Australian Government

Australian Accounting Standards Board

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Sir David Tweedie
Chairman
International Accounting Standards Board
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UNITED KINGDOM

Dear David

AASB comments on IASB Exposure Draft ED/2009/3 *Derecognition* (proposed amendments to IAS 39 and IFRS 7)

The Australian Accounting Standards Board (AASB) is pleased to provide comments on Exposure Draft ED/2009/3 *Derecognition* (proposed amendments to IAS 39 and IFRS 7). In formulating its views, the AASB sought the views of Australian constituents.

The AASB is supportive of the IASB's objective to simplify and improve the derecognition requirements in IAS 39 *Financial Instruments: Recognition and Measurement* by developing a model with a single basis for derecognition. In particular, the AASB supports the development of a derecognition model that uses a control concept as the basis for determining whether instruments should be derecognised.

The AASB acknowledges that the global financial crisis has highlighted that users of general purpose financial statements require better information to understand transfer transactions, and this was reflected in the letter from G-20 leaders to the IASB. The AASB notes that the proposals in this ED respond to concerns regarding off balance-sheet risk.

The AASB does not believe that the proposed approach is a significant improvement to the existing derecognition requirements or that the IASB has achieved its objective of developing a model that is based on a single concept of control. The 'continuing involvement' test is similar to a 'risks and rewards' test. Therefore, we do not believe that the application difficulties that exist under the existing derecognition model would be remedied by the derecognition requirements in the proposed approach.

The AASB believes that the alternative approach is the appropriate model for the IASB to develop and issue in replace of the existing derecognition requirements in IAS 39. The alternative approach has strong conceptual appeal given its consistency with the *Framework*, and is compatible with the proposals in phase 1 of the IASB's project to replace IAS 39 (classification and measurement).

However, the AASB believes the IASB needs to further develop the alternative approach to consider possible implications of its application and develop application guidance and would welcome the opportunity to comment on the alternative approach at a more developed stage.

The AASB encourages the IASB to work closely with the FASB on its various projects as this is critical to addressing the G-20 recommendations and to making substantial progress towards a single set of high quality global accounting standards. The IASB has stated that once the FASB proposals on derecognition are issued, it will issue that document for consideration and comment by its constituency prior to finalising an IASB pronouncement. The AASB noted that this would mean that the topic will presumably need to be reassessed in the near future and require duplication of effort and work by the IASB and its constituency as part of the convergence exercise.

If you have any queries regarding any matters in this submission, please contact me or Natalie Batsakis (nbatsakis@aasb.gov.au).

Yours sincerely,

K M Stevenson

Kevin Stevenson
Chairman

IASB Exposure Draft ED/2009/3 *Derecognition*
(proposed amendments to IAS 39 and IFRS 7)

AASB specific comments

The AASB provides the following responses to the IASB's Exposure Draft ED/2009/3 *Derecognition* (proposed amendments to IAS 39 and IFRS 7).

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?

Yes. The AASB agrees that the determination of the item should be made at the level of the reporting entity.

However, the AASB considers that this issue should not just be clarified in this limited context, but in a broader context, because the accounting for an entity should be undertaken in the context of that entity's circumstances. The AASB considers this notion to be pervasive (in the same way that materiality is pervasive) and, accordingly, that it would be potentially misleading to include the requirement in IAS 39 in any manner that could imply that the same notion does not apply elsewhere.

Question 2 – Determination of 'the Asset' to be assessed for derecognition

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

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

No. The AASB does not support the criteria that require consideration of whether specifically identified cash flows or a proportionate share of cash flows are transferred to determine whether 'the Asset' qualifies for derecognition. The AASB supports the comments made in paragraph AV4 of the Alternative Views that the "...proposed approach would result in recognising assets and liabilities that do not meet the definitions of those elements in the *Framework*." Therefore, the AASB would prefer use of the alternative approach which proposes that an asset is derecognised when the transferor does not have access to all the cash flows or other economic benefits of the financial asset.

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?

No. The AASB is concerned that the definition of 'transfer' proposed in paragraph 9 is too broad and may have unintended consequences. Given the extent to which the definition will be relied upon under the proposed approach, the AASB considers that more consideration needs to be given to its implications.

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?

No. The AASB does not support the use of a 'continuing involvement' filter. The AASB questions whether the control concept for derecognition as proposed is conceptually robust. This is because, in considering circumstances in which the transferor transfers an asset and has some continuing involvement, the 'continuing involvement' filter appears to be similar to the 'risks and rewards' filter in the existing derecognition requirements. Therefore, the AASB supports the comments made in paragraph AV3 of the Alternative views which states that "...the same inconsistencies and application difficulties will be encountered in the guidance...".

This concern about the robustness of the application of the control concept is similar to the comments raised in our submission to the IASB's Exposure Draft ED 10 *Consolidated Financial Statements*, which noted that the AASB does not believe the proposed definition of control in ED 10 could be applied to all entities within the scope of IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation – Special Purpose Entities*. The AASB has similar concerns about the consistency of the treatment of fiduciary relationships under the proposed approach and the proposals in ED 10.

In addition, the AASB is concerned there is insufficient guidance on how to assess continuing involvement – for example, the impact that derivatives acquired in a transfer transaction might have on continuing involvement.

Based on this, the AASB believes that the IASB should reconsider the proposed approach and whether it achieves its objective of developing a single concept for derecognition. However, if the proposed approach is to be adopted, the AASB also agrees that the three exceptions listed in paragraph 18A should not constitute continuing involvement.

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?

No. Whilst the AASB agrees that an assessment of the transferee's practical ability to transfer the asset for its own benefit is necessary in assessing derecognition where the transferor has continuing involvement in the asset, the AASB believes it will be difficult for a transferor to conduct the test and determine what an independent transferee is able, or not able, to do.

In considering whether the transferee has the practical ability to transfer the asset for its own benefit, the transferee must be able to transfer the asset unilaterally, and without having to impose additional restrictions on the asset (for example, considering whether the asset is readily available in the market). Paragraph AG52E of the Application Guidance provides discussion on the factors to consider in assessing 'practical ability to transfer'. The AASB is specifically concerned with the reference in paragraph AG52E(e) to the asset being 'readily obtainable'. The AASB believes that this term is essential in some transfer transactions in determining whether the transferee has the ability to transfer the asset for its own benefit. However, its intended meaning is unclear and there is insufficient guidance on how to determine if an asset is readily obtainable in the guidance to the proposals.

In addition, the AASB is concerned with the introduction of a requirement to consider the ability to transfer assets and restrictions on transfers where no other IFRS requires such consideration in determining the removal of assets from the balance sheet.

Accordingly, the AASB believes that the IASB should consider adoption of the alternative approach which considers the definition of an asset in accordance with the *Framework* – removing the need for additional tests in determining whether an asset should be derecognised.

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.)

The AASB is concerned with paragraph 22A, which proposes that the interest purchased in a transferee be separated between the part that relates to assets transferred to the transferee and the part that relates to the other assets and liabilities of the transferee. The AASB questions whether this requirement would be operational – for example, would the transferor have the ability to obtain information needed to make this separation from an independent transferee and would the information be a reliable basis with which to apportion the transferor's interests purchased in its general purpose financial statements, particularly when the transferred asset becomes part of a larger group of assets.

The AASB acknowledges that the proposed requirements in paragraph 21A are consistent with the existing IAS 39 derecognition requirements.

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?

The AASB favours the alternative approach outlined in the ED. The AASB believes that the alternative approach is conceptually superior to the proposed approach because it considers the definition of an asset in the IASB's *Framework* in determining derecognition. In addition, the AASB believes that the principal in the alternative approach is:

(a) consistent with the proposals in phase I of the IASB's project to replace IAS 39; and
(b) simpler to understand, which is likely to result in more consistent application and accounting outcomes – ultimately providing more decision-useful information to users of the financial statements.

However, the AASB believes the alternative approach could be developed further with consideration of its implications, as well as the development of application guidance. As an example, one issue already acknowledged in the derecognition requirements of IAS 39 is the potential for structuring opportunities that would permit a transferor to derecognise an asset previously held at amortised cost in its entirety by transferring a portion of the cash flows to another party, and recognising its retained portion at fair value – thereby opportunistically achieving an uplift on the value of the portion of the asset that is retained.

The AASB believes this to be a function of the mixed measurement model in which arbitrage will be achieved by structuring transactions to result in a particular outcome (that is, changing the measurement basis of assets from amortised cost to fair value). This will continue to be problematic if the proposals in the ED for phase 1 of the IASB's project to replace IAS 39 are retained, being a mixed measurement model (based on criteria) and the inability to subsequently reclassify financial assets/liabilities.

The AASB would welcome a further opportunity to comment on the alternative approach model at a more developed stage.

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?

The AASB considers that the alternative approach would be more compatible with a consolidation approach based on control given its consistency with the definition of assets and liabilities in the *Framework*. In addition, the AASB considers that the complete removal of any type of risks and rewards test adds to the compatibility of the alternative approach with a consolidation approach based on the concept of control.

As noted in our response to Question 4 of this letter, the 'continuing involvement' filter in the proposed approach is not unlike the 'risks and rewards' test and therefore the proposed approach incorporates both control and risks and rewards concepts. The AASB expressed a similar concern with the definition of control developed in ED 10 and its application to all types of entities captured by IAS 27 and SIC-12. Therefore, the AASB is concerned that the IASB has not achieved its objective of developing a single basis for derecognition and consolidation based on control. In addition, the AASB is concerned with the potentially inconsistent treatment of fiduciary relationships in the proposed derecognition approach and ED 10.

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?

Yes. The AASB supports the proposed amendments to the principle for derecognition of financial liabilities.

Question 10 – Transition

Do you agree with the proposed amendments to the transition guidance in paragraphs 106 and 107? If not, why? How would you propose to amend that guidance instead, and why?

The AASB generally supports the transition guidance. However the AASB considers that the IASB should clarify its intended meaning when an entity early adopts the amendments. As it currently reads, it is unclear whether fair value measurement requirements would be needed for every transaction from the date of adoption of the amendments or on an item-by-item basis. For example, in IFRS 1, the transition requirements for business combinations is such that the requirements shall be applied to all transactions from the earliest date of adoption, whereas the revaluation transition requirements for property, plant and equipment are on an item-by-item basis.

Question 11 – Disclosures
Do you agree with the proposed amendments to IFRS 7? If not, why? How would you propose to amend those requirements instead, and why?

The AASB is concerned with the significant financial instruments disclosure requirements that already exist and that have been recently added to IFRS 7 to address concerns that have arisen as a result of the global financial crisis.

The proposed disclosures would require the reporting entity to obtain data to enable the entity's financial statements to be constructed as if transferred assets continued to be recognised. The AASB believes it is inappropriate to presume that information relating to a transferee's assets and liabilities is readily available to the transferor, and sufficiently reliable to include in the transferor's financial statements. In finalising the disclosure requirements, the AASB suggests the IASB consider the practicality and costs to preparers in gathering information and compare these to the likely benefits to users.

In addition, the AASB questions whether this information is useful to users of financial reports given the entity's exposure is limited to its continuing involvements and not the assets themselves. Such disclosure proposals raise questions about the robustness of the derecognition model. The AASB believes that disclosures pertaining to the extent of the entity's continuing involvement would provide more relevant and useful information to users of general purpose financial statements.

Other issue

The AASB believes that the IASB should consider the application of any derecognition model to non-financial assets in finalising its selected derecognition model. For example, failed sales on non-monetary assets may result in plant and equipment being recognised on the balance sheets of both the seller (that has a call option over equities of the buyer) and the buyer (that operates the plant and equipment and controls it in a day-to-day sense). The seller in this scenario has no interest in the asset nor an obligation for proceeds and therefore, the outcome under existing IFRSs is inappropriate. Application of the alternative approach in this situation would appropriately remove the plant and equipment from the sellers balance sheet.