



Deloitte Touche Tohmatsu
Hill House
1 Little New Street
London EC4A 3TR
United Kingdom

Tel: National +44 20 7936 3000
Direct Telephone: +44 20 7007 0907
Direct Fax: +44 20 7007 0158
www.deloitte.com
www.iasplus.com

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Robert Garnett, Chairman
International Financial Reporting Interpretations Committee
30 Cannon Street
London EC4M 6XH
United Kingdom

Email: ifric@iasb.org

Dear Bob,

Proposed rejection wording: IAS 39 *Financial Instruments: Recognition and Measurement* – Derecognition of financial assets

Deloitte Touche Tohmatsu is pleased to respond to IFRIC's publication in the November 2006 IFRIC Update of the tentative decision not to take onto the IFRIC's agenda a request for an interpretation on various issues on the derecognition of financial assets.

Overall, we disagree with IFRIC's view that these issues do not require a full interpretation. We understood that IFRIC was intending to issue an interpretation on these issues and in order to move this forward IFRIC staff consulted the Board on certain matters to understand the Board's intentions when it finalised the standard. The Board has provided a view on these areas and IFRIC have summarised these views as a basis for rejection. We believe these summarised views do not deal appropriately with the complexity and variations of fact pattern that we see in practice. Even with the rejection wording we believe there is ambiguity as to how the derecognition guidance works; inconsistency in wording between the IASB Update in September and the IFRIC Update in November; and therefore we would expect further questions to be asked of IFRIC in the future in this area.

All three separate issues that were covered in your tentative rejection wording are discussed below.

(i) groups of similar assets

We believe further work is needed before concluding what assets are considered “similar”. The Board have concluded that derivatives and non-derivatives are not similar, and therefore an entity that transfers these two assets together under a single arrangement must apply the derecognition decision twice, once to the derivative, and once to the non-derivative. We do not believe this approach reflects the way these transactions are structured in practice. The most common type of non-derivative assets that are transferred are loans and the most common form of non-derivatives that are transferred with the loans are derivatives or guarantees over the transferred loans. A transferor and transferee will agree a price for the package that reflects the risks and cash flows of the package. By applying separate tests to derivatives and non-derivatives the transferor will need to separate out the proceeds received and allocate them artificially to the different assets.

The Board recognised as part of its debate, as reflected in paragraph 40 of Paper 13A of the September Board meeting, that applying the tests separately in certain arrangements will result in the derivative achieving derecognition, but not the loan. We question the logic of an approach that results in anomalous answers such as this.

The IFRIC rejection provided an example of mortgages that are transferred along with mortgage indemnity guarantees (MIG). As IFRIC has concluded you apply the derecognition tests separately to the loan and MIG, if no cash flows are payable to the transferee unless they are received under the loan or MIG, then both assets could pass the pass-through tests. IFRIC also concluded in its rejection wording that if the transferor is required to pay over amounts to the transferee in the event of a default on the MIG, such an obligation is considered to be the result of a default on the loan, and would therefore result in the loan failing the pass-through tests. This conclusion illustrates the leap in thinking that is required when you apply the derecognition tests separately. If there has been a default under the MIG (i.e. the insurer has failed to pay the transferor), but the transferor is obligated to pay the transferee, why should this payment always be associated with the loan rather than MIG itself? If the arrangement is structured so that if there is a default of the MIG, the transferor still has to pay under the MIG then surely the MIG has failed pass-through and not the loan. We presume IFRIC included these words to avoid arbitrage between the two derecognition tests to stop entities claiming that any cash payable to the transferee was in respect of the MIG and not the loan, and thereby getting derecognition for the loan. This illustrates that applying the derecognition tests separately is artificial as the transferor pays cash to the transferee based on the performance of *both* transferred assets and does not separate out the cash paid to the transferee and attribute this to specific transferred assets.

IFRIC has concluded that derivatives and non-derivatives are not similar. As many guarantees are considered financial guarantee contracts accounted for in accordance with IAS 39 or IFRS 4, they will not be accounted for as derivatives. Does this mean financial guarantee contracts are non-derivatives? Also, if a derivative has different

underlyings (say interest rates and equity prices), does that mean that the derivatives are not similar? These practical issues need to be addressed.

The IASB Update also stated that a derivative that could be an asset or a liability depending on its fair value, e.g. a swap, forward contract, should meet both the derecognition of assets *and* derecognition of liabilities test irrespective of whether the instrument was an asset or liability at the date of transfer. We do not understand how this view can be reached when at the date of transfer the instrument is *either* an asset or liability.

(ii) application of paragraph 18(a) or 18(b)

We believe a summary of the Board's conclusion on when paragraph 18(a) or (b) is applied is as follows: if an entity has transferred the rights to cash flows on an asset to a transferee over a disproportionate set of cash flows then the entity must apply 18(b), i.e. the pass-through tests; but if an entity has the same structure except the transferee has an interest in all the cash flows under the asset or a fully proportionate set of cash flows under the asset then 18(a) applies. We believe this will result in some structures now being treated as transfers under 18(a) and avoiding the pass-through test where previously the pass-through tests had been applied as many practitioners considered pass-through tests applied to proportionate and disproportionate transfers.

We believe if this is the conclusion, then the IFRIC rejection could be clearer. The rejection states that the pass-through tests do need to be applied when an "entity transfers specifically identified cash flows from an asset in accordance with paragraph 16 of IAS 39". The rejection states that "this may be the case" so is not unequivocal. IFRIC's conclusion on this matter would be clearer if it simply copied the conclusion from IASB Update (or cross-referenced to it) as the IASB Update justifies its conclusion by stating an entity must "transfer all the contractual rights to receive the cash flows" in order to avoid pass-through, thereby making it clear that if the arrangement is not over all or a proportionate share of all cash flows then the pass-through tests must apply.

The IFRIC rejection states that an entity can apply 18(a) without transferring legal ownership as long as the transferee has "rights equivalent to legal ownership". A full interpretation on derecognition would give the IFRIC the opportunity to state what rights are relevant in determining whether the transferee is equivalent to a legal owner.

(iii) warranties and representations at the date of transfer

We concur with IFRIC tentative view that warranties and representations regarding the existence of the asset that is transferred do not necessarily affect whether the entity has transferred the contractual rights to receive cash flows but they may affect the assessment of risks and rewards. If IFRIC is going to draw its conclusions from the position taken in IASB Update it must ensure the language is consistent. We note the IFRIC rejection refers only to the "existence" of the asset, whereas the IASB Update

refers to the “existence and value” of the asset. We also note that the IASB rightly rules out representations as to future performance of the asset as these can result in the failure of the pass-through test, but the IFRIC rejection makes no mention of this. Having different wording in the IFRIC rejection compared to the IASB Update can lead to confusion and encourage entities to arbitrage the differences. We suggest that if IFRIC agrees with the conclusions of the Board that either the whole extract from the IASB Update is included in the IFRIC Update or in the instances where this is a cumbersome then a simple cross-reference to the IASB Update will do.

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

Sincerely,

A handwritten signature in black ink, appearing to read "Ken Wild", written over a horizontal line.

Ken Wild
Global IFRS Leader

cc: Allan Cook, IFRIC