Rådet för finansiell rapportering

The Swedish Financial Reporting Board

RFR-rs 2009:12

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sirs,

Re: Exposure Draft ED/2009/3 Derecognition

The Swedish Financial Reporting Board is responding to your invitation to comment on the International Accounting Standard Board's Exposure Draft ED/2009/3 Derecognition.

A Summary of Our Position

We consider that:

- Issues raised by different stakeholders due to financial turmoil have not been adequately addressed.

- The change of focus to legal control instead of a combination of legal control and risks and rewards has resulted in an oversimplified approach that we believe is in total contrast to the needs raised. Both the main proposal and the minority view will result in derecognition criteria that will leave the field totally open for manipulation of both the balance sheet as well as the income statement. Using the proposed solution it will be very easy to achieve derecognition even though all risks remain.

- The oversimplification will reduce the quality of financial reporting. Financial markets are complex with complex products. Therefore simplification should never been an aim that is more important than relevance. The proposed approach will create financial statements that may be completely irrelevant.

- The focus on the transferee instead of the transferor is irrelevant and will complicate the financial reporting enormously.

- Financial reporting should be the same regardless if the reporting entity previously has recognised an asset or liability previously or not. Else the financial statements will be unnecessarily complex to interpret.

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- The disclosure requirements are too extensive. They appear to us to be an attempt to compensate for a proposed derecognition model that does not at all succeed in focusing on the remaining risk to the entity of the derecognised contracts.

The consequence of the above is that to achieve a change in the derecognition principles comprehensive work, including field testing must be carried out. The immediate action to address the crisis that prompted the issue of the ED should therefore be to deal with the perceived lack in disclosures so that all concerns in this area are eliminated.

The ED's Majority View on Derecognition of Financial Assets

Financial assets should be evaluated with the focus on the transferor and on natural components of the financial assets. We recognise that the derecognition project has been intensified due to the financial crisis and the political pressure on standard setters that the crisis has created. However, we believe that the accelerated process to develop an improved standard has lead to an ED that will not improve derecognition and that will not solve the issues addressed by users and politicians.

We are very doubtful to an approach for derecognition which (with some exceptions) almost solely focuses on legal control as is proposed in the ED, instead of a focus that more takes into account risk and rewards. We do not believe that the change in derecognition criteria will result in a financial reporting for financial instruments that reflects the substance of the transactions. The result will be financial statements that do not mirror the needs of the users and that are in sharp contrast to the needs raised due to the financial turmoil. Instead of increasing transparency we are convinced that the proposed derecognition criteria will result in an increased lack of transparency and that a lot of assets that today are recognised will be derecognised. Furthermore, the proposed criteria will make it very easy to achieve derecognition even though significant risks remain with the reporting entity

We do recognise that the present rules are complicated and that there are today some inconsistencies in the present standard. Simplification of accounting standards is important, but we do not think that simplification should be made at the price of significantly reduced quality of financial reporting. We believe that the focus on the transferee instead of the transferor is not helpful. There are enough of difficulties in analysing the situation for the transferor. Having the situation for the transferee as a starting point for derecognition will only complicate the analysis even more, introducing even a greater extent of subjective judgement. Instead the starting point should be the situation for the transferor and how it has changed due to a certain transaction and changes in facts and circumstances.

We believe that the distinction being made based on if the transferee has the practical ability to transfer the assets for the transferee's own benefit is irrelevant. Instead we favour an approach that is based on if the transferor actually has retained or disposed of the risk components of a financial asset or not. E.g. if the transferor, when transferring the ownership of an financial asset, knows that the transferred asset will be bought back at a predefined price, the transferor has retained all the risk components inherent in the transferred asset and therefore no derecognition should take place.

Instead a new component should be recognised; the risk that the transferee will not be able to return the initially transferred asset.

When evaluating the substance of transactions, there is a need to link those transactions that in fact are linked. If an entity sells an asset, potentially with a gain, and at the same time repurchases the same asset, in substance, no transfer of risks has occurred and the financial reporting needs to reflect that. Therefore we can not agree with the text in paragraph 18A (c) that states that forward contracts or other contracts associated with reacquiring the Asset should not be considered. Instead we believe that the paragraph should state that forward contracts or other contracts entered into after an entity has transferred an asset should be considered when evaluating if derecognition should occur only if the contracts have been entered into at a point in time before any substantial change in value could have reasonably been expected to have occurred.

Our Alternative View on Derecognition of Financial Assets

We believe that the main principle should be the following: - "The recognition and the presentation of financial assets or parts of financial assets should be exactly the same regardless of if the assets or parts of the financial assets have been recognised in the entity's financial statement previously or not".

The reason for that statement is that we consider that the focus should be on presenting assets and the risks that are inherent in having those assets in an uniform way. E.g. as is the case today the presentation will be completely different if an entity has sold a financial asset and guaranteed a certain loss level compared to if the entity has not previously owned the financial asset and takes on to provide the same guarantee.

To achieve the goal of an uniform presentation that also recognises the difference in business intent of different entities we consider, as mentioned in several of our previous comment letters, that separately identifiable parts is a good starting point for a partial derecognition of financial assets and liabilities. The reason is that entities normally manage the components of financial assets and liabilities in their asset and liability management rather than the sum of the components since the characteristics' of the components (e.g. traded on liquid markets or not) may differ between the separately identifiable parts of a financial item. That said we consider that the focus should be risk components that are easy to separate. These components may not necessarily be parts that are contractually separated in the initial contract that was initially recognised.

In our model we also consider that the allocation of the carrying amount when an asset is partly derecognised should be based on the relative proportion at initial recognition instead of focusing on the relative proportions at derecognition. We consider that the proposed methodology does not truly reflect the true profit and loss of the part being derecognised. The paragraph therefore should be changed. Instead the focus should be on the relative fair values at the initial acquisition date.

An allocation model that uses the relative values at derecognition will result in a model that produces different results depending on if the derecognised component initially had been bought as a separate asset or as part of another asset. We therefore consider that paragraph 21A has to be revised.

As described on page 1, to achieve a change in line with what is described above, comprehensive work must be carried out and therefore no change in derecognition principles should be implemented at this stage.

Minority View

Today's financial market place is extremely complex compared with the simplified descriptions in the framework. This oversimplification may result in a financial reporting that does not reflect the substance of the transactions that take place in the financial markets. I.e. a lot of inherent risk components are traded as separate contracts while other risk components are managed on an amortised cost basis due to a lack of liquidity in the market or simply because the entity's business model is to manage those risk components with a held-to-maturity strategy to earn steady cash flows. We do not believe that the proposed amendments suggested in the ED will make it possible to create financial reporting that properly can reflect the substance of many financial transactions, with the suggested unit of account. We share the opinion of the dissenting views in the ED that the only solution is to change the unit of account and to focus on separately identifiable risk components and if they qualify for derecognition or not.

However, in contrast to the dissenting view, we do consider that the financial reporting should be the same, regardless of how the components have been acquired or assumed, if all risk components had been bought separately or if they initially where bought together in one transaction, or if the starting point is successive acquisition of components or if the same holdings of components have been achieved trough successive deacquisitions. The retained components should remain in the balance sheet at there relative values, calculated based on the proportions at initial recognition. This means that no remeasurement at fair value should take place at derecognition. The effect will be the same as if the separate components retained had been recognised separately in the balance sheet from initial recognition.

Using the minority model for remeasurement will result in an earnings management methodology since just a derecognition of a minor component of a financial asset will result in a remeasurement of the remaining part. Aside from opening up for earnings management, it will also impair the amortised cost figures. After remeasurement a part of the amortised cost figure will not represent incoming cash-flows, instead they will represent an allocation of a fair value adjustment. This is also a problem that has been identified in the staff paper "Financial Instruments: Recognition and Measurement Transition provisions" dated 1 June 2009, which in p37 states "This blended interest rate is of less, if any, relevance for users in predicting the future cash flows of the entity, because the predictive value of amortised cost information relies on the contractual (effective) interest rate."

The Same Criteria for Assets and Liabilities

Finally we see no obvious reasons why financial assets and liabilities should be evaluated based on different criteria. Instead we believe that they should be evaluated for derecognition based on the same overarching principles. As presently written in the ED, all obligations are evaluated based on the situation for the transferor while assets are evaluated based on the situation for the transferee. As previously mentioned, we believe that in both cases the focus should be on the situation for the transferor. Further to that, there should be a possibility to derecognise a component of a liability if that component is no longer a liability of the transferor. That said we believe that our proposed model would derecognise more components of financial assets than financial liabilities due to the special characteristics of liabilities.

Disclosures

Rightfully applied we consider that IFRS 7 and, when applicable, Pillar III in Basel II taken together should be enough with regards to disclosure requirements using the present derecognition criteria. Basel II has just recently been implemented in some countries and not at all in United States where the financial turmoil began and therefore it could be argued that the present disclosure requirements should not be blamed. However, it is our understanding that the existing disclosure requirements could have been applied in a more transparent and open way and therefore we understand the need to review, and when required to improve, the present disclosure requirements.

If you look to the proposed disclosure requirements based on the proposed rules for derecognition, they viewed in isolation could be seen as reasonable to compensate for the total lack of focus on actual continuing involvement in the derecognised assets. If the chosen derecognition model is kept there is a need for some of the proposed disclosures. However, we consider the disclosures to be extensive and they need to be evaluated together with other disclosures in IFRS 7. Paragraphs with similar requirements are 14, 27 - 42. Since paragraph 42A requires the entity to disclose all information regarding derecognised items in a separate note, there needs to be exceptions in all other IFRS 7 paragraphs that are related to the derecognition paragraphs. If this is not done the requirement to present disclosures related to derecognition in a separate note should be deleted.

In our view, there might be good reasons for presenting some of the disclosure requirements together with other similar disclosure requirements in IFRS 7 instead of giving all information regarding derecognised items in a separate note.

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Final Conclusion

We consider that this ED is not an improvement and that it should not result in a final standard. We consider that there is a need for the IASB to rethink and thereafter produce an amended ED on changed derecognition principles for consultation. In the meantime, IFRS 7 should be amended to address the existing disclosure concerns.

If you have any questions concerning our comments please address our Executive member Carl-Eric Bohlin by e-mail to: carl-eric.bohlin@radetforfinansiellrapportering.se.

Stockholm, August 6, 2009

Kind regards,

Anders Ullberg
Chairman

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