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Dear Steve,

IASB Exposure Draft on Derecognition – Proposed amendments to IAS 39 and IFRS 7 (“Exposure Draft”)

I refer to your letter dated 5 May 2009 on the above Exposure Draft to our Mr. Joseph Mau which has been passed to me for my attention.

We have completed our review of the Exposure Draft and our views are set out in the paragraphs below.

General

The Exposure Draft sets out the preliminary views of the IASB on proposals to improve the derecognition standards for financial assets and financial liabilities in IAS 39 “Financial Instruments: Recognition and Measurement”, and to enhance the disclosures required in IFRS 7 “Financial Instruments: Disclosures” on the evaluation of risk exposures in respect of an entity’s financial assets. The Exposure Draft also aims to provide a short-term solution to develop a single standard on derecognition in order to provide a common ground for the convergence project between IAS 39 and SFAS 140 “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities” issued by the FASB.

Although we agree with the intended objective, we have concerns that the proposals in the Exposure Draft would result in a conflict with the current Framework. Under the existing Framework, the recognition of the elements of financial statements is based on the probability that future economic benefits associated with an item will flow to or from the entity. We believe that an “asset” should be recognised when it is probable that future economic benefits will flow to the entity and a “liability” should be recognised when an outflow of resources embodying economic benefits will result from the settlement of a present obligation. Conversely, the “derecognition” of an “asset” or a “liability” should be

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consistent with the Framework and should not have a different meaning under an individual standard.

The approach proposed for financial assets in the Exposure Draft focuses on the existence of control and differs from the Framework which is concerned with economic benefits flowing to the entity. The existence of control does not necessarily mean that the economic benefits derived from a financial asset will automatically flow to the entity. We note that the IASB is currently revisiting the meaning of “control”.

We suggest that the Board should focus on the “risks and rewards” approach for the purpose of assessing derecognition. Moreover, since there are differences between the IASB and FASB exposure drafts on derecognition, it would appear to be premature to proceed with the proposed changes to avoid potential successive changes that are likely to result from the IFRS/ US GAAP convergence project.

Partial derecognition of financial assets

Paragraph 16A of the proposed amendments to IAS 39 in the Exposure Draft allows derecognition to be applied to part of a financial asset (or a part of a group of financial assets) only if that part comprises:

- (a) specifically identified cash flows; or
- (b) a proportionate share of the cash flows from that financial asset (or that group of financial assets).

We disagree with the principle that derecognition can be made on a part of a financial asset. We believe that specifically identifiable cash flows and whether the performance of the transferred part does not depend on the performance of the retained part are not relevant considerations.

Financial instruments on initial recognition are recognised as an “inseparable whole” and it would be inappropriate and inconsistent that when derecognition is considered it can be made by looking at its separate component parts. We believe that a principle for derecognition should be that if a financial asset is to be derecognised the entire financial asset should be derecognised. Contracts entered into to transfer certain risks and rewards of ownership of the original financial asset should be accounted for by recognising a new and separable financial asset.

Definition of “transfer”

The proposed definition of a “transfer” is where “*one party passes, or agrees to pass, to another party some or all of the economic benefits underlying one or more of its assets*”. It is proposed that the term “transfer” includes “*all forms of sale, assignment, provision of collateral, sacrifice of benefits, distribution and other exchange*”.

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The IASB model focuses on a change in “control” of the economic benefits underlying a financial instrument and the FASB model focuses on change in “control” of the legal title to a financial instrument. We believe that the IASB model is preferable but should be focused on the transfer of the risks and rewards of ownership.

The meaning of transfer covers “all forms of sale”. According to IAS 39, fair value accounting, where required, is determined by the quoted prices in an active market or established by using a valuation technique if the market for a financial instrument is not active. Fair value accounting in substance requires financial instruments to be stated at a value as if the financial instrument is “sold” as at the balance sheet date. A fair value gain or loss is therefore recognised but the financial instrument itself is not derecognised.

We suggest that “as if” sales should be considered to determine if they are regarded as “all forms of sales”. Also the current practice of recognising the gains/ losses of an “as if” sale of an asset in the income statement without derecognising the asset itself should be studied further to determine whether it is conceptually sound and justified.

“Continuing involvement” test

The Exposure Draft replaces the ‘substantially all the risks and rewards have been transferred test’ in the existing IAS 39 with the ‘continuing involvement test’ which is dependent on the test of “control”. Paragraph 17A(b) of the proposed amendments to IAS 39 in the Exposure Draft states that *“an entity shall derecognise the asset if the entity transfers the asset and has no continuing involvement in it”*. We disagree with the proposals as we believe the “risks and rewards” test is a better test.

Proposed amendments to disclosures in IFRS 7

We agree with the principle of increased disclosures to provide more meaningful and useful information so that users of financial statements are able to evaluate the risks and benefits associated with each class of financial instrument. However, we disagree with paragraphs 42C and 42D of the Exposure Draft since these relate to the issue of “continuing involvement”.

Meaning of “control”

The Board should consider the consistency of the meaning of “control” used in the proposed IAS 39 and the proposed IAS 27 to avoid confusion. Under the proposed IAS 39, “control” is not defined within the proposed amendments but is mentioned in the basis for conclusions. According to BC11 and BC12 on pages 56 and 57 of the Exposure Draft, “control” is defined as *“the means by which an entity ensures that the future economic benefits embodied in an item accrue to it and not to others”* and *“the ability to obtain (access) the future cash inflows of the asset”*. In the Consolidation Project, “control” is defined as *“the power to direct the activities of that other entity to generate returns for*

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the reporting entity” and the returns can be positive or negative. We believe that the definition under the proposed IAS 27 is relatively better and is more consistent with the meaning of control used in the Framework.

To ensure consistency in the use of terms, we suggest that the Board should consider including a definition section in the Framework to provide consistent definitions that will be applied in relevant standards.

We hope that the above comments are helpful.

Yours sincerely,
For and on behalf of
The Stock Exchange of Hong Kong Limited



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c.c. Mr. Joseph Mau – Company Secretary
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