the most useful information about those risks and the entity's financial position generally?

(b) when and whether some contracts and investments should be recognised on a gross basis instead of on a net position?

70 Unfortunately, the ED does not discuss these issues. Indeed, it argues (in paragraph BC76) that the issue described in (b) is outside the scope of the derecognition project. (This illustrates why we believe major changes to the existing derecognition requirements should not be made at this time; because key issues central to the subject have not been considered.)

71 Instead, the proposals in the ED focus on determining who controls the asset and they build the control test around the following parameters:

(a) It is necessary to determine whether the transferee controls the asset because if it does the transferor could no longer control the asset;

(b) The transferee controls the asset only if it has a practical ability to transfer the asset for its own benefit;

(c) The fact that the transferred asset is actively traded in the market would in many cases mean that the transferee has a practical ability to transfer the asset for its own benefit irrespective of the transferee's involvement in the asset.

72 We consider each of these in turn below.

<u>It is necessary to determine whether the transferee controls the asset</u>

73 The IASB has concluded that, because derecognition is assessed after a transfer has taken place, it is reasonable to determine whether the transferor has given up control of the transferred asset by considering the transferee's position. If the transferee has control, the transferor will not have it; and if the transferee does not have control, the transferor must still have it. The ED therefore proposes that, in order to determine whether the transferor should derecognise a transferred asset in which it still has a continuing involvement, the transferor shall determine whether the transferee has obtained control of the economic benefits of the transferred asset.

74 We understand the logic behind the proposal in this part of the ED—and note that it is identical to the approach adopted in the existing requirements. However, we nevertheless have a number of concerns about the approach.

(a) The question we are trying to answer is whether the transferor still has control of the asset and in theory it should not matter whether we answer that question by focusing on the position of the transferor or the position of the transferee. Indeed, in theory the ED should suggest that entities focus on whichever position is clearer. However, we are concerned that the practical ability test proposed in the ED would not produce the same results were it applied to the two parties.

(b) We think that asking the transferor to focus on the position of the transferee might not be as simple as it seems. For example, we wonder whether it is reasonable to expect the transferor to know enough about the transferee in all cases to be able to judge whether it has the practical ability to transfer the asset for its own benefit. And, if it is concluded that initially the transferee does not have that ability but the transferee subsequently gets itself into the position where it does have that ability, is it reasonable to expect the transferor to be aware of that. For example, if an entity transfers an asset but at the same time enters into a forward to buy it back, that entity is not bothered whether the transferee has the practical ability to transfer the asset to a third party—all the entity needs to know is that it will be getting the asset back in due course.

<u>The transferee controls the asset only if it has a practical ability to transfer the asset for its own benefit</u>

75 Under the proposals in the ED—and in the existing IAS 39—the transferee having control of the transferred asset is equated with it having the practical ability to transfer the transferred asset for its own benefit. In our view, this is too simplistic a test. We think the problem lies in the ED's argument that the main way by which an entity obtains the economic benefits from a financial asset is via a transfer of that asset in exchange for other assets, in settlement of a liability or as a distribution to the entity's owners. In fact, transferring the asset in one of those ways is only one way of obtaining the economic benefits from a financial asset. Another way is to hold the asset and collect the flows from it. It is not uncommon for an entity to hold an asset that, for various reasons related either to the asset or to the entity's circumstances, it is not able to sell. Yet, we do not usually account for that asset as if the holder does not control it, so it is not clear why we make an exception here. In other words, although an entity that is 'free and able to do what it likes' with an asset almost certainly controls that asset, an entity that is not so free and able might still control the asset; controlling the economic benefits that would arise if an asset is sold is not the same as controlling the economic benefits inherent in the asset.

76 Similarly, the approach makes the mistake of assuming that, if the transferee does not have the practical ability to transfer the asset, it follows that a key aspect of the asset has not been transferred to the transferee. Yet the reason why the transferee cannot transfer the asset might not have anything to do with the transferred asset. For example, the transferee might be a SPE whose bylaws preclude it from transferring the loans it holds. We would not have thought that such a restriction would mean that the transferor still controls the transferred assets.

77 Bearing this in mind, we wonder whether there is a better test of control than this practical ability to transfer test. We note for example that the IASB considered a test that would focus on the transferor's exposure to the risks and rewards of the

transferred asset, but rejected such a test on the grounds of complexity and implementation difficulty. We have said before that we think that such problems are overstated and that, if as much time was invested in developing the risks and rewards notion as is invested in developing the control notion, it might be possible to overcome those problems. Of course, there is the wider issue of whether risks and rewards should play a role in determining who controls the asset.

<u>Emphasis on the notion of 'actively traded in the market'</u>

78 An implication of the proposed approach's use of the practical ability to transfer test is that the continuing involvement of the transferor in the transferred asset will in many cases have no impact on the accounting treatment of that asset if, although the transferor requires the asset to be returned, the transferred asset is a readily available asset—in other words, is actively traded on a market that is accessible by the transferee. On the other hand, if the transferred asset in which the transferor requires to be returned is not readily available, the transferee will not be able to freely transfer the asset, and thus the transfer will not result in derecognition.

79 The existing derecognition model uses a similar practical ability to transfer test, but only requires it to be applied where the transferor neither has retained nor transferred substantially all risks and rewards from the transferred financial asset. As a result of this difference, many transfers of readily available financial assets that would not be derecognised under the existing model (because they fail the risks and rewards test) would qualify for derecognition under the proposed model. For example:

(a) a sale and repurchase transaction where the repurchase price is a fixed price or the sale price plus a lender's return (for example, a repo or securities lending agreement);

(b) a sale of a financial asset together with a total return swap that transfers the market risk exposure back to the entity; and

(c) a sale of a financial asset together with a deep in-the-money put or call option (that is, an option that is so far in the money that it is highly unlikely to go out of the money before expiry).

80 On the other hand, transfers of financial assets that are not actively traded would not result in derecognition some cases where under the proposed model derecognition would be possible. For example, under the existing model it is possible to fully derecognise (if substantially all risks and rewards are transferred) or partially derecognise (ie recognise only to the extent of the continuing involvement) receivables that are sold by an entity to a factorer (eg a bank) with the entity remaining involved in the transferred assets in some way (eg by subordinating some of its interest retained in a transferred asset, providing a guarantee of late-payment risk or providing a guarantee of reimbursement for credit losses above a certain level). Our understanding is that under the proposed model, derecognition will most likely not be possible.

81 The ED further proposes that if the market for asset becomes active subsequently, the asset should be derecognised at that point in time. However, if the market becomes less active later on the asset is not re-recognised.

82 The emphasis on the notion of "actively traded" raises a number of questions and concerns:

(a) What does 'actively' traded actually mean? Would defining the notion of readily obtainable in terms of actively traded in an accessible market preclude derecognition for Level 2 assets, if the transferor requires them to be returned? In fact there is a continuum between highly active markets and highly inactive markets and hence a continuum of economic disincentive to buy them with a short notice. Moreover, what matters is not the level of activity of the market (for which there is some guidance, in particular the concepts behind the 3 categories of inputs in IFRS 7), but the importance of the disincentive that gives rise to a practical inability to transfer. The ED proposes no guidance as to how high the disincentive should be in order to create a 'practical inability'.

(b) In the example in paragraph AG52L(c), when the transferor provides credit enhancement through retaining a subordinated interest in the asset it is considered that the transferee does not have the practical ability to transfer the asset irrespective of whether the transferred asset is readily obtainable or not. On the other hand, in the situation described in paragraph AG52L(e) where the transferor provides a credit enhancement by way of a guarantee, whether the asset is readily obtainable or not makes a difference in determining whether the transferee has a practical ability to transfer the asset. We question whether the difference in the accounting treatment in these two examples is justified.

(c) We are very concerned about the implications of active markets appearing or disappearing, particularly as we think it will be very difficult to persuade users that the derecognition model is correct if, in times of crisis, certain assets disappear from some statements of financial position as a result of changes in market activity.

<u>The purpose of the balance sheet</u>

83 As mentioned above, the ED acknowledges that there is an important issue to resolve concerning the purpose of the balance sheet. The ED also links that to the unit of account issue, but then concludes that the issues are outside the scope of this project. We believe however that this is a fundamental question in the derecognition debate and, unless and until the question is answered, it is unwise to make major changes to the derecognition model, particularly if those changes are being made in a hurry.

84 The ED justifies its approach by arguing that the ED has to draw a line somewhere and it does so by requiring gross presentation of underlying assets and liabilities, thus focusing on leverage and risks in those cases where the transferee does not have full flexibility as to how to use the asset.

> BC79 The Board believes the proposed approach faithfully represents the position of an entity by clearly depicting an entity's leverage and risk relating to that leverage in the statement of financial position. Indeed, if an entity transferred a part of a financial asset and retained the most subordinated interest in it, it would have a leveraged position in the underlying asset. The proposed approach would not obscure that leverage by showing only the net position in the statement of financial position.

85 However, entities will be required to disclose the "opposite" information in the notes: for transfers that qualify for derecognition they will be required to disclose

information about the risks the transferor continues to be exposed to and for transfers that fail derecognition they will be required to disclose information about the relationship between the assets and the associated liabilities.

86 The Dissenters argue that the proposed derecognition model will result in recognising assets and liabilities that do not meet the definitions of those elements in the Framework.

(a) EFRAG thinks that in fact there will rarely be any disagreement that the obligation to make payments exists; the issue is whose obligation is it and, in the context of derecognition, that often becomes two questions: out of which asset will those cash outflows be paid, and whose is that asset. If the asset is the transferor's, then the liability is the transferor's too.

(b) The issue of whether things that are not assets are being recognised as assets seems even more complex. Some stakeholders argue that any test based on risk and rewards (and it could be argued that the continuing involvement test is an example of that) will cause inconsistencies with the Framework, because the Framework definition of an asset makes no reference to risks and rewards. However, others argue that the use of a risks and rewards test in combination with other criteria is merely trying to ensure that a sufficiently sophisticated view of control is applied—and thus it is consistent with the Framework and only things that are assets are being recognised as assets.

87 The Dissenters also argue that the order in which the transactions are carried out matters under the proposed model.

For example, if an entity acquired a subordinated position in the market place it would recognise only a net position. Similarly, if an entity has written a guarantee on receivables that it did not previously own, it will recognise the guarantee but not the receivables on its balance sheet. However, if the entity first owned the underlying financial assets, it will continue to recognise them.

This is referred to as 'stickiness' (or as 'history matters').

88 We believe that in order to resolve the above concerns satisfactorily one has to consider what the purpose of the balance sheet is. Yet, neither the ED's proposals nor the alternative view do that.

89 Furthermore, it is hard to see how the proposed approach would satisfy users needs if, as the ED states, users prefer an approach that would not permit derecognition of a part of the financial asset when the transferor retains substantial risks of ownership of the underlying asset:

(a) For example, where the transferor retains substantially all risks and rewards of ownership of the transferred asset but nevertheless derecognises that asset because the asset is actively traded, the risks of the net position recognised in the balance sheet will be fundamentally different to the risks of the underlying gross exposures. It is not clear why the needs of users would be better served by the balance sheet focusing on the net positions.

(b) On the other hand, in some factoring transactions where the transferor transfers the most risks and rewards of ownership of the underlying contractual rights and obligations but the asset is precluded from derecognition because the asset is not actively traded, the ED requires gross presentation of underlying assets and liabilities. Again, it is not clear—if the focus of the users is on the risks of ownership—how the proposed approach would satisfy these needs.

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.)

Background notes for EFRAG's constituents

90 *Assume for a moment that an entity has a particular financial asset and, by applying the definition of an asset in the ED and the proposed derecognition model, it concludes that it should derecognise part of that asset and continue to recognise part. Under the proposed model, that retained interest is treated simply as part of the old asset and measured on the basis it was measured on prior to the derecognition event.*

91 *Assume an entity transfers an entire financial asset or a group of financial assets to another entity in a transfer that qualifies for derecognition and, as part of the transfer, purchases an interest in that entity (which gives it the right to some of the cash flows from that asset or group of assets). Under the proposals in the ED, it shall treat that interest as a retained part of the asset or group of assets previously recognised. If the transferee has other financial assets or liabilities in addition to those received from the transferring entity, in accordance with paragraph 22A of the ED the transferring entity shall split the interest purchased between:*

(a) *an interest in the previously recognised asset or group of assets, and*

(b) *an interest in new assets or new liabilities.*

EFRAG's comments

92 It seems logical in many ways that the retained part (which would be either specifically identified cash flows or proportionate cash flows of the original financial asset) should be measured on the same basis as immediately prior to the derecognition event.

93 However, we think in some cases it is possible for an entity holding a non-derivative financial asset or financial liability to transfer a part of that asset or liability and, as a consequence, be left with what is in effect a instrument with an embedded derivative. If that is correct, this proposal might enable entities to carry such derivatives at cost. An example is when the entity separates an instrument into the interest-only strip and the principal-only strip and retains one of them, because the performance of the retained element will to some extent be dependent on the transferred element. To address this problem, we think that it might be necessary to stipulate that reassessment under IFRIC 9 *Reassessment of Embedded Derivatives*

would need to be triggered if the entity derecognises a part of the "old" asset and retains on its balance sheet what is considered to be a part of an "old" asset.

94 The only part of the proposal that is new is the guidance in paragraph 22A concerning an interest in a financial asset or group of financial assets that is retained indirectly through an entity. The Dissenters argue that the guidance might not be operational because the transferor may not have access to the information about all the assets and liabilities in the transferee. We share those concerns. We do not think that this affects the conclusion that the retained part should be treated as part of the "old" asset. However, for situations where the required split in paragraph 22A is impracticable, we think an exception needs to be granted, supplemented perhaps by the disclosure of that fact.

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?

EFRAG's comments

95 There are in effect four options on the table: the proposed approach, the Alternative Approach, the existing approach, or some other (so far unspecified approach).

96 As stated in Appendix 1, while we are happy to consider the Alternative Approach as a possible longer-term solution, in our view the changes it makes go far beyond what is necessary to address the crisis-related issues that have arisen over the last couple of years and, in our view, it would not be appropriate to make such changes without a more comprehensive consideration of the issues, more extensive field-testing of the possible implications, and more thorough due process. We are also concerned that, at a time when we are hearing complaints from users about them not being sufficiently aware of the type or extent of the risks to which entities are exposed, the alternative approach would result in much more derecognition than at present. Whatever the technical merits of such an approach, we are not sure such a change is appropriate in the current economic climate.

97 As will be apparent from our responses to the preceding questions, we also have a number of significant reservations about the approach proposed in the ED.

(a) The proposed new definition of a transfer concerns us and the proposal that the existing risks and rewards tests should be replaced by the continuing involvement test concerns us greatly.

(b) We think that testing for control by focusing on the transferee's practical ability to transfer the transferred asset is a flawed approach. While those flaws exist in the existing requirements, making the test play central role in the derecognition model will amplify its shortcomings.

As a result, we would not favour the IASB implementing the model proposed in the ED either.

98 Our preferred approach would be for the existing model to be largely retained, albeit with some incremental improvements identified as a result of the work on this ED. For example:

(a) We found the way the ED presented the issue about the level at which the derecognition assessments should be made (the reporting entity level) clearer than existing IFRS, so we would encourage the IASB to incorporate this material into the existing model.

(b) Furthermore, although we have raised some concerns about the proposed guidance in the ED on determining what is an asset where interest rate swaps are involved, we think that it would be worth sorting this guidance out and introducing it into existing model.

(c) We would add to the existing standard the material in paragraph 22A of the ED, with an additional provision that, where meeting such a requirement is not practically possible, an exception can be applied.

In our view, these changes would clarify some of the aspects of the existing model where there has been some uncertainty, which is likely to reduce the diversity in current practice and this create greater confidence in the accounting information being provided.

99 We also think the disclosures in existing IFRS are in need of improvement in order to meet the needs of users especially in the current economic environment. Disclosure is discussed in more detail later in this letter.

100 Furthermore, as we said at the beginning of this letter, we do share the concerns that the IASB has raised about the weaknesses of the existing model and would therefore encourage work to continue on finding a better model. In our view it will only be by thoroughly exploring some of the fundamental issues underlying the derecognition debate that we will find the way forward to a high-quality global standard on the subject. The Alternative Approach might be a good starting point for that. However, that approach would need to be developed in light of resolving the issues of the unit of account and the purpose of 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?

Background notes for EFRAG's constituents

101 *The Basis for Conclusions in the ED explains:*

BC28 IASB The proposed derecognition approach for financial assets is similar to the approach proposed by the Board in the recently published exposure draft ED 10 Consolidated Financial Statements (albeit derecognition is applied at the level of assets and liabilities, whereas consolidation is assessed at the entity level). ED 10 focuses on control of an entity and defines 'control' as follows: 'A reporting entity controls another entity when the reporting entity has the power to direct the activities of that other entity to generate returns for the reporting entity.'

BC29 The Board's proposed approach to derecognition of financial assets and its underlying principle is also based on control. 'Control' in the context of financial assets is (a) the ability to obtain (access) the underlying future economic benefits and (b) the ability to restrict others' access to those benefits (ie the ability to access the benefits for one's own benefit). Thus parts (a) and (b) in the control definition in this exposure draft are similar to the 'power to direct activities of another entity to generate returns' and 'for the reporting entity' parts, respectively, in the control definition in ED 10.

EFRAG's comments

102 EFRAG is aware that, over the years, there has been much discussion about how important it is that the consolidation and derecognition models adopt broadly the same approach.

(a) Some stakeholders argue that they are separate issues and therefore can be debated and concluded upon separately. Others argue that the tests should be as similar as possible.

(b) However, although control is currently the basis of the IASB's consolidation model and also the IASB's asset definition, the IASB is working on a new asset definition that makes no reference to control. So, even if similar notions underpin consolidation and the asset definition at the moment, that will soon not be the case. That suggests to us that it might not be very important for the approaches to be broadly similar.

103 It has been suggested to us that another aspect of this issue that is perhaps important is that it should not be easier to derecognise an asset by transferring it to a one asset structured entity than to any other counterparty. However, we do not think that would be the case because neither the existing IFRS derecognition requirements nor those proposed in the ED (nor indeed those set out in the Alternative Approach) require different rules to be applied depending on the identity of the counterparty.

104 So, we are not convinced that it is particularly important that the consolidation model and derecognition need to be similar. We are, for example, very comfortable with the idea that an entity might transfer a financial asset to a second entity and, in the separate financial statements of the transferor, the result might be that the transferred asset is derecognised; whilst, because the second entity is a group entity, in the consolidated financial statements of the transferor, the transferred asset will not be derecognised.

105 Having said that, we do not entirely agree with the statement in BC28 that the two approaches are similar. In our view there are as many differences as similarities. But, as we have just said, we do not see that as a concern.

106 The question also asks whether the two approaches are compatible. We think compatibility is a difficult to assess, and is probably best assessed by carrying out field-testing and considering whether the two models together produce sensible and

understandable results for structured entities, because it is there that the two models work most closely together.

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?

Background notes for EFRAG's constituents

107 *Under the proposals in the ED, an entity will be required to derecognise a financial liability (or a part of it) when that liability (or the part) no longer qualifies as a liability of the entity. A financial liability ceases to qualify as a liability of an entity if the present obligation is eliminated and the entity is no longer required to transfer economic resources in respect of that obligation.*

108 *This proposal replaces the following current requirements for derecognising a financial liability as set out in paragraph 39 of IAS 39:*

> *"An entity shall remove a financial liability (or part of a financial liability) from its statement of financial position when, and only when, it is extinguished – i.e. when the obligation specified in the contract is discharged or cancelled or expires."*

109 *The IASB explains (paragraph BC83) that the amendment is designed to more closely align the liability derecognition approach in IAS 39 with the liability definition in the IFRS Framework,[3] focusing on:*

(a) *the continuing existence of a present obligation of the entity; and*

(b) *the requirement that the settlement of this present obligation should be expected to result in a future outflow from the entity of resources embodying economic benefits.*

110 *The IASB also believes the proposed approach would mirror the proposed derecognition principle for financial assets and would make liability derecognition more symmetrical with liability recognition.*

111 *The IASB believes the propose change will not change practice significantly.*

EFRAG's comments

112 EFRAG's interpretation of the liability definition in the Framework is that it has two elements: there needs to be a present obligation; and the settlement of that present obligation should be expected to result in an outflow from the entity of resources embodying economic benefits. If that is correct, EFRAG believes it follows that a liability that is being recognised should be derecognised when <u>either</u> there ceases to be a present obligation <u>or</u> it ceases to be the case that settlement of the present obligation underpinning the liability is expected to result in an outflow from the entity of resources embodying economic benefits. The proposal in the ED is that, for the liability to be derecognised, it is necessary for <u>both</u> the present obligation to cease to exist <u>and</u> for the entity to be no longer <u>required</u> to transfer economic resources in respect of that obligation.

[3] A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

113 We think the difference here might be because, although the ED claims to be more closely aligning the liability derecognition approach with the liability definition, in fact it has not used the wording of the existing liability definition; rather it has pre-empted some of the changes to the liability definition the IASB is considering making through its Framework project. Having said this, we agree that the liability derecognition approach should be consistent with the liability definition.

114 The ED states that the IASB does not expect that the proposed changes will significantly change practice for derecognition of financial liabilities. Indeed we have not identified any differences that could affect the substance of the existing requirements. Nevertheless, it was unclear to us what changes, even if not significant, the IASB expects to see as a result of these proposals. It would be helpful if the Basis for Conclusions was clearer on this point.

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?

Background notes for EFRAG's constituents

115 *The ED proposes that the standard would be applied prospectively to new transactions occurring after its effective date. An entity should not restate information for comparative periods. Earlier application would be permitted.*

116 *The ED proposes certain additional disclosures should be provided in respect of financial assets already derecognised that would not have been derecognised under the proposed requirements. Certain other disclosures would be required for financial assets that are still recognised but would have been derecognised under the proposed requirements.*

EFRAG's comments

117 EFRAG is generally in favour of retrospective application because that maintains the comparability of the information. Furthermore, if the choice is between early implementation but on a prospective basis or later retrospective application, we would generally favour the latter approach.

118 The Basis for Conclusions do not explain the IASB's reasoning for requiring prospective application but in some IASB observer notes IASB staff suggested that the advantages of such an approach were that:

(a) restating past derecognition transactions would be costly, especially if restatement involves determining the fair value of retained servicing assets and liabilities and other components retained in a complex securitisation;

(b) it may be difficult to obtain information on financial assets held by transferees that are not under the transferor's control.

(c) retrospective application would not result in consistent measurement, as entities would need to recreate information about past transactions (including measurements) with the benefit of hindsight.

119 We do not agree that with the concerns raised in (c) about the use of hindsight. In our view the benefits for users in terms of comparability if an amendment to a standard is applied retrospectively will usually far outweigh the risks to comparability that can arise by allowing the use of hindsight.

120 However, we do accept that, in some situations, retrospective application can be impracticable. Therefore, we accept that, depending on the final changes that the IASB decide to make, it might be necessary to permit or require prospective application in those circumstances.

121 We agree with the proposal that earlier adoption should be permitted.

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?

Background notes for EFRAG's constituents

122 *For assets and parts of assets transferred to third parties without being derecognised, the ED proposes to require entities to disclose information designed to enable users to understand the relationship between those assets and the associated liabilities. This information would include:*

(a) *general information about the transferred assets and associated liabilities (nature, carrying amount...);*

(b) *information about the risks to which the entity remains exposed and about the nature of the relationship between the assets and the associated liability (e.g. the fact that the use of the asset is restricted or that the recourse of the liability holders is limited to the transferred assets).*

(c) *if the recourse of the liability holders is limited to the transferred asset, a schedule that sets out the fair value of the assets, of the associated liabilities, and of the net position.*

123 *For assets or part of assets that are derecognised with the entity having continuing involvement in them, the entity shall disclose information that enables users to evaluate the nature of the risks associated with that continuing involvement. That information would include in particular:*

(a) *the carrying amount and the fair value of the assets and liabilities recognised in the entity's statement of financial position that represent the entity's continuing involvement, and the line items in which those assets and liabilities are recognised;*

(b) *the amount that best represents the entity's maximum exposure to loss from its continuing involvement, including how the maximum exposure to loss is determined;*

(c) *the fair value of derecognised financial assets in which the entity has continuing involvement, including a description of the methods and assumptions applied in determining that fair value;*

(d) *the undiscounted cash outflows to repurchase derecognised financial assets (e.g. the strike price in an option agreement or the repurchase price in a repurchase agreement);*

(e) *a maturity analysis of the undiscounted cash outflows to repurchase the derecognised financial assets that shows the remaining contractual maturities of the entity's continuing involvement;*

(f) *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 at the reporting date. The entity shall describe the methods and assumptions used in preparing that sensitivity analysis; and*

(g) *qualitative information that explains and supports the above quantitative disclosures.*

EFRAG's comments

124 In our view it is the disclosure aspects of the existing IFRS derecognition requirements that most need enhancing in the light of the financial crisis, because it seems that users did not fully understand the nature or extent of some of the risk entities were exposed to and did not understand why assets and liabilities that had previously been derecognised seemed to be re-appearing on the statement of financial position in the middle of the crisis.

125 For that reason we believe the disclosures proposed in the ED, together with those already in existing IFRS, should have two main objectives:

(a) to provide information that enables users to evaluate the nature and extent of the risks associated with the entity's continuing involvement in assets that are derecognised and in assets that are recognised. The intention is to provide users with information relevant in assessing the amount, timing and uncertainty of the entity's future cash flows and risks for stewardship purposes; and

(b) to provide some information about the main judgement calls made in preparing the financial statements. It is important to emphasise that the purpose of such disclosures is not to enable users to second guess management; but to help users understand the key assumptions and assessments on which the accounts have been prepared.

126 We are concerned that the proposed disclosures about transferred financial assets that have been derecognised go much further than that. Indeed, in our view the proposed disclosures give the impression that they are trying to make up for a derecognition model that is flawed. If that is not the case, we do not understand why the disclosures about transferred financial assets that have been derecognised are so much more extensive than those required for transferred assets that are not derecognised—after all, the objectives as we have described them are the same.

127 We are also not sure why similar sorts of disclosures are not required for assets that that the entity did not previously have but now has in the form of a net position.

128 Subject to that, we are broadly happy with the objectives proposed for the new disclosures (which are described in the second sentence of paragraph 42B and in paragraph 42C) but are concerned that what then follows seems just to be a list of disclosures. In our view lists of this kind encourage a checklist mentality in exactly the circumstances in which thoughtful implementation is needed. IFRS 7 tends to talk about "disclosures an entity might consider making in order to meet the objective", and we think a similar formulation should be adopted for these disclosures.

129 We suggest that the IASB's priority should be to enhance the disclosure requirements for certain net positions recognised in the statement of financial position both as a result of derecognising previously recognised financial assets and

of acquiring net positions related to financial assets that the entity did not previously own.

130 **Question to constituents**

In this draft comment letter EFRAG argues that the IASB should focus first of all on improvements that are necessary to address crisis-related issues and concludes that the emphasis at this stage should be on improving the quality of the disclosures. Therefore, we would like to ask constituents for their views on how disclosure requirements could be improved to get better information about risk exposures of entities related to transfers of financial instruments.