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International Accounting Standards Board
30 Cannon Street
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Comments on the Exposure Draft of *Derecognition (proposed amendments to IAS 39 and IFRS 7)*

To the Board Members:

The Japanese Institute of Certified Public Accountants appreciates the continued efforts of the International Accounting Standards Board (IASB) on the financial crisis and welcomes the opportunity to comment on the exposure draft of *Derecognition, proposed amendment to IAS 39 and IFRS 7*.

Since the project promotes convergence with US GAAP, we are in favor of the direction of its activities. On the other hand, while the exposure draft proposed as part of the comprehensive reconsideration of 'off balance sheet' activities, many issues associated with the derecognition of financial assets relate to the issues concerning the recognition of gain or loss on sale of financial assets. Therefore, another review should be taken depending on and in response to the direction and the outcome of the 'Classification and Measurement', which is being discussed separately.

The following is our response to the items in 'invitation to comment' with which we disagree or have questions or concerns.

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?

Comment:

We do not agree with the proposed criteria.

In determining the item (i.e. the Asset) to be assessed for derecognition, the scope should not be limited to specifically identified cash flows or a proportionate share of the cash flows; instead, the first 90 per cent of the cash flow from a loan receivable as exemplified in paragraph AV3 and other such items that no longer fit the definition of assets in the Framework for the Preparation and Presentation of Financial Statements should widely qualify.

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?

Comment:

We agree with the definition proposed.

However, the definition of a transfer has been substantially expanded and is deemed difficult to apply in practice. Therefore, we believe it is necessary to either narrow down and list the criteria of transfer or present an additional application guidance. Also, we are afraid that the scope of disclosure depends on whether the item has been assessed for derecognition or not, since detailed disclosure is required even in the case of transferred financial assets that are not derecognised. Such treatment might be difficult in practice.

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?

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?

Comment:

We do not agree with the 'practical ability to transfer' derecognition test, due to the overreliance on the test.

Under the current standard, an asset can be derecognised if, at least, substantially all of the risks and rewards are transferred, whereas in the proposed amendment, an asset cannot be derecognised in cases where there are restrictions on the transferee's right, even if substantially all of the risks and rewards are transferred, on the grounds of being controlled.

For the derecognition of an asset, for example, 'whether or not substantially all the risks and rewards have been transferred' should be asked in the middle of the test for determining the derecognition of assets.

If our alternative approach proposed above is rejected, based on the proposed approach in the exposure draft, we agree with the 'for the transferee's own benefit' test.

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?

Comment:

We do not agree with the proposed accounting treatment.

The new guidance proposed in paragraph 22A is deemed to interpret a transaction involving the acquisition of shares and the transfer of shares as effectively inseparable transactions. However, the accounting method would be different depending on whether

they are executed at the same time or in different periods, which may give rise to inconsistency in some cases. It would also be difficult to apply this in practice as stated in paragraph AV14, holding of equity instruments lead to control over a company but is deemed to be separate from control over the asset itself in the first place.

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?

Comment:

We agree that the proposed approach as a whole should be established as the new approach for determining the derecognition of financial assets. However, the following matters should be considered.

While the exposure draft proposed as part of the comprehensive reconsideration of 'off balance sheet' activities, many issues associated with the derecognition of financial assets relate to the issues concerning the recognition of gain or loss on sale of financial assets. Therefore, another review should be taken depending on and in response to the direction and the outcome of the 'Classification and Measurement', which is being discussed separately.

Unit of Derecognition

For the following reasons, we believe that the criteria for what qualifies as 'the Asset' are unnecessary, and that it would be appropriate to make the judgment in units of cash flows or other economic benefits of identifiable assets (paragraphs AV10 and AV18).

- (1) The criteria proposed in the exposure draft are the same as those in the existing IAS 39, but the subsequent approach is different. According to the existing IAS 39, even in cases where an asset in its entirety including the part retained is deemed as 'the Asset', if risks and rewards have effectively been transferred, the entire asset is

derecognised. If the risks and rewards have not been transferred, the asset is ultimately recognised only to the extent of its continuing involvement. In contrast, according to the proposed approach, the entire 'the Asset' is recognised or derecognised in both outcomes. We believe such accounting would not help improve financial reporting as it is in conflict with the intent of the exposure draft and the Framework, which require that if the future economic benefits underlying a financial asset cease to exist, the entity that has recognised that asset should remove it from its financial statements (paragraph BC10). With respect to parts that are not exposed to the risks and rewards, we believe it would be appropriate to eliminate the criteria for what qualifies as 'the Asset' so that they could be removed from the financial statements and make the judgment in units of cash flows or other economic benefits of identifiable assets.

- (2) In the existing IAS 39, an asset or liability in which the entity has continuing involvement may be recognised to the extent of the continuing involvement. In the proposed approach, even though there is a subsequent 'practical ability to transfer' test, there is a possibility of not only the asset or liability in which the entity has continuing involvement, but the entire transferred asset being recognised (e.g., subordinated interest (paragraph AG52L (d)) and credit guarantee with which the transferred asset is not readily obtainable in the market (paragraph AG52L (e)). Also, in cases where there are multiple entities with identical contractual rights and obligations, different accounting might be required among them solely on the grounds of whether they are a part of the transferred financial asset (paragraph AV7).
- (3) Most financial instruments comprise bundles of contractual rights and/or contractual obligations (paragraph AV11). Unlike physical assets (i.e., inventory, property plant and equipment, etc.) and intangible assets, financial assets already have the right to acquire cash or other financial assets and are characterised by their relative ease of unbundling and rebundling due to the lack of physical constitution. Therefore, 'control' should be defined in units in consideration of the characteristics of financial instruments. Given that the Board believes that users generally support an approach that would not permit derecognition of a part of a financial asset when the transferor retains substantial risks of ownership of the underlying asset (paragraph BC80), we believe that if the carrying amount of the transferred asset and the retained asset are measured properly and the gain or loss

on sale are recognised based on the result of measurement, users will generally be in favor of derecognising the parts not to be exposed to risks and rewards.

Pass-through Requirements

The proposed approach has no provisions on pass-through as required in the current IAS 39. However, due to its broad definition of the concept of 'transfer', the question boils down to whether or not the exceptions made in the 'continuing involvement' test (paragraph 18A (b)) apply, and if they do not apply, whether or not the transferee has the 'practical ability to transfer' the asset.

For the assessment of continuing involvement, the proposed approach gives examples such as fiduciary or agency relationships being exceptions to continuing involvement (paragraph 18A (b)), and the transferee having the right to terminate the servicing contract (paragraph AG49A). However, it is not clear whether it amends or relaxes the existing pass-through provision. If the proposed approach amends or relaxes the pass-through requirements in the current IAS 39, it should be clear in the proposed requirement.

Repo Transactions

According to the proposed approach, sale and repurchase agreements (repo transactions) are treated as a sale of the transferred assets (paragraphs BC59 and BC60). However, the transactions are substantively loan transactions for which securities are pledged as collateral. We believe accounting must reflect the substance to comply with the Framework (paragraph 35). If sale and repurchase agreements are treated as a sale of the transferred assets, the treatment of financial assets corresponding to held-to-maturity investments should be clarified: in other words, if they are treated as a sale, whether or not such assets could still be classified into held-to-maturity investments after such treatment should be made clear.

Bankruptcy Remoteness Requirement

The Board does not include bankruptcy remoteness as a requirement for derecognition on the grounds that a test that might make it necessary for the transferor to obtain a legal opinion specific to US bankruptcy laws would be difficult to apply in jurisdictions outside the US (paragraph BC24 (b)). However, there are countries other than the US where bankruptcy isolation is a requirement for derecognition, including Japan. Also, given that the bankruptcy isolation requirement involves providing objective evidence in the judgment of derecognition, we believe it is necessary to include the bankruptcy

remoteness requirement in the criteria to be considered in the 'practical ability to transfer' test even if it may not be a sufficient condition for derecognition.

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?

Comment:

We agree that the proposed derecognition and consolidation approaches are compatible.

However, the derecognition of financial instruments is applied to each asset and liability, whereas consolidation is assessed at the entity level. The 'control'-oriented approach is deemed to be consistent with the definition of assets in the Framework, but on the other hand, the form of 'economic benefits' that flow to the entity varies from asset to asset. Therefore, in applying 'control', and determination of 'the Asset', in concrete terms, we believe the characteristics of the asset up to the point where 'economic benefits' are received should be taken into consideration.

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?

Comment:

We agree with the proposed amendments to IFRS 7.

However, the disclosure of transferred financial assets that are not derecognised is expected to be unduly onerous in practice due to the broad definition of 'transfer'. Accordingly, we believe it would be appropriate to limit the scope of 'transfer' to be disclosed or reduce the contents to be disclosed.

Yours faithfully,
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Executive Board Member - Accounting Standards

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