Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Our Ref.: C/FRSC

Sent electronically through the IASB Website (www.iasb.org)

31 July 2009

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sirs,

IASB Exposure Draft on *Proposed Amendments to IAS 39 and IFRS 7 - Derecognition*

The Hong Kong Institute of Certified Public Accountants is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We welcome the opportunity to provide you with our comments on the captioned Exposure Draft. Our responses to the questions raised in your Exposure Draft are set out in the Appendix for your consideration.

In view of the commonality of financing structures around the world, we believe it is essential that there is no difference between the accounting treatment afforded to such structures under different accounting regimes. Consequently we support the proposal for the IASB and the FASB to work together on developing a single standard based on this exposure draft.

We also believe that any revisions to the derecognition framework must be compatible with the consolidation standard that is expect to be issued later this year, as well as the planned modifications to the recognition and classification requirements for financial instruments that were exposed for comment earlier this month.

Proposed model

We do not support the derecognition model set out in the exposure draft for a number of reasons. Primarily, the proposed model is not a pure control model since it imposes a risk and rewards overlay in the form of an assessment of continuing involvement, the proposed model therefore will simply be replacing one mixed model with another and will not provide the benefits to justify replacing the existing model. We believe that this overlay is required in the model because of a flawed definition of control that is based on an assessment of whether the transferee has the practical ability to dispose of the asset in its entirety. We believe that the test for control should consider whether the transferor has retained control over the asset, rather than whether the transferee has obtained control. Defining control in this way would be consistent with the proposals in ED10 and would remove the need for any “continuing involvement” filter.

Prima facie, it would appear that assessing the retention of control by the transferor or the receipt of control by the transferee should provide consistent conclusions (as it would be unusual for joint control to exist for a financial asset, as opposed to the underlying business of that asset). However, gaps appear because of the definition of

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control used in the derecognition exposure draft. The requirement that the transferee should have a practical ability to dispose of the asset relies disproportionately on a single indicator of whether the transferee controls the asset.

Furthermore, the proposed model does not result in accounting that reflects the transferor's true exposure to the cash flows of the financial asset. For example, under the proposed model it is likely that few, if any, factoring arrangements will be derecognised, since the transferor typically will retain servicing rights that would be considered to be a form of continuing involvement as removal rights are not substantive. Equally, securitisation transactions in which the entity retains an insignificant, disproportionate interest in the transferred assets will also fail derecognition, resulting in the recognition of an associated liability in respect of which the transferor has no obligation to transfer resources, other than to pass on cash received from the assets. Repurchase agreements (or 'repo' transactions), however, will achieve derecognition, despite repos being viewed almost universally as financing arrangements, with the transferred asset being collateral held against a borrowing.

Alternative View

At a conceptual level, we support the Alternative View in the exposure draft. This model is superior to the proposed model because it:

- prevents the recognition of assets in respect of which future economic benefits will not flow to the entity, and associated liabilities for which the entity has no obligation to give up its resources;
- considers control over the cash flows of the asset, and avoids an overlay of risk and rewards; and
- is not built on the premise that assets are 'sticky'; two entities with the same contractual rights and obligations will account for them consistently, irrespective of whether one of the entities previously owned the transferred asset.

However, some market participants are concerned that this model results in the derecognition of virtually all assets transferred, including those for which only a small proportion of the cash flows are passed to another party. Accordingly, an entity would be able to recognise gains (or losses) on a financial asset in its entirety just through the transfer of an insignificant portion of the cash flows of that asset.

Others, however, believe that gain recognition is possible currently through wash sales of assets traded in an active market, and hence the Alternative View merely extends the opportunity to recognise such gains to illiquid assets. Those market participants that hold this latter view are therefore not uncomfortable with the possibility of gain recognition arising from the Alternative View. The possibility of 'gaming' the timing of gain recognition remains a concern in any mixed measurement model and there is no coherent rationale for deferring gain recognition only in the case of illiquid assets.

Similar to the model proposed in the exposure draft, the Alternative View also results in derecognition of financial assets transferred in a repo transaction, contrary to the business model of banks that use repo arrangements for financing purposes. Since the continued recognition of the asset subject to the repo, together with a liability reflecting the entity's obligation to repurchase the asset, would more closely mirror the substance of these arrangements as collateralised borrowings, we would not object to an exception to exclude repos from the proposed derecognition requirements, perhaps

in the form of an amendment to the definition of a transfer so as to explicitly exclude assets subject to a repurchase obligation.

Disclosures

We do not believe that the proposed disclosure requirements are appropriately defined or risk focused. Paragraphs 42D and 42E require a voluminous amount of information to be disclosed that is likely to obscure relevant information with an excess of detail.

We suggest that a principle should be established for disclosures. The principle could be used by preparers of financial statements to provide appropriate and risk focused disclosures. The principle should be applied to all derecognised financial assets in which the entity has continuing involvement.

The following principle, might be considered:

"An entity should disclose information to the extent that it is necessary for an understanding of the effect that financial assets that the entity derecognised in the current or prior periods have, or may have, on its financial position, profit or loss, liquidity and capital resources."

If you have any questions on our comments, please do not hesitate to contact me at ong@hkicpa.org.hk.

Yours faithfully,

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Director, Standard Setting Department

SO/WC/ac

Hong Kong Institute of CPAs

Comments on the IASB Exposure Draft on Proposed Amendments to IAS 39 and IFRS 7 – *Derecognition*

<u>Question 1 - Assessment of 'the Asset' and 'continuing involvement' at reporting entity level</u>

Do you agree that the determination of the item (i.e. 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?

We agree that the determination of the Asset to be evaluated for derecognition, and the assessment of continuing involvement, should be made at the level of the reporting entity.

<u>Question 2 - Determination of 'the Asset' to be assessed for derecognition</u>

Do you agree with the criteria proposed in paragraph 16A for what qualifies as the item (i.e. the Asset) to be assessed for derecognition? If not, why? What criteria would you propose instead, and why?

(Note: The criteria proposed in paragraph 16A are the same as those in IAS 39.)

As noted in our covering letter, we do not support the proposed model included in the exposure draft. We support the Alternative View to the exposure draft, which considers the entire asset, rather than components thereof, for derecognition.

If, however, the Board continues with the approach proposed in the exposure draft we believe that disproportionate cash flows of a financial asset can be identifiable cash flows, and concur with the statement in AV12 that 'the contracting parties know which cash flows they have relinquished and acquired and that agreement is not arbitrary'. Accordingly, under the Board's proposed model 'a part of a financial asset' should be defined as any sub-set of identifiable cash flows, including disproportionate cash flows, of the financial asset transferred.

The absence of such a definition otherwise leads to inconsistent conclusions. For example, an entity may transfer an asset to an SPE in a securitisation transaction, but retain 10% of a senior tranche of the securitised assets. Since this is a not a proportion of the asset, this would result in no derecognition. However, if the entity retained a greater interest in the asset by taking 10% of each tranche, it could achieve derecognition of 90% of the asset and reflect only the retained 10% interest on its balance sheet.

Question 3 - Definition of 'transfer'

Do you agree with the definition of a transfer proposed in paragraph 9? If not, why? How would you propose to amend the definition instead, and why?

We agree with the inclusion of a broad definition of what constitutes a transfer for the purposes of the derecognition test. However, we believe that it is unclear how the definition is intended to apply to total return swaps (or similar instruments) that result in:

(a) the transfer of cash flows that resemble, or are dependent upon, cash flows of another financial instrument held by the transferee, but
(b) are not subject to a formal linkage, collateralisation or other pass-through arrangements (such that the transferor has the right, for example, to sell the related asset).

For example, does the establishment of a TRS with a third party vis-à-vis the returns of a financial instrument held by the transferor result in the passage of economic benefits 'underlying' one or more of the transferor's assets? We believe that this situation could be dealt with either way based on the current wording.

As we explained in our covering letter, both the proposed and alternative models in the exposure draft result in derecognition of financial assets that are transferred yet are subject to a repurchase agreement (or 'repo' transactions). Many have argued that derecognition in a repo transaction is not consistent with the substance of the arrangements, i.e. collateralised borrowings. We would not, therefore, object to an amendment to the definition of a transfer that excludes from that definition the delivery of a financial asset that the entity is required to repurchase in the future.

Question 4 - Determination of 'continuing involvement'

Do you agree with the 'continuing involvement' filter proposed in paragraph 17A(b), and also the exceptions made to 'continuing involvement' in paragraph 18A? If not, why? What would you propose instead, and why?

We do not support the inclusion of a 'continuing involvement' filter.

This filter represents a risk and rewards overlay that is inconsistent with the move to a control model. This overlay is required in the proposed model principally due to a flawed definition of control; an outright sale of an instrument that is not quoted in an active market, for which the transferee does not have the practical ability to dispose of, would otherwise not achieve derecognition. We do not believe that the transferor controls the asset in such instances based on a faithful interpretation of the term "control" (see our response to Question 5), and hence this risk and rewards filter should be unnecessary.

Furthermore, the term "continuing involvement" captures items that are insignificant to the risk and rewards of the transferred asset, such as the retention of servicing rights in a fiduciary or agency relationship (irrespective of whether there are substantive removal rights). We do not believe that such incidental features of a transfer should be determining factors in the derecognition test.

While certain items have been scoped-out in paragraphs 18A and AG49A, we do not support the inclusion of such a list of exceptions to continuing involvement. A list of exceptions without an underlying principle may not be capable of application to transactions that are economically similar but have a different form, and therefore any list is likely to be incomplete. For example, we believe that a transferee's ability to issue discretionary credit notes against factored receivables (often referred to as 'dilution risk') should not constitute a "continuing involvement" that would prevent derecognition. To the extent that the Board retains a "continuing involvement" filter in the way currently defined, we believe that a principle should be established that defines those forms of "continuing involvement" in the cash flows of the asset that should be taken into account.

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?

We do not agree with the proposed 'practical ability to transfer for the transferee's own benefit' test in paragraph 17(c). As we noted in our covering letter, we believe that any revisions to the derecognition framework must be consistent with the proposed consolidation requirements. We believe that the test for control should consider whether the transferor has retained control over the asset, rather than whether the transferee has obtained control. Defining control in this way would be consistent with the proposals in ED10.

Prima facie, it would appear that assessing the retention of control by the transferor or the receipt of control by the transferee should provide consistent conclusions (as it would be unusual for joint control to exist for a financial asset, as opposed to the underlying business of that asset). However, gaps appear due to the definition of control used in the derecognition exposure draft. The requirement that the transferee should have a practical ability to dispose[1] of the asset relies disproportionately on a single indicator of whether the transferee controls the asset.

For example, consider the transfer of an unquoted financial asset to a third party. As part of the transfer, the transferor has written a put option over the asset that is presently out of the money. Since the transferee does not have the practical ability to dispose of the asset, as defined in AG52L(b) of the exposure draft, the transferor would be considered to be retaining control of the asset. While the transferor has

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[1] Paragraph 17A(c) refers to the 'practical ability to **transfer**' the asset. However, it is clear from the application guidance contained in AG52B that the requirement is that the transferee has the practical ability to **dispose** of the asset.

retained certain risks associated with the asset, the transferor does not have present access to the cash flows of the asset in the above scenario, nor does it have any rights or obligations associated with those cash flows. The transferor has adopted a stand-ready obligation to buy back the asset if required to do so, but does not have the ability to require the transferee to return the asset so as to deprive the transferee of the benefit of those cash flows. Accordingly, we do not believe that the transferor controls the asset.

We support the control concept that underlies the Alternative View, which assesses whether the transferor has control over all of the future economic benefits inherent in the asset, and an ability to restrict others' access to those benefits. The unit of account in the Alternative View is the entire asset; if the transferor loses control over any of the future economic benefits inherent in the asset, its interest (if any) in the transferred asset represents a different asset. Our views regarding the measurement of assets received and liabilities incurred as part of the transfer are set out in our response to Question 7.

Question 6 - Accounting for retained interests

Do you agree with the proposed accounting (both recognition and measurement) for an interest retained in a financial asset or a group of financial assets in a transfer that qualifies for derecognition (for a retained interest in a financial asset or group of financial assets, see paragraph 21A; for an interest in a financial asset or group of financial assets retained indirectly through an entity, see paragraph 22A)? If not, why? What would you propose instead, and why?

(Note: The accounting for a retained interest in a financial asset or group of financial assets that is proposed in paragraph 21A is not a change from IAS 39. However, the guidance for an interest in a financial asset or group of financial assets retained indirectly through an entity as proposed in paragraph 22A is new.)

We agree with the proposed accounting for a direct interest retained in a financial asset or a group of financial assets (paragraph 21A).

We agree with the accounting proposed for the retained interest by paragraph 22A where the interest retained is held indirectly through a special purpose entity with no other assets, liabilities or operations, such that there is no substantive change in the entity's holding before and after the transaction. However, we agree with the comments in AV14 that for other indirect holdings the transferor may not be aware of all the assets and liabilities held by the transferee, and hence that this approach is not operational.

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?

We do not agree that the proposed approach should be established as the new approach for determining the derecognition of financial assets.

The proposed model purports to be a control model, yet overlays a primary test of risk and rewards that is inconsistent with the control notion. The continuing involvement step is deemed necessary to prevent an outright sale from failing to be derecognised where there are insufficient potential buyers to create a market for the transferred asset. However, this outcome serves to demonstrate that the notion of control is flawed and should be repaired, rather than to include a risk and rewards filter.

Furthermore, the proposed model does not result in accounting that reflects the transferor's true exposure to the cash flows of the financial asset. For example, under the proposed model it is likely that few, if any, factoring arrangements will be derecognised, since the transferor typically will retain servicing rights that would be considered to be a form of continuing involvement, as removal rights are not substantive. Equally, securitisation transactions in which the entity retains an insignificant, disproportionate interest in the transferred assets will also fail derecognition, resulting in the recognition of an associated liability in respect of which the transferor has no obligation to transfer resources, other than to pass on cash received from the assets. Repurchase agreements (or 'repo' transactions), however, will achieve derecognition, despite these being viewed almost universally as financing arrangements, with the transferred asset being collateral against a borrowing.

The Alternative View considers whether the transferor has access at present, for its own benefit, to all of the cash flows or other economic benefits of the financial asset. At a conceptual level we support the Alternative View in the exposure draft. This model is superior to the proposed model since it:

- prevents the recognition of assets in respect of which future economic benefits will not flow to the entity, and of associated liabilities for which the entity has no obligation to give up its resources;
- considers control over the cash flows of the asset, and avoids an overlay of risk and rewards; and
- is not built on the premise that assets are 'sticky'; two entities with the same contractual rights and obligations will account for them consistently, irrespective of whether one of the entities previously owned the transferred asset.

However, we did find the notion of 'present access' to cash flows confusing. It is unclear, for example, whether a transferor with an option to reacquire an asset has present access to the cash flows, or whether it needs to exercise the option before having access, at present, to those cash flows. It is also unclear whether the transferee's ability to sell the transferred asset impacts whether the entity has present

access to the cash flows of that asset for its own benefit where there is a repurchase right and obligation (repo).

While we support the Alternative View from a conceptual perspective, some market participants are concerned that this model results in derecognition of virtually all assets transferred, including those for which only a small proportion of the cash flows are passed to another party. Accordingly, an entity would be able to recognise gains (or losses) on a financial asset in its entirety through the transfer of an insignificant portion of the cash flows of that asset. The Alternative View also results in derecognition of financial assets transferred in a repo transaction, which is contrary to the business model of banks that use such arrangements for financing purposes. We have provided further thoughts on these issues in our covering letter.

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?

We do not believe that the proposed derecognition and consolidation approaches are compatible. Consolidation seeks to understand whether the entity can control assets and liabilities; the approach to control proposed in this exposure draft assesses what others can do with the transferred asset. This contrary perspective can result in divergent conclusions regarding whether the transferor controls an asset. An example of such a scenario is set out in our response to Question 5.

The requirement that the transferee should have a practical ability to dispose of the asset relies disproportionately on a single indicator of whether the transferee controls the asset.

We believe that the Alternative View approach is compatible with the proposed consolidation approach. The Alternative View approach assesses whether the transferor has control over all of the future economic benefits inherent in the asset, and an ability to restrict others' access to those benefits.

Question 9 - Derecognition of financial liabilities

Do you agree with the proposed amendments to the principle for derecognition of financial liabilities in paragraph 39A? If not, why? How would you propose to amend that principle instead, and why?

We agree with the intended principle regarding the derecognition of financial liabilities in the exposure draft, and would support a modified version of the proposed amendments, which would require derecognition when it ceases to qualify as a financial liability of the entity. The second sentence of paragraph 39A appears to be driven by the definition of a liability in the Framework and IAS 37, rather than the definition of a financial liability in IAS 32. The proposed wording constrains the circumstances in which a recognised financial liability ceases to qualify as a liability to those where the present obligation is eliminated and the entity is no longer required to transfer economic resources in respect of that obligation. This constraint will result in an entity continuing to recognise a liability for a continuing obligation that does not meet the definition of a financial liability.

For example, an obligation to deliver the entity's own equity instruments may cease to meet the definition of a financial liability in IAS 32 where the number of equity instruments becomes fixed subsequent to initial recognition. We believe that such obligations should also be derecognised when they no longer meet the definition of a financial liability.

However, we also note that the Board's proposed model for derecognition of financial assets results in the recognition of liabilities in respect of a failed sale that do not meet the definition of a financial liability. Accordingly, if the Board continues with the proposed model for financial assets, additional guidance should be included regarding the derecognition of such associated liabilities.

The existing '10% test' regarding both exchanges of, and modifications to, debt instruments with the creditor has been retained in paragraph 40A and AG62. We recommend that paragraph 42B should be expanded to clarify that the effective interest rate should be reset for debt instruments for which the modification was not substantial. In the absence of such a statement it may be argued that AG8 should be applied to the financial liability, giving rise to a gain or loss on re-measurement; this treatment would be inconsistent with the requirement in paragraph 42B that costs or fees incurred should be amortised over the remaining term of the liability.

The requirements should also be modified to clarify that AG62 is intended to apply only to those financial liabilities that are measured at amortised cost.

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?

We agree with the proposed amendments to the transition guidance in paragraphs 106 and 107.

<u>Question 11 - Disclosures</u>

Do you agree with the proposed amendments to IFRS 7? If not, why? How would you propose to amend those requirements instead, and why?

The proposed disclosure requirements appear overly voluminous. Paragraph 42C requires an entity to disclose information that enables users to evaluate the nature of risks associated with the entity's continuing involvement in those derecognised financial assets. However, paragraphs 42D and 42E mandate an extensive 'shopping list' of information that is likely to obscure relevant information behind an excess of detail. Indeed, the disclosures for derecognised financial assets are significantly greater than for those financial assets that the entity does not control and hence that have been derecognised.

We suggest that a principle should be established for disclosures. The principle could be that preparers of financial statements should provide appropriate and risk focused disclosures. The principle should be applied to all derecognised financial assets in which the entity has continuing involvement.

The following wording for the principle might be considered:

"An entity should disclose information at least to the extent that is necessary for an understanding of the effect that financial assets that the entity derecognised in the current or prior periods have, or may have, on its financial position, profit or loss, liquidity and capital resources."

The transitional provisions proposed in paragraph 106 require prospective application of the derecognition requirements to transactions after the effective date of the amendments. This transitional arrangement eliminates the need to assess previous transfers for derecognition under the proposed amendments. The transitional provisions in IFRS 7.44H, however, require the entity to make disclosures based on an assessment of historical transfers under the proposed amendments. In view of the conclusion reached in respect of assessing transfers for derecognition prospectively, which we support, we consider the requirements regarding disclosure to be excessively onerous. We therefore believe that, consistent with the proposed amendment to IAS 39, the proposed disclosures should be applied prospectively to transfers after the effective date, or an earlier date provided that the entity had obtained the information needed to apply the amendments at the time it initially accounted for those transactions.