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Exposure Draft ED/2009/03 Derecognition - Proposed Amendments to IAS 39 and IFRS 7

Grant Thornton International is pleased to comment on the International Accounting Standards Board's (the Board) Exposure Draft ED/2009/03 *Derecognition - Proposed Amendments to IAS 39 and IFRS 7* (the ED). We have considered the ED along with the accompanying draft Basis for Conclusions.

General comments

We support the Board's decision to review the derecognition requirements of IAS 39 *Financial Instruments: Recognition and Measurement* (IAS 39). We share the Board's concern that these requirements are unduly complex and give rise to frequent application issues. Further, we believe that IAS 39's 'continued recognition to the extent of continuing involvement' outcome can lead to double-counting and may not generally provide useful information.

Although we support a review, we also note that derecognition is a complex and difficult issue. We therefore question whether substantial changes should be implemented on a fast-track timetable. We are aware that the Board's decision to proceed direct to the exposure draft stage is part of its response to the global financial crisis. Although we certainly agree that crisis-related issues must be addressed expeditiously, we suggest that the concerns raised by the Financial Stability Forum and others might be addressed in the short term by improved disclosure.

In our view, a necessary first step in developing a new model is to reconsider the objective of detailed derecognition requirements for financial instruments. Broadly, existing requirements aim to draw a line between transactions to be accounted for as sales and those to be accounted for as financing transactions or failed sales (in other words a 'sale/financing' model). However, this distinction is of course simplistic. Even if consensus could be achieved on identifying the factors that should differentiate a sale and a financing, the two alternative outcomes are unlikely to reflect that fact that many transactions share characteristics of both. Moreover, making any such model operational and capable of consistent application seems in practice to involve complex, rules-based requirements. These detailed rules in turn tend to create structuring opportunities.

### The proposed model

The proposed new model follows the existing sale/financing approach. As such, the proposals aim to establish where a line should be drawn and are therefore susceptible to the limitations and challenges noted in the preceding paragraph.

Having said that, we believe the proposed model has some advantages over the existing one. In particular the ED's proposals:

- are expressed in clearer terms and follow a more logical structure
- should be easier to apply and could therefore lead to greater consistency in some respects. For example, we believe that (i) the 'practical ability to transfer for own benefit test' is simpler to apply (although not always entirely straightforward) than the risks and rewards assessment that has primacy in the existing model; (ii) the broader definition of the concept of a 'transfer' will address uncertainty as to whether some arrangements qualify under the current pass-through tests
- removed the 'continued recognition to the extent of continuing involvement' outcome - a welcome step in our view.

However, we are not convinced that the ED will actually lead to better derecognition outcomes. We acknowledge that judging what is a 'better outcome' pre-supposes some (preferably) objective basis for making that assessment. Further work on conceptual issues such as element definitions, definition of control and the relationship between control and risk and reward concepts may shed further light on the question. We also note that this subject gives rise to complex 'unit of account' issues as to the extent of unbundling of rights and obligations for the purpose of derecognition assessment. This is an area in which IFRSs, and the Conceptual Framework are rather weak at present.

Pending more work in these areas, views on appropriate outcomes are inevitably subjective. That said, in a sale/financing model we find it counter-intuitive that transactions such as repos (where the repurchase price is the sale price plus a lender's return) and sales with total return swap should be accounted for as a sale. (As noted above, we share many of the concerns in the Alternative Views regarding a sale/financing derecognition model).

We are also concerned as to the implications of the proposed model for the accounting treatment of stocklending transactions. We explain our concerns in detail in the Appendix, as part of our response to Question 7 of the Invitation to Comment.

Moreover, the Basis for Conclusions does not in our view make a convincing case that the proposals will lead to better outcomes. In the circumstances, we question whether it is sensible to change the model along the lines proposed.

### The alternative model

For the reasons noted, we find the arguments in the Alternative Views quite persuasive. The alternative approach moves away from the traditional 'sale or financing' dividing line and instead aims to portray the transferor's future rights and obligations following a transfer transactions. The alternative model is also much simpler and less susceptible to structuring. We therefore believe that the alternative approach offers promise as the foundation for a comprehensive replacement of IAS 39's current requirements.

However, the alternative approach is also quite radical. We also believe it needs further development in some areas and would not recommend its introduction on a fast-track basis.

Our suggested way forward

Rather than proceed with the revised model on a fast-track timetable we suggest it would be better to:

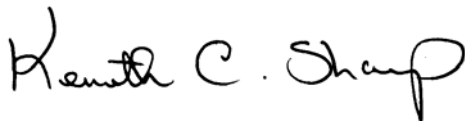
- address the concerns raised by the Financial Stability Forum and others by focusing on short term improvements to disclosure requirements
- maintain the existing model in large part, while considering making limited improvements to address known application issues (including possible removal of the 'continued recognition to the extent of continuing involvement' outcome)
- carry out further work on the alternative approach with a view to developing this as a possible longer-term replacement for the existing model.

Our responses to the questions in the ED's Invitation to Comment are set out in the Appendix.

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If you have any questions on our response, or wish us to amplify our comments, please contact our Executive Director of International Financial Reporting, Andrew Watchman (andrew.watchman@gtuk.com or telephone + 44 207 391 9510).

Yours sincerely,



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Invitation to comment questions

**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?**

We agree.

**Question 2 - Determination of ‘the Asset’ to be assessed for derecognition**

**Do you agree with the criteria proposed in paragraph 16A for what qualifies as the item (ie the Asset) to be assessed for derecognition? If not, why? What criteria would you propose instead, and why? (Note: The criteria proposed in paragraph 16A are the same as those in IAS 39.)**

We agree. We have some sympathy with the Alternative Views regarding the lack of a strong conceptual basis for these requirements. Nonetheless, we note the proposals in 16A are the same as those in IAS 39. We believe that this approach has proven to be operational in practice and has not led to demonstrably inappropriate outcomes.

**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 note that meeting the definition of transfer is a necessary but not sufficient condition to achieve derecognition. We agree that some form of definition or filter is needed. A filter avoids a need for an assessment of derecognition whenever any obligation is assumed.

In a sale/financing model, we are not convinced that the ED’s proposed broadening of the transfer concept is an improvement. In our view an obligation to transfer cash flows should be capable of qualifying as a sale of the underlying asset (or part-asset) only if the linkage between the cash flows and those asset is sufficiently strong. We believe that this is the case for:

- transfers of legal title
- assignment of rights to all or specified cash flows (and similar)
- pass-through type arrangements in which the transferor in effect acts as agent in collecting and passing on cash flows on behalf the eventual recipients.

We believe this is broadly what IAS 39’s existing requirements achieve, although some aspects of the pass-through tests may benefit from clarification.

#### Question 4 - Determination of 'continuing involvement'

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

We agree that a transfer with no continuing involvement should lead to derecognition (noting our comments on the definition of 'transfer').

We note that the continuing involvement filter could equally be described as a risks and rewards filter. We therefore suggest that it is somewhat inaccurate to assert that the proposed new model focuses on control alone (and has no test to evaluate the extent of risks and rewards retained). This is not merely a semantic point; the effect of the continuing involvement step (as defined in paragraphs 18A(a)-(c)) would be to require derecognition for some transfers that would 'fail' the proposed practical ability to transfer test in 17A(c). An example of this is the transfer of a not readily obtainable asset subject to a fair value repurchase forward option.

We observe that the continuing involvement filter sets a 'no continuing involvement' threshold. This is significantly different to the existing IAS 39 test which requires an assessment of whether 'substantially all' the risks and rewards of a financial asset are transferred or retained. This will have the effect that a transfer will achieve derecognition if substantially all (but not quite all) the risks and rewards are transferred and the practical ability to transfer test in 17A(c) is failed. We have reservations as to whether this is a superior outcome.

#### 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 recognize that the test in paragraph 17A(c) is very similar to IAS 39's existing control test. However, the test is more significant in the proposed new model. If a control test is to be the primacy basis for assessing derecognition, we believe that the design of the test (including the definition of control) needs careful and thorough consideration. The test as set out seems to us to be a curious way of applying a control-based model. For example, the proposed test:

- requires the transferor to assess the transferee's practical ability to do something (ie sell the asset for its own benefit)
- presumes that that sale is the only way of controlling the economic benefits inherent in a financial asset (a challenge referred to in BC20)
- infers that neither party may control a financial asset in many cases (neither party may have the practical ability to sell the asset in question)
- confuses practical ability with economic constraints such as credit guarantees (with reference to AG52L(e)).

### 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 subject to the following comments.

The proposed guidance in paragraph 22A seems to capture transactions in which an entity subscribes for shares in another entity in exchange for cash. It would in that case require the investment to be reported as a retained interest in the cash consideration rather than as an equity interest. We assume that this is not the intention.

### 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?**

No we do not agree. As noted in the main body of the letter we are particularly concerned as to the implications of the ED's approach on the accounting for repos (and reverse repos) and stocklending transactions.

We explain our concerns in the following paragraphs, by reference to stocklending transactions.

#### Stocklending transactions

In a typical stocklending transaction the lender transfers the security to the borrower and the borrower deposits collateral (eg 110% of the value of what was borrowed). Title of the security transfers to the borrower. Accordingly, the borrower receives all coupon or dividend payments. In most cases, these dividends or coupons will be passed back by the borrower to the lender in the form of a 'manufactured dividend'. During the term of the loan any income arising on the collateral is passed back to the borrower. A fee for the stocklending service is payable by the borrower, normally as a percentage of the value of the assets loaned. At the end of the term of the loan, the stock (or its equivalent stock) is returned to the lender and the collateral to the borrower. Some stockloans are returnable on demand.

At present, these transactions do not result in derecognition as the risks and rewards of the loaned securities are retained by the lender. The transaction is therefore accounted for as a secured borrowing. Under the proposed approach (with reference to the flowchart in paragraph AG36A), the loaned asset is derecognized. During the term of the loan the lender recognises a new financial asset representing its right to receive the income that it would have received on the stock, and the right to the return of the stock at the end of the period of the loan. We have several concerns with this outcome which are explained below.

*Increased complexity*

Although the ED purports to be less complex than the existing requirements, we believe that the application of the proposed model to stocklending transactions will be more complex for preparers and less transparent for users. The effects of the proposed model would include:

- derecognition of the loaned asset with possible gain or loss recognition (depending on the measurement category of the asset concerned)
- recognition of a new derivative financial asset, which would be recorded at fair value through profit or loss over the term of the loan
- recognition of a 'new' financial asset on return of the loaned stock (presumably with a reset of the effective interest rate in the case of debt assets)
- presentation of the 'manufactured dividend' as a settlement of the derivative asset over the life of the loan rather than as dividend income for the reporting entity
- additional disclosures to explain the accounting and the stocklending position.

With reference to the second bullet point above, we note that the lender may in some cases be required, or have the opportunity, to switch between IAS 39 measurement categories as a consequence of the approach. For example, the original asset may have been categorized as an available-for-sale financial asset. Over the term of the loan the derivative would be reported as at fair value through profit or loss. The 'new' asset recognized at the end of the loan term would be reassessed for categorization for purposes and could potentially be designated under the fair value option (for example).

Overall, we suggest that the accounting will be considerably more complex than the existing requirements.

*Not decision-useful*

We believe that the accounting effects described above will reduce transparency and render the financial statements less decision-useful.

We believe that investors in entities such as closed-ended and open-ended investment companies and funds expect the statement of financial position to include investments to which the entity is exposed (ie the risks and rewards that underlie the investment made). Investment trusts typically disclose at least their most significant investments and many disclose all their investments (albeit outside the audited financial statements in most cases). This gives an indication of the portfolio risks (such as a weighting towards a particular sector). Many entities also give a broad geographical analysis of the portfolio. This will be more of a problem if the loaned stock is not disclosed as an investment but as a derivative asset.

In summary, we believe that the approach places too much emphasis on the legal form of stocklending and similar transactions and may fail to reflect their underlying substance.

### 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 find it difficult to comment given the significantly different contexts for the two sets of requirements. We are also not clear on what is meant by compatibility in this question.

The relationship between consolidation and derecognition is probably most sensitive in the context of securitizations involving a special purpose entity (SPE). In this context, we suggest that SIC-12 and the existing IAS 39 model are if anything more compatible. Both sets of requirements have an emphasis on risks and rewards (including risks associated with the SPE's underlying assets). ED10 and the proposed amendments to IAS 39 both purport to adopt a control-based model but (i) apply very different tests of control (probably of necessity); and (ii) combine concepts of risks and rewards with the control approach, again in quite different ways.

In practice, in the context of securitization we believe preparers and users are interested in whether particular structures achieve derecognition. We are not convinced that, under a sale/financing model, derecognition is appropriate if the transferor remains exposed to significant risks or rewards in the transferred assets. However, as noted in the main body of this letter, assessing whether a specific structure should achieve derecognition is not straightforward.

Ultimately, we do not find either the existing requirements or the proposed new ones incompatible.

### 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 have no objection to the proposed amendments. We agree with the Board's comment in BC83 to the effect that the proposals seem unlikely to have a significant effect on current practice.

### **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?**

These paragraphs propose a prospective application approach from a date yet to be specified, subject to a permission to select an earlier date. We agree with this general approach on the grounds that retrospective application is likely to be burdensome and may often be impractical.

On a detailed point we suggest that the proposed permission to select an earlier date from which to apply the amendments (paragraph 107) should clarify that earlier date must be the beginning of an annual reporting period.

### **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?**

We support enhancements to IFRS 7's disclosure requirements. We agree with most of the proposed additions to IFRS 7, in particular the objectives set out in proposed paragraphs 42B and 42C.

We note that the list of disclosures in 42(D)(a)-(h) are proposed to be the minimum requirements. Our preference would be to describe these as indicative disclosures and to permit some flexibility as to what is disclosed to meet the overall objective.

More specifically we question:

- whether it will always be practical to determine the fair value of derecognised financial assets (paragraph 42D(d))
- a sensitivity analysis (paragraph 42D(g)), given that maximum exposure to loss and undiscounted cash outflows to meet repurchase commitments are also disclosed.