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International Accounting Standards Board

30 Cannon Street,

London EC4M 6XH

United Kingdom

Dear Sirs,

This letter is the response of the staff of the Canadian Accounting Standards Board (AcSB staff) to the IASB's Exposure Draft (ED) on Derecognition, dated March 2009.

The AcSB staff discussed this ED with the AcSB's Academic Advisory Council, the AcSB's Insurance Accounting Task Force, representatives from three of the largest Canadian banks, three of the largest accounting firms in Canada, two investment firms, two legal firms, representatives from provincial and federal government agencies, various Canadian financial statement preparers and one financial statement user. Except as indicated at the end of this cover letter, the views expressed in this letter and the Appendix are the views of the AcSB staff, taking into account comments and perspectives raised by these constituents. The views do not necessarily represent a common view of the AcSB, its Committees or others with whom we consulted. Views of the Board are developed only through due process.

Overall, **we do not support** the proposals in the ED because we think they do not represent an improvement over the existing derecognition provisions in IAS 39 *Financial Instruments: Recognition and Measurement*. We support the "alternative view" summarized in the Basis for Conclusions accompanying the ED, subject to the IASB addressing the concerns outlined in our

response to Question 6 on the measurement of retained interests and our concerns on the timing of the proposals, discussed below.

The alternative view is more principles-based and focuses on the entity that controls the economic benefits arising from the asset before and after a transfer. Accordingly, we think it will better reflect the underlying economics of transactions. In our view, the derecognition model adopted needs to focus on the rights and obligations an entity holds before and after a transfer so as to represent faithfully its financial position. We think that a principles-based approach, complemented by adequate disclosure, is appropriate, considering that some entities will seek ways to structure around rules. Also, we are concerned that, by requiring entities to recognise assets they do not control, the proposed model has the potential to inflate their balance sheets artificially and will create issues discussed further in the Appendix to this letter.

As outlined in our response to questions 2, 4 and 5 in the Appendix, we also have very strong concerns with the proposed criteria for determining “the asset” that is the subject of the derecognition assessment, the “continuing involvement filter,” and the “practical ability to transfer test.”

While the alternative view was not fully developed in the ED, we have assumed that aspects of the proposed approach that are consistent with the alternative view, such as the level at which the asset and continuing involvement should be assessed, would also apply under the alternative view.

**We emphasize strongly** that, whichever approach the IASB chooses, it is important that the proposals be finalized as soon as possible, to allow sufficient time for a first-time IFRS adopter to review, interpret and make informed decisions pertaining to the amended standard before these entities issue their first IFRS financial statements. A short delay in finalizing these proposals may force a first-time IFRS adopter to adopt the existing requirements in IAS 39, including the need to apply those existing requirements retrospectively, and shortly thereafter change the basis of accounting again to adopt the new derecognition provisions – two changes in a complex area of accounting. For a first-time adopter, the issue will be further compounded,

as entities may be required to consider the interaction of the new standards on derecognition and consolidation twice – once with existing IAS 39 and again with the new derecognition standard.

We also wish to highlight the challenge of evaluating fully the likely effects of the derecognition proposals in the absence of final standards on consolidations and financial instruments. Care must be taken to ensure that finalization of standards on all three of these topics results in a cohesive set of standards.

The Appendix to this letter includes our detailed comments on the proposals in the ED.

While most individuals with whom we consulted appeared to support the AcSB staff view in general, the financial statement user with whom we discussed the ED preferred the IASB's proposed approach. Academics also generally shared that view, except that some expressed the desire to see a "more stringent" model that would prohibit derecognition of assets in which the transferor has any continuing involvement in the financial asset transferred. Both the academics and the financial statement user either agreed with, or preferred, the IASB's proposed approach because it would result in continued recognition of more items in which there is some continuing involvement in the asset transferred. The user also preferred the proposed approach because it would make it easier to monitor credit migration.

We would be pleased to elaborate on any of our comments in more detail if you require. If so, please contact Peter Martin, Director Accounting Standards at +1 416 204-3276 (e-mail [peter.martin@cica.ca](mailto:peter.martin@cica.ca)), Ian Hague, Principal Accounting Standards at +1 416 204-3270 (e-mail

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Yours truly,



Peter Martin  
Director,  
Accounting Standards

## APPENDIX

The following is the response of the staff of the Canadian Accounting Standards Board (AcSB staff) to the detailed questions in the IASB Exposure Draft, *Derecognition*. While we support the alternative view in the Exposure Draft, we have also provided comments on aspects of the IASB’s preferred approach in the event that the IASB decides to continue with that approach. Such comments should not be construed as contradicting our support for the alternative view model.

### RESPONSES TO QUESTIONS IN THE INVITATION TO COMMENT

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

**Yes.** As noted in our main letter, we have assumed that the proposal in the ED to determine the item to be evaluated for derecognition, as well as the assessment of continuing involvement at the reporting entity level, will also apply under the alternative view. The proposal is similar to the existing requirement in IAS 39 *Financial Instruments: Recognition and Measurement*, and we are not aware of any major issues that would arise in applying these requirements at the level of the reporting entity under the alternative view model.

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

**No.** We do not agree with the criteria proposed in paragraph 16A for what qualifies as “the Asset” to be assessed for derecognition. We support the objective in the Basis for Conclusions, which notes, “an entity should derecognize a financial asset or a part of it when it or the part of it ceases to qualify as an asset to the entity.” However, we think that the proposed criteria for what qualifies as “the Asset” (i.e., specifically identified cash flows or a proportionate share of the cash flows) do not achieve that objective. We think the proposed “asset” criteria are a major source of the flaws in the model proposed.

First, if the criteria for determining what qualifies as “the Asset” are not met, an entity is required to apply the derecognition criteria to the entire item that is the subject of the

derecognition assessment. Second, if the item transferred differs from “the Asset” that is the subject of the derecognition assessment, the item will fail the derecognition assessment. This is true even if the substance of the transferor’s arrangement with the transferee is purely that of a servicer. As a result, items will remain on the balance sheet when the entity does not control the economic benefits.

In our view, there is no reason to apply criteria other than assessing whether the definition of an asset in the IASB *Framework for the Preparation and Presentation of Financial Statements* (the *Framework*) is met. We have been unable to identify the conceptual basis for requiring the “performance of the part retained” to “not depend on the performance of the part transferred.” The requirement for what may qualify as “the Asset,” coupled with the “practical ability to transfer test,” will result in all items for which the part retained is dependent on the part transferred failing the derecognition test, since the transferee will never have the practical ability to transfer “the Asset”.

We are concerned with assets appearing on an entity’s statement of financial position when it has no rights to economic benefits arising from those assets. Also, we think that retaining all of a portfolio of receivables on an entity’s statement of financial position because it has sold only a disproportionate interest in those receivables to another party does not represent faithfully the underlying economics. The economic benefits the entity controls after the transfer are not the same as it had before selling the disproportionate interest. We think the standard should require derecognition for portions of assets transferred.

The outcomes yielded by the proposed criteria for what qualifies as “the Asset” will undoubtedly affect capital and other requirements and result in economically similar transactions being accounted for differently.

We think that the approach proposed in the alternative view would address these concerns.

**Question 3—Definition of ‘transfer’**

**Yes.** We also recommend that the standard state the transfer definition applies both to the original transfer as well as the transferee’s practical ability to transfer “the Asset” and clarify that the transfer definition is intended to include non-reciprocal transactions.

**Question 4—Determination of ‘continuing involvement’**

**No.** We have strong concerns with the ramifications of this proposal. In our view, this hurdle pinpoints a weakness in the core criteria proposed for what would qualify as “the asset” and would be an unnecessary step in the context of the alternative view model we support.

If the derecognition assessment is based on whether an entity has an asset it controls, introducing the “stickiness” notion of whether the entity once had an asset and continues to have some involvement in it should be irrelevant. Consistent with the approach taken in the alternative view, we consider it more appropriate to have a clear overarching principle for assessing “the asset” and do not support the proposed filter. Its inclusion casts doubt on the portrayal of the proposed approach being control-based.

We are also concerned with the guidance provided on the exceptions to the continuing involvement filter in paragraph 18A (and discussed in paragraph BC 44), requiring the service provider to perform its duties at market rates. In Canada, securitization transactions generally do not include fees at market rates because of related value added tax effects. Instead, these arrangements typically include an implicit spread built into the transaction pricing to reimburse the originator for providing ongoing servicing, which it is obliged to do without a fee. The fact that arrangements are structured in this manner for tax purposes should have no effect on whether the entity controls “the Asset.” However, the proposals will result in items inappropriately failing the derecognition test in Canadian transactions when typical servicing arrangements are in place.

If the IASB does decide to retain this filter we recommend that the standard clarify the use of the word “any” in the context of assessing continuing involvement. We think that, consistent with

other IFRSs, the words should provide for some degree of significance. For example, IFRS 4, *Insurance Contracts* includes guidance and examples to illustrate whether a contract would be an insurance contract. We are concerned auditors and others will interpret “any” to mean any involvement over and above absolutely no continuing involvement. In that case, the proposal as currently written could result in arrangements that are servicing in nature failing the derecognition test when complete control of the economic benefits of the asset has been transferred but the transferor has some insignificant continuing involvement in the transferred asset.

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

**No.** We do not agree with the “practical ability to transfer” test. We think the introduction of this test also highlights the flaws with “the Asset” definition. An asset definition should be strong enough to provide guidance both on when to recognize an asset and when to derecognize it. The control test should not focus on another party’s ability to transfer the asset, but consistent with the *Framework* and ED 10, *Consolidated Financial Statements*, should focus on whether the transferor has rights to economic benefits related to the transferred item.

We think that assessing control from the transferor’s perspective is more appropriate and consistent with how assets are assessed for recognition under the *Framework*. In our view, an entity should consider its rights before and after the transfer, rather than what the transferee is or is not capable of doing with the asset. We acknowledge that, when evident, information about what the transferee can do with the asset might help understand what the rights of the transferor are, but we do not think that should be the sole determining factor.

Some with whom we consulted also expressed the view that this test is not operational. For example, in some Canadian transactions, the transferor is not able to monitor whether there are third-party restrictions placed on the transferee’s ability to transfer an item. It is also common for a third-party to impose restrictions on a special-purpose vehicle to protect its creditors, but we think that should not necessarily preclude an entity from derecognizing an asset transferred to that special-purpose vehicle.

Regarding the proposal in paragraph AG52E, we do not think it is necessary to distinguish an active market from an over-the-counter market for the asset.

#### **Question 6—Accounting for retained interests**

**Yes, we agree** with the proposed accounting for retained interests, because we support the use of a measurement basis that is neutral to the form of transaction undertaken and does not increase the potential for arbitrage opportunities. While the measurement basis proposed under the alternative view model has conceptual merit, we think that an entity's ability to fair value the retained interests increases the potential for earnings management. Accordingly, we suggest a different measurement basis for the retained interest in our response to question 7, below.

#### **Question 7—Approach to derecognition of financial assets**

**No.** As noted in our responses to questions 1 to 6, we support the alternative view and think that the IASB's proposed approach should not be established as the new basis for determining whether financial assets should be derecognized. We support a modified alternative view that would assign a pro rata share of the carrying amount of the pre-transfer asset to the retained interest. The allocation should be based on the relationship of the fair value of the retained interest to the fair value of the pre-transfer asset, as at the transfer date.

#### **Question 8—Interaction between consolidation and derecognition**

We prefer a control approach on both topics and do not support the various risk and reward overlays that have been built into each set of proposals. As noted in our response to question 2, we think consistent parameters should be used to test control, both at the entity level and at the level of the asset. In our view, the alternative view model is more consistent with the definition of an asset under the *Framework* and with ED 10. That model requires an entity to derecognise an asset when it no longer qualifies as an asset and does not hinge the derecognition assessment primarily on one aspect – the transferee's ability to transfer the asset. Because of the interaction of the two proposals, we encourage the IASB to finalize and implement them at the same time, ensuring that they are compatible.

**Question 9—Derecognition of financial liabilities**

**Yes, in part.** We agree with the proposed criteria for the derecognition of a liability – i.e., when it no longer qualifies as such under the *Framework* and think this degree of symmetry should also exist in the model for derecognition of an asset.

We note that a literal reading of the proposed amended text of paragraph 14(c) of IFRS 4 could yield unusual results. For instance, in structured settlement arrangements, a property and casualty (P & C) insurer with the obligation to make weekly or monthly indemnity payments often settles or discharges such obligations by acquiring an annuity from a life insurer and directing that payments be made directly to the beneficiary. A literal reading of the requirements could be taken to mean that until an entity fully settles the liability – i.e., until the annuity is fully paid out and the P & C insurer is no longer secondarily liable to make payments – the original obligation should remain on the insurer’s statement of financial position. Hence, rather than use of the words “is eliminated” in paragraph 14(c) of the proposed amendments to IFRS 4, we suggest use of words such as when the obligation is “discharged, cancelled or expired.”

Structured settlement arrangements also highlight the need for symmetry in the asset/liability recognition/derecognition requirements to avoid the possibility of an entity being required to recognize assets under such arrangements but not liabilities, and vice versa.

To deal with these issues, drafting changes should be made to the proposed amendments to IFRS 4, *Insurance Contracts*, so that paragraph 14(c) would read as follows:

*shall derecognise an insurance liability (or part of it) when it (or the part) no longer qualifies as a liability of the insurer. An insurance liability ceases to qualify as a liability of the insurer when if the present obligation is discharged, cancelled or expired ~~eliminated~~ and the insurer is no longer required to transfer economic resources in respect of that obligation.*

**Question 10—Transition**

**We agree** with the proposed transitional provisions for entities already applying IFRSs. However, we think that the proposed transitional provisions will need to be revisited once the replacement of IAS 39 is complete, given that they are written as proposed amendments to a standard that will likely no longer exist.

We think the transitional provisions in the standards on consolidation, derecognition and the financial instruments replacement project should be coordinated because of the linkages between them. We propose that they be made mandatorily effective in 2012 or later, with the usual option provided to adopt the standards early. It would be very helpful if the IASB were to announce in clear terms that it intends the mandatory dates of these standards to be no earlier than for years beginning on or after January 1, 2012. That would provide considerable clarity to entities considering how best to implement these new proposals.

We are concerned with the possibility that Canadian entities may be required to change from current Canadian GAAP requirements for derecognition to the existing derecognition requirements in IAS 39 on changeover to IFRSs in 2011, and then the Exposure Draft proposals shortly thereafter. We think it will be particularly burdensome for entities to learn two new standards rather than one. We recommend that the changes be finalized as soon as possible (but not later than the first half of 2010) to enable first-time adopters to assess the implications of the final standard and make informed decisions whether to adopt the proposals early on transition to IFRSs.

**Question 11—Disclosures**

**Yes, in part.** We agree that the disclosures proposed will provide useful information. However, we think that the IASB should assess the overall set of disclosures that will be required as a result of the separate projects to revise the consolidation, derecognition and financial instruments standards. In the longer term, we strongly support the development of a Disclosure Framework for accounting standards.