

31 July 2009

Sir David Tweedie
Chair, International Accounting Standards Board
International Accounting Standard Board
30 Cannon Street
EC4M 6XH
United Kingdom

Re: ED Derecognition *Proposed amendments to IAS 39 and IFRS7*

Dear Sir David,

The CFA Institute Centre for Financial Market Integrity (CFA Institute Centre),¹ in consultation with its Corporate Disclosure Policy Council (CDPC)², appreciates the opportunity to comment on the IASB Exposure Draft Derecognition *Proposed Amendments to IAS 39 and IFRS 7*.

CFA Institute, through the Centre, represents the views of its membership, which includes portfolio managers, investment analysts, and advisors, worldwide. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protection. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the CFA Institute Code of Ethics and Standards of Professional Conduct.

¹ The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With offices in Charlottesville, VA, New York, Hong Kong, London, and Brussels, CFA Institute is a global, not-for-profit professional association of more than 95,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 131 countries, of whom almost 84,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 countries and territories.

² The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The Council is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the Council provides the practitioners' perspective in the promotion of high quality financial reporting and disclosures that meet the needs of investors.

EXECUTIVE SUMMARY

Summary of Exposure Draft

The International Accounting Standards Board (IASB) issued an exposure draft (ED) *Derecognition Proposed amendments to IAS 39 and IFRS 7* of proposals to improve the requirements for derecognition of financial instruments. The ED seeks to clarify the steps by which financial assets are removed (“derecognized”) from financial statements when a company no longer controls a financial asset or no longer has an obligation to settle a financial liability. Included in the exposure draft are proposals to enhance the disclosures currently required by *IFRS 7 Financial Instruments: Disclosures*. These disclosure enhancements are especially directed at situations where an entity has continuing involvement in a financial asset that would be derecognized in accordance with the proposals.

The current approach for derecognition of financial assets in *IAS 39 Financial Instruments: Recognition and Measurement* (IAS 39) is complex, given that it combines various concepts, such as risks and rewards, control, and continuing involvement to assess whether a financial asset or a financial liability should be derecognized. The proposals in the ED do not combine these concepts; rather the focus is on control and is different from the current IAS 39 requirements in the following key areas:

- For financial assets subject to derecognition there is no test to evaluate the extent of risks and rewards retained or specific pass-through requirements.
- It uses control as the primary test of whether an asset or liability should be recognized.
- There would be certain circumstances where transfers of financial assets with repurchase agreements would qualify for derecognition if the assets subject to the transfer were readily obtainable.

Key Implications for Investors

We believe that asset derecognition would become more prevalent than under current existing IFRS. The proposal is less restrictive than existing guidance today and thus would result in more frequent derecognition of financial assets. To derecognize an asset under the current guidance requires an assessment of control over the asset in question and also an assessment of the risks and rewards. The “risks and rewards” filter is eliminated in the proposal, thereby removing an obstacle for derecognition.

We do not support the removal of this filter and encourage the Board to retain the risks and rewards assessment to augment other indicators of control.

Enhanced disclosures would provide investors with better information about derecognized financial assets and financial liabilities. Compared to current practice, the proposed amendments to the disclosure requirements should greatly amplify information about both

derecognized financial instruments and financial instruments that do not qualify for derecognition.

We strongly support these enhanced disclosures which will enable investors to identify risks not previously known or understood.

Summary of CFA Institute Positions

General Comment: **Accounting standards should not permit companies to structure financial arrangements to avoid recognition or disclosure of material risk exposures.** Off-balance-sheet activities use the credit, liquidity, and other financial resources provided by investors or creditors in the entity. These investors must be informed of how their investment is being used. We therefore believe that financial statements must include assets, liabilities, and activities that are currently off-balance-sheet.

Derecognition of Financial Assets: We support derecognizing assets only when control has been surrendered, and associated financial benefits and risk exposures have ceased, and derecognizing liabilities only when they have been extinguished. However, we are not convinced that surrender of control (along with the related elimination of associated benefits and risk exposures) with respect to a specific transaction viewed in isolation is a sufficiently rigorous criterion.

For example, a financial institution may securitize a pool of credit card receivables in a transaction that transfers control. However, the transferor's critical need for ongoing financing of credit card receivables often means that it would be willing or able to bear the liquidity constraints that would be a consequence of financial problems. The ED does not contain reporting and disclosure requirements that would inform a user of such potential liquidity constraints, and the resulting lack of financial flexibility. To that end we urge the Board to adopt a no-continuing involvement model for transferred assets to qualify for derecognition, accompanied by robust disclosures designed to inform investors and users of potential liquidity, financial flexibility, and earnings concerns related to specific transfer transactions as well as issues stemming from a class of transfer transactions, such as credit card securitizations.

This model would be the least complex approach that would also eliminate financial engineering opportunities. In the event that the Board allows some form of continuing involvement, **we urge that there be a rebuttable presumption that the transferor maintains effective control. If the entity satisfactorily rebuts the presumption of effective control, but there is still some form of continuing involvement, the entity should report the derecognized assets and liabilities as a supplement to the statement of financial position in a caption such as “Transferred Assets with Continuing Involvement” and “Transferred Liabilities with Continuing Involvement” (if applicable) accompanied by appropriate disclosures.** This supplemental reporting would continue until the entity's continuing involvement has been fully ended. The rerecognized assets and liabilities should both be reported at fair value. Displaying these transactions on the face of the statement of financial position would improve the transparency of these transactions for users.

Effective Control: The Board is proposing to eliminate the “substantially all risks and rewards retained” test that is in the existing model. We believe that this test is essential to fully understand which entity is in control of the transferred financial assets or financial liabilities. While it may not be the sole indicator of control it is an important assessment. To that end, we encourage the Board to retain a risk and rewards assessment to augment other indicators of control. The potential risks and rewards could be implicit or overt in that there is an expectation that the transferor would support the liquidity, credit or other economic requirements of the transferred assets.

Disclosures: Recent financial market events signal the importance of full disclosure of all of an entity’s obligations, including off-balance-sheet obligations, continued involvement in transfers of financial assets and liabilities, and the substantive or explicit need to support liquidity, credit, or other economic consequences of securitization or other asset transfer activities. To that end, enhanced disclosures would enable investors to identify risks not previously known or understood. We further emphasize that the proposed disclosures should be presented in a manner that (1) strengthens the clarity of the transactions, (2) clearly reflects management’s evaluation of risk and return relationships as they relate to transferred assets, and (3) for those entities using securitizations or transfers of financial assets as a critical funding mechanism integral to their operations, management’s assessments of alternative sources of liquidity. **We recommend that the final standard provide sample disclosures linking the requirements with the expected outcome of enhanced qualitative and quantitative information.**

GENERAL COMMENTS

Events of the past several years have clearly exposed why the issue of off-balance-sheet accounting and its impact on the global capital markets are of extreme importance to investors and capital markets. The proposed accounting for securitizations fails to provide the transparency needed for users to make reasoned and informed investment decisions. During the current financial crisis this lack of transparency has led to investor surprise at the substantial losses and a substantive decline in confidence in financial reporting. The present problems in the financial markets are linked to inadequate reporting of exposures on the balance sheet and confusion as to the nature of exposures both on-balance-sheet and off-balance-sheet.

CFA Institute Centre’s position regarding the financial reporting of on or off-balance-sheet assets and liabilities is that:

- Assets which a company owns, or in which a company holds or has the right to receive an expected beneficial interest, should be properly recorded in the company’s balance sheet with gains and losses recorded as incurred in the income statement; and that
- Liabilities or other obligations for which the company bears exposure to risk should be properly recorded in the company’s balance sheet with gains and losses recorded as incurred in the income statement.

In addition, we believe that all remaining off-balance-sheet activities that constitute critical funding or financing mechanisms integral to continued operations should be accompanied by clear and transparent disclosures of the impact of those activities, as well as management’s

assessments of alternative sources of liquidity. **These assessments may be provided in the form of a sensitivity analysis of critical factors or indicators that would require management to seek those alternative funding sources.**

We believe that the financial reporting requirements of the entity should be viewed from the perspective of the shareholder who bears the ultimate risk of its assets, obligations, and operating activities. Through the process of preparing information that is useful for the most subordinate member of a company's capital structure (the common shareholder) we believe sufficient information is ultimately furnished that allows more senior members of the capital structure to effectively assess their relative positions. After all, common shareholders must value these senior positions to value the equity.

To this end, the financial statements should fully reflect the fair values of exchanges and transactions, including commitments and other arrangements that have, or possess the potential to have, an economic effect on the risk and rewards of the company as well as continued operations, and, consequently, on the investor's equity position. **We are concerned that the current and the proposed derecognition accounting standards provide companies with the flexibility to selectively omit assets and obligations and to obscure critical financing mechanisms and sources of liquidity.** Statements that understate assets or liabilities, financing mechanisms and other risks of a company severely impair the usefulness of the information to investors and other users. The needs of investors for complete, reliable, relevant and timely information should supersede all other interests.

Accounting standards should not permit companies to structure financial arrangements to avoid recognition or disclosure of material risk exposures. Off-balance-sheet activities use the credit, liquidity, and other financial resources provided by investors or creditors in the entity. These investors must be informed of how their investment is being used. We therefore believe that financial statements must include assets, liabilities, and activities that are currently off-balance-sheet.

We believe that any new standard for derecognition should improve the relevance, representational faithfulness, and comparability of information provided by an entity about a transfer of financial assets including a transferor's continuing involvement in transferred financial assets.

We appreciate the IASB's effort to address the complexity and inconsistencies for derecognition by issuing its ED, however we feel that the issues need to be addressed in further detail in order to avoid the potential for misinterpretation and/or opportunistic structuring.

CFA Institute Centre has followed and commented on the recent proposals of both the Board and the Financial Accounting Standards Board (FASB) regarding off-balance-sheet activities, transfers of financial assets, and transfers of financial liabilities. We have provided comments on what we feel should be the key parameters for determining the appropriateness of achieving derecognition and disclosure requirements as noted below.

No Continuing Involvement Model

We strongly believe that in order for a transfer of financial assets to be accounted for as a sale that an entity should have no continuing involvement in the transferred assets. Adopting a no-continuing involvement model significantly reduces the opportunity to develop structures whereby transferors may continue to exert influence over the transferred assets and yet record the transaction as a sale. Such a model also would help reduce accounting complexity.

However, should the Board reject a strict no-continuing involvement model then we believe that evidence of continuing involvement should raise a rebuttable presumption that the activity is a financing, not a “sale”. In general, we believe the definition of continuing involvement should include any transfer of assets or liabilities (to a related or unrelated entity) that:

- Constrains the resources of the transferor,
- Limits the benefits the transferor would normally receive from a sale or transfer,
- Adds to or does not reduce risks related to or stemming from operating, investing, or financing activities of the transferor,
- Exposes the transferor to incremental risks in the event the transferee is unable to provide services or discharge its contractual obligations, or
- Implies continuing involvement affecting risk or return (i.e., requires or may require additional collateral, cash or equity investment, repurchases of transferred assets or liabilities).

If there is continuing involvement, the transferor 1) must rebut the presumption that it has not relinquished effective control, and 2) must affirm that it has no intent to support the transferee, the transferred assets, or any class of the beneficial interest holders in the event of financial distress.

If the entity satisfactorily rebuts the presumption of effective control, but there is still some form of continuing involvement, such transactions should be reported as a supplement to the statement of financial position in a caption such as “Transferred Assets with Continuing Involvement” and “Transferred Liabilities with Continuing Involvement” (if applicable) accompanied by appropriate disclosures. This supplemental reporting should continue to be reported until the entity’s continuing involvement no longer exists. Both assets and liabilities should be reported at fair value. Displaying these transactions on the face of the statement of financial position increases the transparency of these transactions for users. Netting on the face of the balance sheet should not be permitted; assets and liabilities should be shown gross but may be aggregated. The notes should sufficiently disaggregate the reported amounts based on transfer class for investors to fully understand and interpret information about the assets.

Determining an entity’s continuing involvement in a transfer requires judgment especially as it relates to remaining de minimis risks and benefits. While it may seem that insignificant involvement would not warrant disclosure, it may be important for investors to understand (1) the reason for continuing involvement, and (2) the likelihood of the need to use alternative funding methods. In those situations, entities should follow a principles-based approach for

disclosing information deemed useful to investors. For example, an entity should disclose the business purpose, risks, guarantees, liquidity needs, and other information (as it relates to the different classes of continuing involvement) considered beneficial to investors.

Effective Control

The Board is proposing to eliminate the “substantially all risks and rewards retained” test that is currently in the existing model. We believe that this test is essential to fully understanding which entity is in control of the transferred financial assets or financial liabilities. While it may not be the sole indicator of control it is an important assessment. To that end, we would encourage the Board to retain a risk and rewards assessment to augment other indicators of control. The potential risks and rewards could be implicit or overt in that there is an expectation that the transferor will support the liquidity, credit or other economic requirements of the transferred assets.

For example, there are many entities with strong brand identification, and due to their reputational risk, the market assumes that they would step in to support the transferred asset in the event of failure. This implicit assumption has implied economic value. If in fact the transferor retains risks and rewards, then the transaction should be accounted for as a financing. **Reputational risk is a key consideration in this assessment and a no-continuing involvement approach in the final standard would incorporate such risk as a rebuttable presumption.** We believe that if a transferor has historically made investors whole on losses or shared in the benefits or is likely to have reputational risks that would cause it to make investors whole on losses or share in the benefits above and beyond some rate of return to the investors, then the transactions should be reported as liabilities or benefits respectively. The recognition of substantive commitments of an entity distinct from stated contractual obligations is not new in accounting.

It is also unclear in the ED how kick-out right provisions would be considered as a determinant of control. These provisions provide structuring opportunities to conclude that no single party would in essence have control. We believe that substantive kick-out rights should be excluded from a qualitative assessment of control unless they are held by a single party. We also emphasize that even in situations where kick-out rights are held unilaterally, the holder is not necessarily deemed to have control if the exercise of such rights would create an economic disadvantage.

We believe that to be substantive and considered in assessing control, kick-out rights must have the following characteristics:

- a) they must be held by a single party
- b) the decision maker can be removed by the vote of a simple majority, and
- c) the party holding the kick-out rights must have the ability to exercise those rights if they choose to do so; that is, there are no significant barriers to the exercise of those rights.

Barriers include financial penalties or operational barriers associated with replacing the decision maker that would act as a significant disincentive for removal. **This underscores the need for the derecognition accounting standard to require careful scrutiny of any underlying kick-out rights provisions.**

Disclosures

Recent financial market events signal the importance of full disclosure of all of an entity's obligations, including off-balance-sheet obligations and the continued involvement in transferred financial assets and liabilities. To that end, enhanced disclosures should enable investors to identify risks not previously known or understood. We further emphasize that the proposed disclosures should be presented in a manner that (1) strengthens the clarity of the transactions, (2) clearly reflects management's evaluation of risk and return relationships as they relate to transferred assets, and (3) for those entities using securitizations or transfers of financial assets as a critical funding mechanism integral to their operations, offers management's assessments of alternative sources of liquidity. **We recommend that the final standard provide sample disclosures linking the requirements with the expected implementation outcome, namely enhanced qualitative and quantitative information.**

We strongly believe that the level of disclosure proposed by the ED is essential to understanding the nature of these highly-complex transactions and their associated risks because of the general lack of transparency in the accounting and disclosures existing today. Given the actual losses incurred from off-balance-sheet transactions to date and the potential for more, we feel that the added transparency is essential to fully understanding the economic effects and risk exposure. Although preparers of financial statements argue frequently that additional disclosures cannot be assimilated or are not used, we believe that more accurate and useful information does not result in overload if the disclosures are succinct, of high quality, clearly written, and are not so highly aggregated as to obscure the effects of transactions and trends. Entities with sound risk management and financial reporting practices should have much of the required information readily available as a part of their routine risk assessment for these investments. The failure to analyze risks regularly could prove more costly in the long run as unforeseen developments adversely impact the financial fundamentals for these investments.

We agree with the Board's view that, when an entity retains continuing involvement in financial assets that it has derecognized, users would benefit from information about the risks to which the entity remains exposed. This information should permit users to assess the risks associated with an entity's continuing involvement and their possible impacts on the amount, timing and uncertainty of the entity's future cash flows. **As indicated above, we also believe that if a transferor has reputational risks likely to cause it to make investors whole on losses, or share in the benefits above and beyond some rate of return to the investors, then the transactions should not be derecognized.** However, should the Board disagree with our view, then the entity should be required to disclose information to allow investors to make their own assessment regarding possible losses.

We therefore strongly suggest that the Board include disclosure requirements about derecognized financial assets and financial liabilities in sufficient detail to enable users to

essentially re-recognize the assets and liabilities if they deem it appropriate. Disclosures should enable users to make their own judgments as to the likelihood that a sponsor or transferor of the assets would stand behind the assets it originated and absorb losses or benefit from the structures, or have power over the assets.

SPECIFIC COMMENTS

As expressed above, we are strongly supportive of a no-continuing involvement threshold as a key determinant necessary for achieving derecognition of financial assets and financial liabilities. Financial statements taken as a whole enable investors and other users of financial information to understand the performance, risk and financial condition of reporting entities. Ensuring that the balance sheet reflects all transactions is essential to this understanding; therefore we are opposed to any standard that has the potential to remove financial transactions from prominent display. Moreover, we fear that adopting the proposed approach would result in more derecognized financial assets and financial liabilities than we have today.

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

We agree that derecognition requirements should be assessed for continuing involvement at the reporting entity level. This would be consistent with the notion that general purpose financial reports should provide information about a particular *reporting entity*. Those reports provide information about the entity’s economic resources (i.e., its assets), claims on those resources (i.e., its liabilities and equity), and the effects of transactions and other events and circumstances that change an entity’s resources and the claims on them. We recommend that the assessment include analysis of whether any kick-out rights are substantive.

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

We agree with the Board’s view in Paragraph 16A, that an entity applies derecognition to a part of a financial asset only if that part comprises specifically identified cash flows or a proportionate share of cash flows from the financial asset. We believe that the two essential characteristics of an asset as noted below are conceptually sound and are faithfully represented in a transfer of a part of a financial asset.

- a) an asset represents ‘future economic benefits’ that ‘are expected to flow to the entity; and
- b) the right to the expected future economic benefits is ‘controlled by the entity’.

As noted in Paragraph BC80 of the ED, we believe that this approach would generally not permit derecognition of a part of a financial asset when the transferor retains substantial risks and rewards of ownership of the underlying asset. Furthermore, under the alternative approach, derecognition of the entire financial asset regardless of the magnitude of the amount transferred would result in more earnings management opportunities.

Question 3—Definition of ‘transfer’

We support broadening the definition of a transfer to ensure that all economic transfers of financial assets should be assessed for derecognition. We agree with the Board that a transfer takes place when one party passes, or agrees to pass, to another party some or all of the economic benefits underlying one or more of its assets.

Question 4—Determination of ‘continuing involvement’

See our comments regarding no continuing involvement above.

Question 5—‘Practical ability to transfer for own benefit’ test

See our comments regarding no continuing involvement above.

Question 6—Accounting for retained interests

We agree with the Board decision to carry forward the recognition and measurement guidance which calls for an entity to allocate the carrying amount of the financial asset previously recognized between the part retained and the part transferred on the basis of the relative fair values of those parts on the date of transfer. We share the Board’s concern that allowing a different measurement attribute for the part retained may provide opportunities for earnings management.

Question 7—Approach to derecognition of financial assets

Given the extent of our comments noted in the main body of our response above, we cannot categorically support the proposed approach for derecognition of financial assets. We believe that the requirements for derecognition of financial assets and financial liabilities could be strengthened through a strict no continuing involvement requirement and including a risks and rewards assessment when assessing control.

Question 8—Interaction between consolidation and derecognition

The Board’s proposed approach for consolidation in ED 10 *Consolidated Financial Statements* defines ‘control’ of another entity when it possesses both the power to direct the activities of that other entity to generate returns for the reporting entity. In ED 10 ‘control’ in the context of financial assets is (a) the ability to obtain (access) the underlying future economic benefits and (b) the ability to restrict others’ access to those benefits. While these two definitions appear to be compatible, it is difficult to say with certainty and so the Board should field-test these concepts to better understand of how they work together.

Question 9—Derecognition of financial liabilities

We agree with the proposal that a financial liability ceases to exist when it no longer qualifies as a liability of the entity. This should occur when there is no longer a present obligation and the entity is no longer required to transfer economic resources as it relates to the obligation.

Question 10—Transition

We favor retrospective application of new accounting standards in order to preserve the comparability of financial statements.

Question 11—Disclosures

As noted above we support the enhanced disclosures and further emphasize that the proposed disclosures should be presented in a manner that (1) strengthens the clarity and understandability of the transactions, (2) clearly reflects management’s evaluation of risk and return relationships as they relate to transferred assets, and (3) for those entities using securitizations or transfers of financial assets as a critical funding mechanism integral to their operations, management’s assessments of alternative sources of liquidity. We recommend that the final standard provide sample disclosures linking the requirements with the expected implementation outcome, namely enhanced qualitative and quantitative information.

However, we want to stress again our strong support for qualitative and quantitative disclosures in sufficient detail to enable users to rerecognize those financial assets and financial liabilities removed from the financial statements. Furthermore, should the Board disagree our view that reputational risk should require transactions to continue to be reported as liabilities or benefits; we request that the entity should be required to disclose information to allow investors to make their own assessment regarding possible losses.

CLOSING REMARKS

In closing we thank the Board for the opportunity to comment on the Exposure Draft. We urge the Board to expeditiously issue an improved standard so that significant off-balance-sheet transactions are made more transparent to investors and other users of financial statements.

If you, other Board members, or your staff have questions or seek further elaboration of our views, please contact Matthew M. Waldron, CPA, by phone at +1.434.951.5321, or by e-mail at matthew.waldron@cfainstitute.org.

Sincerely,

/s/Kurt N. Schacht

Kurt N. Schacht, CFA
Managing Director

/s/ Gerald I. White

Gerald I. White, CFA
Chair, Corporate Disclosure Policy
Council

cc: Corporate Disclosure Policy Council