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Sir David Tweedie, Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

Re: Exposure Draft, Derecognition - proposed amendments to IAS 39 and IFRS 7

Dear Sir David,

Deloitte Touche Tohmatsu is pleased to respond to the exposure draft, *Derecognition,* proposed amendments to IAS 39 and IFRS 7 (the "ED").

We support the objective of the ED to change the existing derecognition requirements in IAS 39 to a more robust model based on a single principle for derecognising financial assets. Overall, however, we do not support the model proposed in the ED, rather our preference is for a modified alternative approach that in some respects is a combination of the proposed approach and the alternative approach described in the appendix to the ED. Our preferred approach is closer to the alternative approach with the significant difference that if a transferor retains control over certain rights to cash flows under the transferred asset that those cash flows are not included in the derecognition assessment, i.e. they continue to be recognised. A detailed description of our preferred model is contained in our response to Question 7, however, in summary:

- We support a derecognition model based on control. However, our preference is that the assessment of whether the transferor has given up control of the asset should be performed from the perspective of the transferor, i.e. based on their ability to control the rights to cash flows under the asset, rather than as proposed in the ED that control by the transferor is assessed by determining what the transferee potentially may or may not do with the transferred asset.

- If the transferor retains control over certain rights to cash flows but surrenders control over other rights to the cash flows of the transferred financial asset, the rights surrendered should be derecognised and the rights retained should continue to be recognised by the transferor. This compares to the ED where in many instances the ED would result in the transferor failing derecognition, thereby continuing to recognise the transferred asset when its involvement in the asset may be different to its original involvement, and may not meet the definition of an asset in the Framework or the definition of a financial asset in IAS 39. We struggle to see why the transferor should continue to recognise an asset as if it controls all the same rights to cash flows in the original asset when its rights have changed and some of its original rights are controlled by the transferee.

- Where the entity transfers an asset and as part of the transfer arrangement retains an interest in the cash flows of the asset, the transferred asset that shall be assessed for derecognition should be the net interest in the cash flows that are transferred to the

transferee. We believe this approach can apply to instances where the transferor retains a proportionate or disproportionate share in the interest in the cash flows of the transferred asset. We do not believe it is appropriate that the ED will have the effect of failed derecognition for all arrangements whereby the transferor retains a disproportionate share of cash flows in the asset.

We believe our suggested approach is more consistent with the principle of assessing whether the transferor has given up control of the transferred asset; will result in more meaningful derecognition and recognition of new contractual rights that meet the definition of assets and liabilities, and will result in a more meaningful gain/loss recognition in the case where control of all or part of an asset is given up.

In addition, we believe the definition of a transfer in the ED is too broad. In particular, the transfer of 'economic benefits' could capture arrangements which simply transfer risk and reward without any transfer of the contractual rights to cash flows under the asset or transfer of the right to receive the contractual cash flows under the asset.

Although the guidance on derecognition of financial liabilities is largely unchanged from the existing standard, and we support the derecognition principle in this guidance, we believe that the guidance on assessing derecognition when there is a substantial modification or exchange could be enhanced. Specifically, guidance is needed on assessing derecognition of compound instruments and assessing derecognition where the existing and/or new liability is subject to prepayment options.

Our detailed responses to the invitation to comment questions are included in the Appendix.

If you have any questions concerning our comments, please contact Ken Wild in London at +44 (0) 207 007 0907 or Andrew Spooner in London at +44 (0) 207 007 0204.

Sincerely,

Ken Wild
Global IFRS Leader

Appendix

Question 1—Assessment of 'the Asset' and 'continuing involvement' at reporting entity level

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?

Yes. We agree that all subsidiaries should be consolidated before assessing derecognition of transferred financial assets for the reporting entity.

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 (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.)

We do not agree with the proposed criteria for defining the Asset when assessing derecognition, specifically in relation to transfers of a disproportionate share of cash flows in a financial instrument that is an asset. We believe a transferor can transfer a disproportionate share of cash flows of a financial instrument that is an asset and assess derecognition on that basis, i.e. the entity should not assess derecognition based on the whole financial instrument as described in the ED.

We propose an alternative model, described in more detail in our response to Question 7, which defines the transferred asset from the perspective of the transferor as being equivalent to the rights to cash flows that the transferee obtains had it acquired those rights independently of the larger asset. Put another way, the transferred asset represents the rights to cash flows of the original asset that the transferor has transferred to the transferee net of any rights to cash flows in the original asset the transferor has retained as part of the transfer arrangement. This is consistent with a view that a transferor's financial instrument prior to transfer consists of a right to multiple cash flows, and that some, but not all, of these cash flows may be transferred, leaving the transferor with an entitlement to some of the same cash flows it was entitled to prior to the transfer. For example, an entity transfers a disproportionate share of cash flows in an instrument, being the first CU90 of cash flows of an instrument with cash flows of CU100. In our view, the transferee's asset is the right to the first CU90 of cash flows of a larger contractual instrument to which it has no other involvement. Therefore, the asset from the transferor's perspective is the right to the last CU10 of cash flows of a larger contractual instrument in which it has no involvement (as these other cash flows have been transferred to the transferee).

Should the Board decide to pursue the model proposed in the ED we have the following comments.

We believe the ED could be clearer as to whether "the Asset" as defined in the hands of the transferor is the same asset as defined in the hands of transferee. For example, using the above example, the ED considers the transferor's interest in the asset as the entire asset, being a right to CU100, but is the transferee's asset for the purposes of assessing control also CU100 or is it the cash flows to which the transferee is entitled, i.e. the first CU90? If the

former interpretation is correct, which we suspect is the Board's view, then a transfer that has a disproportionate share in the cash flows of a larger asset will *never* achieve derecognition as the transferee will never have the right to transfer the *entire* asset (of CU100) as the transferee does not have an entitlement to the CU10 of the cash flows of the asset. In other words, the definition of "the Asset" appears to be the condition that fails derecognition[1]. If the latter interpretation is applied, then the transferee must consider whether it has the practical ability to transfer the contractual cash flows that the transferee has an entitlement to, being the first CU90 of the entire asset, for its benefit. If the answer is yes, that portion of the asset, being the first CU90 of the asset can potentially be derecognised if it meets the derecognition criteria. If the former interpretation is what the Board intended we are surprised that the existence of a disproportionate sharing of cash flows becomes the critical feature of whether an asset is derecognised, rather than whether the transferor has control of the asset.

Where a derivative may be an asset or a liability, for example, a non-optional derivative such as a forward contract or a swap, the ED requires application of *both* the derecognition tests for assets and liabilities if there is a transfer of part of a financial instrument. We agree with this approach in the case where the derivative may be net settled, because in the case where part of the contractual cash flows are being transferred, those cash flows may be an in or out flow depending on movements in the underlying price/index. However, we disagree with this approach in the case of a non-optional derivative where gross settlement is required. For example, a transferor may receive consideration that entitles the transferee to identified cash inflows on a gross-settled interest rate swap. If the interest rate swap is an asset, and therefore the asset derecognition model is applied, the transferor has transferred identified contractual inflows (that will always be inflows, never outflows). This is consistent with the identification of an interest-only strip in a debt instrument being identifiable and be considered the asset for derecognition.

Paragraph 16A differentiates between specifically identified cash flows and a proportionate share of the cash flows from other instances by stating that "the performance of the part retained does not depend on the performance of the part transferred, and vice versa". In the case where cash flows are tranched/subordinated between the transferee and transferor, for example the transferor issues a note that passes the first CU90 of cash flows on specific assets (where total cash flows are CU100), the performance of the CU90 note does not 'depend' on the CU10 subordinated note because if CU90 of cash is received on the assets, that cash is passed to the transferee. We suspect the 'dependence' that is referred to in the paragraph is referring to the dependence of the CU90 with the performance of the *entire* asset immediately prior to the date of transfer, and if so, the paragraph should be amended accordingly.

Paragraph 16A states that if there are two or more transferees, no transferee is required to have a proportionate share of the cash flows from the asset provided that the transferring entity has a proportionate share. This paragraph makes sense in the case of applying derecognition to a proportionate share of an asset from the perspective of the transferor. However, we would expect this to also apply in the case of 'specifically identified cash flows' or in the case of assessing derecognition to the entire asset (i.e. not to 'part of a financial asset'). Our suggestion is to separate this section from paragraph 16A (which deals only with a part of a financial asset) with a separate paragraph along the lines of:

> "If there are two or more transferees, no transferee is required to have the same proportionate share of the cash flows of the entire or part of the financial asset that is assessed for derecognition as the transferor, providing that the sum of the transferees interests in the transferred assets equals the transferor's interest that is assessed for derecognition."

[1] We note that AG52L(c) could be read as supporting this interpretation: "… because of the transferor's retained interest, the transferee will not have the practical ability to transfer the Asset to an unrelated third party for its own benefit.

Paragraph AG42A should be clearer in the case where a group of assets assessed for derecognition includes instruments that may in the future be assets or liabilities (e.g. non-optional derivatives). In that scenario the paragraph states that "… the assets shall be evaluated for derecognition individually". We presume in this example the assets in the group that can be assets or liabilities in the future should be assessed separately from those assets in the group that will only ever be assets in future. For example, a group of assets that include two loans and two interest rate swaps must be assessed for derecognition as two groups, one that includes the two loans, and one that includes the two interest rate swaps. As currently drafted, the paragraph would imply that the inclusion of the interest rate swaps results in all four instruments being assessed for derecognition separately. It is not clear whether that approach is intended, and if it is intended, what is the benefit.

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?

The existing standard defines a transfer as a transfer of contractual rights to cash flows under the asset or a transfer of the right to receive the contractual cash flows under the asset. We support that as a principle. We believe the proposed definition of a transfer is too broad. Specifically, we believe a transfer of 'economic benefits' may capture transactions which simply transfer risk and reward without any transfer of the contractual rights to cash flows under the asset or transfer of the right to receive the contractual cash flows under the asset. We do not believe these transactions should be subject to the derecognition requirements. For example, if an entity enters into physically settled forward sale contract on an asset it recognises (or even a net settled forward) is the asset considered transferred as the forward passes economic benefits of referenced instruments? Would the answer differ if the proceeds under the forward contract were prepaid, i.e. consideration was received by the transferor and the transferor retained an obligation to deliver the asset under the prepaid forward contract to the transferee in the future? Similarly, is the portion of floating rate interest cash flows on a debt instrument considered transferred if the entity enters into floating to fixed interest rate swap? We believe the above examples should not be considered transfers but as currently drafted, this is ambiguous.

Clarity is also needed as to whether 'economic benefits' extend to benefits such as voting rights, subscription rights, both which are likely to be inherent in the contractual terms of the transferred asset. We believe they should not.

It is not clear how a 'provision of collateral' is a transfer. If provision is merely the referencing of collateral we believe this should not be a transfer. However, if an entity provides another entity with collateral that the receiving entity has immediate and unrestricted access to, for example cash collateral, we agree this should be considered a transfer that is subject to assessment for derecognition. Equally, we would expect foreclosure of collateral to be a transfer.

We recognise that there is some ambiguity with the existing standard as to whether assignment and novation are considered transfers (as acknowledged by the IASB in IASB Update in September 2006) and we welcome the clarification on these aspects in the proposed definition of a transfer.

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 if a transfer results in no continuing involvement then the asset should be derecognised. However, our modified alternative approach that we propose in our response to Question 7 would assess whether the rights to cash flows (and other involvement) following the transfer are different to the right to cash flows immediately prior to the transfer. If they are different, the asset is derecognised and new assets and liabilities may be recognised. This approach does not require a definition of continuing involvement, nor require the exceptions contained in paragraph 18A. This approach relies on the assessment of what is the 'Asset' subject to derecognition, and once this asset is defined, continuing involvement is not a factor in determining whether something is derecognised. This approach has the benefit of being simpler and not requiring exceptions.

If the Board decides to pursue the model proposed in the ED we have the following comments.

Similar to our response to Question 3 we are unsure whether retention of voting rights inherent in a transferred asset is continuing involvement. Paragraph 18A refers to "contractual rights or obligations inherent in the Asset", of which voting rights are contractual rights. As the definition of a transfer refers to "economic benefits" as opposed to "contractual rights" we suspect the reference in paragraph 18A should be amended to "contractual economic rights". The standard should make this clearer.

Based on the model proposed in the ED we disagree with the conclusion that a transaction that requires or permits the transferor to buy the transferred asset at a future fair value is not continuing involvement. Such an arrangement is not in our view a 'clean' sale, i.e. the transferor maintains involvement in the asset. However, based on the model in the ED, if the asset is readily obtainable in the market, the transferor would not retain control of the asset. If the transferee has the right to force the transferor to buy the transferred asset at a future fair value and the asset is not readily obtainable in the market (i.e. from the transferor's perspective, a written put at a future fair value) then this would also not constrain the transferee from transferring the asset to a third party, and therefore the transferor does not have control. However, if a transferor has the right, or is obligated under a non-optional derivative to buy back a non-readily obtainable in the market asset at a future fair value (e.g. from the transferor's perspective a purchased call or forward purchase at a future fair value) then this would constrain the transferee from transferring the asset to a third party without strings, because of the obligation (or potential obligation) to return the asset to the transferor. We believe this is consistent with the control principle that is articulated in the ED.

Paragraph 18A states that a transferor has no continuing involvement "if, as part of the transfer, it neither retains any of the *contractual rights* or obligations inherent in the Asset nor obtains any new *contractual rights* or obligations relating to the Asset." *[Emphasis added]* Retaining or obtaining contractual rights would appear on the face of it to prohibit a transaction that previously met the pass-through tests in the current requirements in IAS 39 ever being deemed 'no continuing involvement' (under paragraph 17A(b)) as in a pass-through the contractual rights of the original asset are *always* retained by the transferor. If a transferor passed all cash flows with respect to the asset to the eventual recipient(s) without material delay we do not believe this should be regarded as continuing involvement. We note that paragraph AG52L(g) contains an illustration of a pass-through of an investment in shares and states "*Entity A has no continuing involvement…*" which appears to be consistent with our preference, but the words as currently drafted in paragraph 18A do not appear to reflect this.

For completeness, if the Board's intention was to require a pass-through transaction where cash flows are passed without material delay to be assessed under the continuing involvement criteria in paragraph 17A(c), in order for the transferor to derecognise, the transferee must have the practical ability to transfer the Asset. In a pass-through arrangement, the Asset, from the perspective of the transferor, can never be transferred by the transferee, as the transferor must retain the asset in order to pass cash flows under it to the transferee. We do not believe this was the Board's intention and paragraph 18A should be amended to reflect that.

We note that listed under the exceptions in paragraph 18A there is no exception for the rights of creditors to clawback a transferred asset in bankruptcy or receivership. Consideration should be given to whether the right of the creditor to access the cash flows that the creditor is entitled to under the remaining terms of the transfer arrangement, for example in a pass-through arrangement, is considered continuing involvement in the asset. If it was considered continuing involvement (i.e. it was not considered an exception that should be listed in paragraph 18A) then we consider many pass-through arrangements that attempt to legally isolate the transferred asset from the remaining assets of the transferor would fail derecognition. This would appear surprising and therefore we do not believe that the transferee's exercise of rights to access the cash flows on the transferred asset at bankruptcy or receivership of the transferor should be regarded as continuing involvement.

Paragraph AG52B & C should be clearer as to whether 'without additional restrictions' is referring to restrictions that are 'additional' to a 'clean sale' (i.e. a sale without *any* restrictions), as opposed to restrictions that are additional to the transfer arrangement that the transferee has entered into with the original transferor to get the asset. We believe this clarity is needed, particularly as the definition of a transfer is broad. For example, if the transferee obtained the asset under a repo from the original transferor, and all the transferee can do in way of transferring the asset is a further repo to a third party, as a repo meets the definition of a transfer, it is not clear whether the 'additional restrictions' are referring to restrictions additional to the original repo or to a clean sale without any restrictions. If the former interpretation was permitted then the original transferor could achieve derecognition as the restrictions under both repos are the same, even though the transferee has limited ability to transfer the asset as the only method is a transfer that results in the transferee buying the asset back for delivery back to the original transferor. We do not believe this interpretation was intended by the Board nor do we believe that it is appropriate.

Paragraph 18A(b) does not regard servicing of the asset as continuing involvement. It would be beneficial if there was a clear principle which supported this rule. We assume the basis for this treatment is that the transferor is not receiving cash flows to retain for its own benefit, rather receiving them and in combination servicing those cash flows for the benefit of others. Also, it would be helpful to state whether servicing is deemed an "additional restriction" in paragraph AG52B & C. If the transferee can transfer the asset but retain a servicing right, say, because the cash flows on the asset it would transfer are dependent on receiving cash flows under a servicing arrangement with the original transferor, then would the need to include a servicing right prohibit the transferee ever to be able to transfer for its under own benefit (under paragraph 17A(c))?

The ED does not regard servicing of an asset as continuing involvement in that asset subject to meeting certain criteria in paragraph AG49A. With respect to the right to terminate the servicing arrangement in paragraph AG49A(c), is the right to terminate determined based on *all* transferees agreeing to terminate the servicing contract with the transferor, or is a majority vote of all transferees sufficient? The consideration of a majority vote will be relevant when there are multiple transferees.

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 support the approach contained in the ED in assessing whether the transferor has retained control. Our modified alternative approach proposed in our response to Question 7 focuses on whether the transferor controls the contractual rights to cash flows under the transferred asset (or retains the contractual rights to receive the cash flows under the asset). Control is assessed from the perspective of the transferor, not transferee (although the transferee's right to pledge or exchange the financial asset without restrictions is a strong indicator that the transferor does not control the asset). If following the transfer the transferor has transferred and surrendered control over certain rights within the financial instrument and retained other rights, the transferor should derecognise those rights transferred and continue to recognise the rights retained.

In our view the ED focuses too much on what the transferee may do with the transferred asset, as opposed to the position of the transferor, who is the party that is assessing whether they have given up control over the asset. For example, if the transferor transfers an entire asset that is not readily obtainable in the market and as part of the transfer arrangement acquires a call option from the transferee, the ED regards the transferor as having control over the original asset. We believe the transferor does not have control to the contractual rights to cash flows of the asset; rather it has a right to obtain control of the asset in the future (and thereby access the contractual cash flows of the asset in the future). Conversely, the transferee does have the right to the contractual cash flows of the asset, and therefore does have control, yet the ED would regard the transferee as not having control. Similarly, the transferee may be restricted from selling a transferred asset due to restrictions not included in the transfer arrangement and therefore the transferor is deemed to still control the asset, yet the asset that continues to be recognised does not meet the definition of an asset because it does not convey the contractual rights to cash flows.

If the Board decides to pursue the model proposed in the ED we have the following comments.

Paragraph AG52L(e) states that a guarantee on an asset non-readily obtainable in the market may economically constrain the transferee and thereby result in the transferor retaining control. It is not clear in this paragraph why the guarantee does constrain the transferee. If the transferee pays a premium for the guarantee and the transferee can only claim under the guarantee if it does not transfer the asset to a third party, i.e. the transferee must be in possession of the asset and suffer loss on the asset to make a claim, then we can see that this may economically constrain the transferee (this would be the case for an arrangement that meets the definition of a financial guarantee contract). However, if the transferee can make claim without suffering loss under the transferred asset, the guarantee does not constrain the transferee. Similarly, if the asset is assignable, and the guarantee can be transferred with the asset, does this economically constrain the transferee? We believe the Board regards 'the Asset' to exclude the guarantee (as that is what is recognised in the hands of the transferor prior to the date of transfer) and therefore if the transferee can sell the asset and the guarantee together, or separately, then the guarantee would not appear to economically constrain the transferee.

Paragraph AG52E(c) regards the transferee as having the practical ability to transfer the asset if the transferee is able to replace the transferred asset with a replacement asset for delivery back to the transferor. We consider this would only be relevant if the asset that could be replaced is itself readily obtainable in the market as this would be necessary for the transferee to obtain the replacement asset for delivery back to the transferor. If the acceptable replacement is not readily obtainable in the market then it would appear the transferee is constrained from transferring the transferred asset. It would be preferable if this point is included. In addition, the paragraph refers to an 'acceptable replacement' that is not identical to the transferred asset, implying that the replacement asset should be similar to the transferred asset. The extent of similarity should not be relevant; rather the replacement asset should simply be acceptable to the transferor as a substitute for the transferred asset. For example, if the transferee can deliver cash equal to the value of the transferred asset as acceptable replacement, then this would not hinder the ability for the transferee to transfer the transferred asset.

The example cited in paragraph AG52L(a) states that the transferee's acquisition of the readily obtainable in the market asset along with the derivative entered into with the transferor does not constrain the transferee from selling the asset. This assumption may be appropriate when the transferee is not thinly capitalised, i.e. has other net assets other than the transferred asset and the derivative. We question whether this applies in the case of a thinly capitalised entity, for example, a special purpose entity set-up to buy the transferred asset, as the entity cannot risk selling the asset and bearing the risk that the proceeds and investment returns are sufficient to meet the obligations under the derivative. For example, if the transferee acquires an equity share that is readily obtainable in the market and as part of the transfer agreement enters into a reverse repurchase agreement to sell the asset back to the transferor at a specified date, then if the transferee has no other net assets it will be limited from selling the transferred asset as doing so would expose it to price risk of the transferred asset which it will need to reacquire though may not have sufficient resources to do so. This is equally relevant to the examples in paragraphs AG52L(b) and AG52(h) even where the continuing involvement derivative is net settled. Both paragraphs should make clear that even though the transferee may have the ability to transfer the transferred assets, its practical ability may be limited by its ongoing financial commitments under the derivative with the transferor or if other constraints (not part of the transfer arrangement) limit the transferee's ability to transfer the asset then these constraints should be taken into account in assessing whether the transferee has the practical ability to sell the asset.

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 that a retained interest should continue to be recognised based on an allocated carryover basis and not as new assets initially recognised at fair value. However, we have the following additional comments.

As a servicing right is not deemed continuing involvement in paragraph 18A(b) (if it meets the conditions in paragraph AG49A) we believe it is inconsistent to treat it as part of the asset when determining the amount of the asset to be derecognised in paragraph 21. Instead, we would propose that all servicing assets or liabilities relating to an asset derecognised should be recognised initially at fair value as a separate asset (or liability). In addition, it is not clear why paragraph AG52H is only referring to a transfer of "an entire financial asset" as opposed to an entire or part of a financial asset. If the asset was a fully proportionate part or specifically identifiable cash flows of a financial asset this could be derecognised and that part be serviced by the transferor. We suggest removing the word "entire" as this could then mean either an entire or part of a financial asset as appropriate.

Paragraph 22A refers to a scenario where an entity transfers an asset to another entity "in a transfer that qualifies for derecognition" and as consideration receives an interest in that entity (which gives it the right to some of the cash flows from that asset or group of assets). The paragraph explains that the interest in the transferee shall be treated as a "retained part of the asset or group of assets previously recognised". We have concerns with this approach for a number of reasons.

Firstly, if the interest acquired in the entity is different from the interest held in the asset then from the perspective of the separate financial statements of the transferor we consider qualitatively their holding has changed from an interest in an asset, to an interest in an entity that holds the asset (which may or may not include holdings in other assets or issued liabilities). The newly acquired interest in the transferee held by the transferor is a continuing involvement and therefore derecognition will depend on the transferee's ability to sell the asset.

Secondly, if derecognition is not achieved, because the transferee is not capable of selling the transferred asset without restrictions, it is not clear how the transferor's liability arising on failed derecognition should be measured. In the instances of cash consideration received and returnable under repurchase transactions the measurement of the collateralised borrowing arising on failed derecognition is relatively simple to apply. However, it is not clear to us how the liability will be measured when the transferor's retained interest is an interest in the transferee (where cash is not returnable to the transferee), nor do we suspect it will be simple. We acknowledge the comments made in paragraph AV14 that this approach may not be operational.

Thirdly, we question whether paragraph 22A was intended to capture only non-cash consideration received under a transfer in the form of beneficial interests in the transferred asset issued by 'passive' structured entities, as opposed to operating entities. We are concerned that what is proposed in paragraph 22A will have far reaching consequences that will, perhaps unintentionally, change the accounting for more simple transactions, e.g. investing cash in a subsidiary in exchange for ordinary shares in the subsidiary which if arising at inception of the subsidiary will be treated as a failed derecognition of cash in its entirety and not as recognition of an investment in a subsidiary.

Fourthly, the paragraph states that the asset "qualifies for derecognition". It is not clear how derecognition has been achieved. In many cases the retained interest would be a disproportionate share in cash flows which would prevent derecognition under the proposals in the ED.

The ED provides no guidance on the measurement of the transferred asset in the case when the asset fails derecognition. It can be assumed therefore that the measurement of the asset remains unaffected. In the current standard this is generally regarded as acceptable as the transferor retained substantially all of the risks and rewards of ownership. However, has the

Board considered whether retaining the existing measurement for the transferred asset is appropriate in all cases where the transferred assets fails to be derecognised? For example, an entity transfers an asset that is measured at fair value and concurrently enters into a physically settled written put option with the transferee. Therefore, the transferor retains the downside fair value below the put strike price, but transfers the upside fair value above the strike price. Assuming the written put economically constrains the transferee then derecognition will not be achieved for the transferor. Is it still appropriate for the transferor to fair value both the up and downside when the exposure following the transfer is only the downside? The same question applies in the case of a transferred asset measured at fair value when the transferor retains a purchased call option and therefore is only exposed to the upside fair value above the strike price of the call option where the asset is not readily obtainable in the market and therefore the transferor continues to control the transferred asset. We suggest the retention of similar accounting as currently prescribed in IAS 39.AG48 to ensure that the rights to a transferred asset subject to continuing involvement and control are fairly presented from the perspective of the transferor.

The ED has removed the guidance in paragraph AG49 in the existing standard. This guidance stated that derivatives that are an impediment to achieving derecognition are not recognised as to do so would be double-counting. This guidance is still relevant in the case when a transfer asset fails derecognition and therefore we suggest it should be retained.

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?

In summary, we are not supportive of the proposed approach for a number of reasons:

- We believe a share in a disproportionate cash flows can be a transferred asset;
- We believe control should be assessed from the perspective of the transferor's control over cash flows of the transferred asset (i.e., does it meet the definition of an asset consistent with the framework from the perspective of the transferor), not inferring control based on what the transferee can do with the transferred asset, and
- We believe in many cases failed derecognition will result in the transferred asset continuing to be recognised when from the perspective of the transferor the rights retained do not meet the definition of an asset, or if they do, they represent different rights than the original rights inherent in the transferred asset.

We are not fully supportive of the alternative approach contained in the Appendix to the ED as this approach will result in derecognition of the entire asset in the case where the transferor retains an interest in part of the cash flows of the asset. We believe this approach would overstate the gain/loss on derecognition when only part of the asset has been transferred. This issue is particularly relevant in the case where a mixed-measurement model is retained for financial instruments (which is the case in IAS 39 and likely to be the case in the replacement of the classification model in IAS 39). At its most extreme, a transferor could transfer an asset with rights to cash flows of CU100 and retain an interest in the first CU99 of cash flows in the transferred asset. In our view, the most appropriate assessment for derecognition is a transfer

of a disproportionate share of cash flows of CU1, not for derecognition of the whole asset of CU100 and initial recognition at fair value of an asset with rights to cash flows of CU99 where those cash flows are already inherent in the transferred asset of CU100. As the transferor could classify the newly recognised asset at initial recognition differently from the classification of the whole asset prior to the transfer, this approach would be tantamount to an unrestricted option to reclassify financial assets.

Consequently, our preferred approach can be regarded as a combination of the proposed and alternative approach as set in the ED. Our preferred approach is as follows:

- We support a derecognition model based on control. However, our preference is that the assessment of whether the transferor has given up control of the asset should be performed from the perspective of the transferor, i.e. based on their ability to control the rights to cash flows under the asset, rather than as proposed in the ED that control by the transferor is assessed by determining what the transferee may or may not do with the transferred asset (although the transferee's rights may be an indicator in the assessment of control by the transferor).

- If the transferor has continuing involvement in the transferred asset, but this involvement is different to the contractual rights to cash flows originally contained in the transferred asset held by the transferor then the transferred asset should be derecognised and the new asset representing the (different) rights to cash flows recognised. For example, the transfer of an asset with a right for the transferee to put the asset to the transferor at a fixed price should result in derecognition of the transferred asset as the rights to the contractual cash flows inherent in the asset have been given up, i.e. are not controlled by the transferor, and a written put option recognised by the transferor at fair value. Under the ED, the transferred asset will continue to be recognised even though the transferor has no rights to the contractual cash flows under the transferred asset. We believe this fails to meet the definition of an asset in the Framework and the definition of a financial asset in IAS 39.

- Where the entity transfers an asset and as part of the transfer arrangement retains an interest in the cash flows of the asset, the transferred asset shall be assessed as the net interest in the cash flows that are transferred. For example, if an instrument that contains a contractual right to cash flows of CU100 is transferred and the transferor retains a right to receive 10% of cash flows from the asset, then the transfer is 90% of all cash flows. An interest of CU10 is part of the asset that will continue to be recognised and the classification or measurement of it will not change. Similarly, if the retained interest is the first CU10 of cash flows on the asset then the transferred asset is the right to all cash flows on the asset after the first CU10 of cash flows are retained by the transferor. The transferor's interest in a disproportionate share of cash flows of CU10 is part of the original asset and therefore is not subject to derecognition or a change in its classification or measurement at the date of transfer.

We believe our suggested approach is more consistent with the principle of assessing whether the transferor has given up control of the transferred asset; will result in more meaningful derecognition and recognition of new contractual rights that meet the definition of assets and liabilities, and will result in a more meaningful gain/loss recognition in the case where control of all or part of an asset is given up.

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 agree that applying a consistent model for derecognition of assets and consolidation of entities is preferable. We agree that the model should be based on control. However, we note that the application of a control model to derecognition of financial assets and consolidation of subsidiaries is different. Assessing whether control has been retained or transferred as part of assessing whether an asset should be derecognised is different from assessing whether an entity controls another entity. The fact that an asset may be derecognised in the separate financial statements, yet in the consolidated financial statement the transferee is consolidated, thereby, continuing to recognise the asset in the consolidated financial statements that was derecognised in the separate financial statements is meaningful as it reflects the difference in how the reporting entity is defined in the two sets of financial statements.

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 that the proposals are broadly similar with the existing guidance in IAS 39, which we generally support, but we do not believe the IASB has taken the opportunity to improve the existing guidance enough. We believe the followings improvements should be included to remove divergent views and remove practical difficulties with the existing standard.

We believe paragraphs 41A(b) and 42A(b) should be clarified to state "… the fair value of the consideration paid (including any non-cash assets transferred or liabilities or equity instruments issued)." The first part of this clarification should ensure that the liability is extinguished at its then fair value, reflecting the value of the liability given up. Currently, there are divergent views on whether the issue of equity as extinguishment of a financial liability should be at fair value or carrying value[2]. Our view is that it should be at fair value, reflecting the issue of shares at fair value as extinguishment of the fair value of the liability (irrespective of whether the original liability is subsequently measured at fair value or not). Our proposed clarification would make this point clearer and avoid the anomaly that a debt for debt exchange that is treated as an extinguishment results in a gain/loss on derecognition of the old debt because the new debt must be initially recognised at fair value under IAS 39.43, yet a debt for equity exchange some believe does not result in a gain/loss on derecognition of the old debt because of the lack of guidance on whether issued equity instruments are initially recognised at their fair value. The second part of this clarification will ensure that the issue of equity instruments is regarded as 'consideration paid'.

[2] We note that the IFRIC tentatively agreed at its July IFRIC meeting that the financial liability should be derecognised at its fair value and intends to issue a draft Interpretation to this effect.

In the case where a debt for debt exchange/modification results in failed derecognition the guidance should clarify that no gain/loss should arise. Specifically, the application of IAS 39.AG8 is not relevant at the date of exchange/modification, i.e. the entity is not required to estimate the future cash flows of the new debt and discount them at the original EIR of the old debt thereby resulting in a gain/loss. In addition, the standard should be clearer that the EIR is updated at the date of exchange/modification and that this revised EIR is used as the basis for interest recognition under IAS 39.AG6-8 immediately following the date of the debt exchange/modification.

The existing and proposed guidance does not provide guidance on how to assess whether a compound instrument is substantially different in the case of a modification or exchange with the existing lender. The guidance rightly focuses on just the financial liability component as that is the scope of IAS 39, whereas the equity component is not, however, guidance is needed in this area as differing views exist as to whether the compound instrument should be assessed qualitatively based on the terms of the old and new instrument, or whether the components of the compound instrument should be assessed separately (including application of the 10% test to the financial liability component before and after the modification and exchange).

Similarly, there is a lack of guidance as to how an entity assesses whether a financial liability is substantially different when prepayment options, i.e. call and put options, are introduced, removed, or amended. In US GAAP, EITF 96-19 applies the same 10% derecognition test as in IAS 39, and provides useful guidance that requires the entity to perform a separate cash flow analysis for exercise or non-exercise of the prepayment options and the scenario that generates the smaller change in the discounted value of future cash flows would be used to decide whether the 10% hurdle is breached. The Board should consider including equivalent guidance in IAS 39 as prepayment options are common yet the standard provides no guidance in this area.

Paragraph 39A refers to a financial liability ceasing to "qualify as a liability of an entity if the present obligation is eliminated". It should be clear that 'present obligation' is referring to the obligations inherent in the contractual terms of the instrument which may include obligations that are contingent. The introduction of the term 'present' could imply that only obligations inherent in the contractual terms of the instrument that are payable at present, i.e. at the date of the assessment of derecognition, should be considered, which we do not believe is appropriate. Paragraph 39 in the existing standard is clearer as it refers to "… when the obligation specified in the contract…".

We do not see the benefit of deleting "… intends to resell it in the near term" from paragraph AG58. The acquisition of debt with the intention to resell is not limited to a market maker and therefore we consider the inclusion of the words as still useful.

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 prospective approach proposed when transitioning to the new derecognition requirements.

Paragraph 107 allows entities to pick a date earlier than the date specified in paragraph 106 to apply the amendments. The ED refers to this as 'prospective application', even though it relates to transactions in the past, which we assume means that the standard is applied to

transactions on or after that date without restatement of comparative periods (unless of course the date chosen is in the comparative period). We consider the paragraph could be clearer in this respect.

If an asset was partially derecognised under the continuing involvement approach and the entity chose not to back-date the effective date to transactions that occurred before the date the continuing involvement transaction took place, it is not clear to us whether the measurement of the continuing involvement asset and associated liability will remain unaffected following the adoption of the new standard. The standard is not clear, as the asset is neither recognised nor derecognised, rather it is partially derecognised to the extent of the transferor's continuing involvement. We note that the continuing involvement measurement paragraphs will have been deleted from IAS 39 upon introduction of the new standard on derecognition.

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 generally agree with the proposed amendments to IFRS 7 but have the following comments.

We suggest that the derecognition disclosures contained in paragraphs 42A-42F should be included in the main body of IFRS 7 with the other required statement of financial position and statement of comprehensive income disclosures (as currently included in IFRS 7.13) as opposed to a section in the standard.

Paragraph 42A refers to a "… period within the reporting period". It is not clear what length of period the proposal is referring to. This may be interpreted in many different ways, for example a month, a week, a day. Clarification as to what length of time the Board considers is reasonable would be beneficial.

We note that there are no disclosures for financial liabilities that fail derecognition. We consider it may be useful for users to understand if during the period the entity had a modification or exchange of a financial liability with an existing lender. In particular, disclosure of the revised effective interest rate immediately following and immediately proceeding the date of the modification or exchange will provide the user with the amount of gain/loss that is effectively being spread over future periods as opposed to be recognised at the date of the modification or exchange.

Editorial comments

We recommend the following editorial comments (tracked changes):

Paragraph 9:

> Derecognition is the removal of a previously recognised financial asset or financial liability from of a financial asset or financial liability is ceasing to recognise that asset or liability in an entity's statement of financial position.

We note that the wording that describes the servicing of the transferred asset in paragraphs AG49A(a) and AG52H(a) appears to differ. We presume the wording in the paragraphs should be consistent?