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30 July 2009

International Accounting Standards Board
30 Cannon Street
LONDON EC4M 6XH
United Kingdom
Email: CommentLetters@iasb.org

Dear Sir/Madam

SAICA SUBMISSION ON EXPOSURE DRAFT *DERECOGNITION PROPOSED AMENDMENTS TO IAS 39 AND IFRS 7*

In response to your request for comments on the IASB's exposure draft on *Derecognition Proposed Amendments to IAS 39 and IFRS 7*, attached is the comment letter prepared by The South African Institute of Chartered Accountants (SAICA). Please note that SAICA is not only a professional body, but also secretariat for the Accounting Practices Board (APB), the official standard-setting body in South Africa. The SAICA comment letter results from deliberations of the Accounting Practices Committee (APC), which is the technical advisory body to the APB.

We thank you for the opportunity to provide comments on this document.

Please do not hesitate to contact us should you wish to discuss any of our comments.
Yours sincerely

Sue Ludolph
Project Director – Accounting

cc: Moses Kgosana (Chairman of the Accounting Practices Board)
Prof Alex Watson (Chairman of the Accounting Practices Committee)

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SAICA SUBMISSION ON EXPOSURE DRAFT *DERECOGNITION PROPOSED AMENDMENTS TO IAS 39 AND IFRS 7*

GENERAL COMMENTS

Whilst we have some supporters of the proposed approach for the derecognition of financial assets, on balance we do not support the proposed approach and instead favour the alternative approach. We support the IASB's objective of seeking to achieve a compatible approach between the consolidation of entities and the derecognition of financial instruments. On balance we believe that, in many respects, the alternative approach is more consistent than the proposed approach with the control based consolidation model as proposed in ED 10 – *Consolidated Financial Statements* ('ED 10'). The alternative approach is favoured since it retains the concept of control throughout the assessment of derecognition, results in the recognition of financial assets that meet the definition of an asset in terms of the framework, and results in the recognition of only those assets that are controlled by the entity.

We would also like to note that in the event that the IASB's direction of thinking on ED 10 changes (for instance to a risks and rewards approach), then our comments on this exposure draft may change. Accordingly, we have recommended below that the IASB should consider reissuing both ED 10 and this exposure draft simultaneously after consideration of all comments. This will provide constituents with an opportunity to consider whether the principles have been applied consistently across the two exposure drafts.

We agree in principle with the proposed approach for the derecognition of financial liabilities.

Our answers to the specific questions, which have been based on the IASB adopting the proposed approach, have been provided below, together with other comments that we have on the proposals.

SPECIFIC COMMENTS

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?

We agree, in the context of both the proposed and alternative approaches, that the determination of the item to be evaluated for derecognition should be made at the level of the reporting entity.

We do however note that the exposure draft (similar to the existing IAS 39 – *Financial Instruments: Recognition and Measurement* ('IAS 39') requirements) indicates that an entity first consolidates all subsidiaries in accordance with IAS 27 – *Consolidated and Separate Financial Statements* ('IAS 27') and SIC 12 – *Consolidation – Special Purpose Entities* ('SIC 12') and then applies paragraphs 15A, AG37A and AG47A to the resulting group. We do not believe that paragraph 15A has been appropriately worded to ensure the continuous recognition of assets that fail the transfer criteria at group level. For example, assume assets are transferred at the subsidiary level, but fail the derecognition criteria at the group level; strict reading of paragraph 15A of the exposure draft would imply that the balance sheet of the subsidiary (which excludes the transferred assets) is first consolidated into the group's financial statements at which time the requirements of 16A, 17A and 18A are applied. However, since the assets are excluded from the subsidiary's balance sheet, those paragraphs are not applied to any assets. We recommend that the wording of paragraph 15A be amended as follows: *'Hence, if the reporting entity is the group, an entity consolidates all subsidiaries in accordance with IAS 27 and SIC 12 – Special Purpose Entities* ***(before the application of those paragraphs in the entities separate financial statements)*** *and then applies those paragraphs to the resulting group.'*

We also recommend that similar criteria to that contained in paragraph 15A be provided for the derecognition of financial liabilities, i.e. that the determination as to whether a financial liability should be derecognised should be made at the level of the reporting entity. To demonstrate why this is necessary, consider the following example: Parent A owns 100% of Subsidiary B. B has a liability of CU100 to a creditor C. During the year Parent A agrees with C to exchange a new liability with C in exchange for B's existing liability to C. From a group perspective, the accounting for the exchange of liabilities would need to be considered in terms of paragraph 40A of the exposure draft.

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 agree, in the context of the proposed approach, with the criteria proposed in paragraph 16A for what qualifies as the item to be assessed for derecognition.

We do however note that paragraph 16A refers to specifically identified cash flows or the proportionate share of the cash flows from that financial asset. Accordingly it is questionable whether the derecognition requirements of paragraph 16A would be able to be applied to all financial assets. For instance, an entity has a physically settled commodity contract (e.g. exchange of one commodity for another with no future cash flows) that is accounted for at fair value (since the contract meets one of the criteria in paragraph 6 of IAS 39). The contract's fair value at the date of transfer is positive. Since the instrument does not have a future cash flow the requirements of paragraph 16A cannot be applied. Furthermore, other physically settled derivatives accounted for at fair value may include a cash inflow (the sale of an item) or outflow leg (the purchase of an item) but may be an asset owing to the relative fair value change between the non-financial item and the cash leg. It is questionable whether paragraph 16A would apply to the entire financial asset since part of the asset's contractual terms includes the sale or purchase of a non cash item.

Accordingly we recommend that the wording of paragraph 16A be amended as follows: *'An entity applies paragraph 17A and 18A to a part of a financial asset (or a part of a group of financial assets) only if that part comprises specifically identified* *cash flows* ***(or specifically identified and recognised future benefits)*** *or a proportionate share of the cash flows* ***(or proportionate share of the recognised future benefits)*** *from that financial asset (or that group of financial assets) (i.e. the performance of the part retained does not depend on the performance of the part transferred, and vice versa).'*

We have included the reference to '*recognised future benefits'* in our recommendations above. This is because we understand that the derecognition principles of the exposure draft should be applied to the cash flows (or recognised future benefits as proposed by ourselves) of an asset, rather than also being applied to unrecognised future benefits of an asset such as the intangible value of a customer list. For example, an entity that transfers its debtors book to another entity would apply the derecognition principles only to the recognised cash flows of that book of assets and not to the underlying customer list which it retains ownership of.

Question 3—Definition of 'transfer'

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

We agree, in the context of the proposed approach, with the definition of a transfer as proposed in paragraph 9.

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 note from BC29 that the Board's proposed approach to the derecognition of financial assets and its underlying principle is based on control which, in the context of financial assets, is the ability to obtain access to the underlying future economic benefits and the ability to restrict other's access to those benefits (i.e. the ability to access the benefits for one's own benefit).

In our view the 'continuing involvement' filter as proposed by the proposed approach brings a risks and rewards concept into a model that is otherwise based on control. This is one of the reasons why we favour the alternative approach as opposed to the proposed approach since it is a control based model.

Based on our understanding that the proposed approach's derecognition model is to be applied to specifically identified cash flows, we recommend that the following additional example be included within paragraph 18A:

(d) the sale of the rights to the future cash flows of a book of debtors, but retaining the rights to the customer list.

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.)

We agree, in the context of the proposed approach, with the proposed *'practical ability to transfer'*.

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?

Yes, we agree with the *'for the transferee's own benefit'* test as proposed as part of the *'practical ability to transfer'* test. We do, however, recommend that the reference to gross versus net settled derivatives as discussed in the examples in AG52L(b) be incorporated into AG52E as a factor that should be considered in making the determination of whether the transferee has the practical ability to transfer 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 with the proposed accounting treatment in paragraph 21A for an interest retained in a financial asset or group of financial assets in a transfer that qualifies for derecognition.

We do not agree with the proposed accounting treatment in paragraph 22A for an interest in a financial asset or group of financial assets retained indirectly through an entity.

In our view paragraph 22A contradicts the principles of ED 10. For instance, ED 10 indicates that if an entity loses control over its subsidiary then the assets and liabilities of that subsidiary are derecognised with any investment retained in that entity being accounted for in accordance with other IFRSs from the date that control is lost. In a similar manner, we believe that the requirements outlined in the proposed approach should be applied in determining whether the financial asset is derecognised. If, in return for the transfer of the asset, the transferor purchases an interest in that entity (to which the asset was transferred), then the requirements of ED 10 should be applied on consolidation in determining whether the assets should continue to be recognised.

We also believe that the application of paragraph 22A may result in the recognition of new assets and liabilities at values that are not equivalent to fair value on the date of initial recognition (for example, the transfer of assets to a fund that holds existing assets). It is also unclear what the subsequent accounting would be for the two components referred to in paragraph 22 A (a) and (b), i.e. would the interest referred to in (b) be accounted for as an investment in an entity in terms of IAS 39, IAS 27 or

IAS 28 as appropriate, or would the individual new assets or liabilities be accounted for in accordance with relevant IFRSs?

Accordingly, we recommend that paragraph 22A be deleted from the proposed approach.

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?

As noted above, on balance we do not support the proposed approach as the new approach for determining whether financial assets should be derecognised or not for the following reasons:

- the proposed approach starts as a control based model and subsequently evolves into a risks and rewards based model through the application of a 'continuing involvement' test, which is akin to a risks and rewards test, and then back into a control based model through the application of a '*practical ability to transfer the asset for its own benefit'* test (agreement with AV3). We believe that where the model is to be based on the control aspect, that the concept of control should then be retained throughout the assessment of derecognition;
- a transfer of a financial asset that fails the derecognition criteria under the proposed approach due to the transferor having continuing involvement, does not necessarily imply that the transferor controls the asset;
- the proposed approach results in the recognition of financial assets and financial liabilities that may conflict with the definitions of assets and liabilities in terms of the framework. For instance, a transfer of financial assets that fails the derecognition criteria would be accounted for as a securitised borrowing arrangement (the recognition of a liability together with cash or another financial asset). However, the liability does not meet the definition of a liability in terms of the framework since the transferor does not have the present obligation to remit any cash until it has received such cash flows on the underlying assets (agreement with AV6). We also believe that, for similar reasons above, the proposed approach is inconsistent with the principles outlined in ED 10;
- the proposed approach results in the recognition of assets and liabilities that may not represent the transferor and transferee's contractual rights and obligations. For instance the transfer of 99.99% of the cash flows of a group of assets that fails the derecognition criteria of the proposed approach would continue to be recognised as an asset with a comparable liability to remit any cash flows to the transferee. We agree with AV4 that the assets do not represent a future economic benefit to the holder since the holder has the obligation to remit any cash flows it receives on the assets to the transferee;
- different accounting treatments will arise depending on whether the entity previously owned the transferred assets or whether the entity entered into a

derivative instrument over those transferred financial assets (agreement with AV8); and
- the proposed approach to the derecognition of financial assets is not consistent with the derecognition criteria for financial liabilities (agreement with AV8). Similar to the proposed approach's requirements for the derecognition of financial liabilities, the derecognition of financial assets should commence with a reference to the framework's definition of an asset and then build the derecognition approach based on that definition.

Most favour the alternative approach as it retains the concept of control throughout the assessment of derecognition. The alternative approach also results in the recognition of financial assets that meet the definition of an asset in terms of the framework and is consistent with the principles outlined in ED 10, whereby only those assets that are controlled by the entity are recognised. Those also believe that whether an entity transfers a proportionate or disproportionate interest in the cash flows of an asset should not affect the decision as to whether the financial assets should be derecognised. Whilst there is preference for the alternative approach, we refer you to our comments in Question 2 – determination of the asset to be assessed for derecognition which apply equally to the alternative approach. Those who favour the proposed approach have noted one of the potential downfalls of the alternative model is that it has the potential to result in the recognition of many derivatives whose measurement will presumably rely on Level 3 inputs, especially since Level 3 inputs incorporate subjectivity into the measurement basis of assets and liabilities.

Question 8—Interaction between consolidation and derecognition
In December 2008, the Board issued an exposure draft ED 10 Consolidated Financial Statements. As noted in paragraphs BC28 and BC29, the Board believes that its proposed approach to derecognition of financial assets in this exposure draft is similar to the approach proposed in ED 10 (albeit derecognition is applied at the level of assets and liabilities, whereas consolidation is assessed at the entity level).

Do you agree that the proposed derecognition and consolidation approaches are compatible? If not, why? Should the Board consider any other aspects of the proposed approaches to derecognition and consolidation before it finalises the exposure drafts? If so, which ones, and why? If the Board were to consider adopting the alternative approach, do you believe that that approach would be compatible with the proposed consolidation approach?

We do not believe that the proposed approach and the consolidation approach as outlined in ED 10 are compatible with one another, since the proposed model incorporates a continuing involvement test which is akin to a risks and rewards approach that is not inherent in ED 10's control model.

We believe that the alternative approach is better aligned with the concept of control inherent in ED 10.

Given that a concept of control is inherent in both ED 10 and this exposure draft, we recommend that the IASB should consider re-exposing both exposure drafts after the consideration of all comments received. This will provide constituents with an opportunity to reconsider whether the proposed derecognition and consolidation approaches are compatible with one another.

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 in principle with the proposed approach to the derecognition of financial liabilities. However:

- in the context of the proposed approach we recommend that the requirements of paragraph 16A as they apply to financial assets in determining what a part of a cash flow is, i.e. specifically identified cash flows or a proportionate share of the cash flows, be equally applicable to financial liabilities.
- in the context of the alternative approach (which we favour), we recommend that paragraph 39A be amended as follows: '*An entity shall derecognise a financial liability* ~~**(or a part of it)**~~ *when it no longer qualifies as a liability of the entity …*'

Some are of the view that Paragraph AG62, being the 10% threshold for the determination of whether a financial liability is derecognised or not, should be deleted in line with the absence of quantitative thresholds in other IFRSs (examples include the replacement of the 90% requirement in IAS 17 – Leases in the context of the minimum lease payments with the words '*substantially all*'). Others believe that the provision of the quantitative threshold is useful since it provides definitive guidance and eliminates judgmental/alternative accounting treatments from arising.

Further, we refer you to our recommendation in our response to Question 1 to provide similar guidance as contained in paragraph 15A of the exposure draft for the 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?

Whilst we agree with the transitional requirements, we do not believe that the requirements provide sufficient guidance with respect to assets that the entity had a continuing involvement in, in terms of IAS 39's existing derecognition model (IAS 39, paragraphs 31 -34 and AG48). Given that the transitional requirements will not result in those assets having to be derecognised, such guidance would need to be retained.

Paragraph 107 of the proposed approach permits an entity to apply the amendments prospectively to transactions entered into before the date specified in paragraph 106. Some have interpreted this to mean that this should be a date at the commencement of an entity's annual period, whilst others have interpreted this to imply that any date within a financial period may be selected. We believe that the date should be at the commencement of an entity's annual period and recommend that the Board provide clarity in this regard.

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 agree with the disclosure requirements as specified in paragraph 42B, noting that these are substantially the same as those that are currently required in terms of IFRS 7 - *Financial Instruments: Disclosures*.

We do, however, question the usefulness of the disclosure requirements as specified in paragraphs 42D and 42E for transferred financial assets that are derecognised in assisting users of financial statements to evaluate the nature of and risks associated with the entity's continuing involvement in those derecognised financial assets. We believe that these disclosure requirements effectively second guess the appropriateness of the entity's assessment of control in determining whether a financial asset should be derecognised or not. Instead, we believe that such disclosures should be based on that which is reported to key management personnel (as defined) in terms of managing its exposure to risks arising through its continuing involvement with the assets.

OTHER COMMENTS

Definition of control

BC29 defines control in the context of financial assets as the ability to obtain access to the underlying future economic benefits and the ability to restrict other's access to those benefits (i.e. the ability to access the benefits for one's own benefit). We recommend that this definition of control be placed in the body of the standard as opposed to the bases of conclusions.

Measurement of the financial liability relating to financial assets transferred, but not derecognised

The proposed approach provides that a liability associated with a financial asset that continues to be measured at amortised cost following a transfer shall not be designated as at fair value through profit or loss (FVTPL).

Whilst permitting designation at FVTPL for such liabilities would result in a measurement inconsistency between the liability and the asset, this prohibition may result in other measurement inconsistencies that could be eliminated by permitting designation at FVTPL. For instance, a fixed rate liability that arises following a transferred asset that continues to be recognised is hedged by means of an interest rate swap: The interest rate swap is required to be measured at fair value, whilst the liability is to be measured at amortised cost. This measurement inconsistency could be eliminated by permitting designation at FVTPL where hedge accounting would otherwise have been required. Permitting designation at FVTPL is also consistent with the IASB's exposure draft on classification and measurement (ED2009/7), which permits designation to eliminate or significantly reduce a measurement or recognition inconsistency.

Renegotiated financial assets

There is currently no guidance for the accounting treatment for the renegotiation of a financial asset (e.g. renegotiation of a short term non-interest bearing receivable into a term interest bearing loan). We recommend that similar requirements as to those specified in paragraph 40A for the exchange of financial liabilities that are substantially different should be incorporated into IAS 39 for the renegotiation of financial assets (in the context of both the proposed and alternative approaches). We believe that the incorporation of such guidance would assist in ensuring similar accounting treatment by preparers for such items.

Consistency with the derecognition of other assets in terms of IFRS

Derecognition in terms of both the proposed and alternative approaches arises through the application of a control based assessment (and continuing involvement in the context of the proposed approach).

The derecognition of assets in terms of other IFRSs is not based on the same basis of assessment and includes risks and rewards tests and/or continuing involvement assessments that are not consistent with the principles in the exposure draft. For instance, IAS 16 – *Property, Plant and Equipment* indicates that *‘the carrying amount of an item of property, plant and equipment shall be derecognised on disposal or when no future economic benefits are expected from its use or disposal.’*

We recommend that the Board consider adopting control based approaches for the derecognition of other assets that are based on the definition of an asset in the framework.

We also note that the IASB’s discussion paper on revenue proposes the incorporation of a control concept in the recognition of revenue. Where control is going to be an underlying principle in IFRS such as in the consolidation of entities; the assessment of derecognition; and the recognition of revenue, that the concept of control be provided for in the conceptual framework.

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