ACCOUNTING
STANDARDS
BOARD

Holborn Hall
100 Gray's Inn Road
London WC1X 8AL

Telephone +44 (0) 20 7611 9700
Fax +44 (0) 20 7404 4497

http://www.asb.org.uk

Sir David Tweedie
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

13 December 2002

Dear David

The proposed revisions to IASs 32 and 39

1 I write to set out the Accounting Standards Board's views on some broad issues raised by the IASB's recent exposure drafts on IASs 32 and 39.

2 As you know, we have already written to the IASB suggesting how the hedge accounting provisions might be amended to make them more principles-based and to eliminate apparently unnecessary requirements (see my letter of 14 November 2001). We have also suggested that the IASB should reconsider its support for recycling (see my letter of 4 July 2002). We have not repeated those comments here, although we consider them still to be valid.

Recognition and derecognition - The continuing involvement approach

3 If the continuing involvement approach set out in the exposure draft were to be proposed as a possible long-term, definitive approach, we would be very concerned because we believe that it is flawed. However, we think those flaws are probably manageable in the context of an interim standard, as long as some further development work is carried out (see paragraphs 4-12 below). Therefore, if the matters set out below are addressed satisfactorily, we would support the implementation of the proposed continuing involvement approach for financial items as an interim measure.

Field-testing

4 The discussions that we have had with those who undertake complex transfers of financial assets have raised a number of questions as to what the current text requires. Bearing this in mind, we think it would be extremely helpful in readying the proposals for implementation if the IASB were to carry out more extensive discussions with such experts, as well as some field-testing.

Linkage

5 It appears to us that certain aspects of the standard as currently drafted will be easy to 'loophole'; in other words, transactions that, if carried out as currently structured, would be treated as a financing under the proposals could relatively easily be restructured so as to be treated as a sale.

6 Perhaps the most significant of these loopholing opportunities involves breaking a transaction in two in order to get a different accounting treatment. Unless some sort of linkage notion is introduced into the standard, we fear that the recognition of financial assets will become optional under the proposals. We are therefore pleased to see that the IASB has started to discuss linkage, and we hope this work will be given a high priority. It would be helpful, of course, to see linkage introduced into IAS 39 and not merely left as an IFRIC Interpretation.

Economically insignificant options

7 Under the proposals, options that are highly unlikely to be exercised will have the same effect on the accounting as options that are highly likely to be exercised. We believe that options that are of no economic significance should have no accounting significance.

8 In practical terms, we do not think that the IAS 39 proposals' treatment of options that are highly unlikely to be exercised will create problems in the specific context of that standard. Continuing involvement means that the transferor's balance sheet is 'grossed up' and its gearing ratio will deteriorate. It seems unlikely that any entity will insist on inserting an economically insignificant option in a transfer agreement solely in order to achieve that effect; the pressure will be on netting down balance sheet items and improving the gearing ratio.

9 However, we do have concerns about the treatment's possible implications for adjacent projects such as leasing and therefore think it would be worth incorporating into IAS 39 the notion that an option has to be substantive to create a continuing involvement. There seems to be some precedent for

this in paragraph 42 of the ED 2 'Share-based Payments' (which differentiates between a choice that is substantive and one that is not) and paragraph 32 of FAS 140 (which differentiates options that are so far out-of-the-money for it to be probable that they will not be exercised from other options).

Maximum potential amount or expected amount?

10 Under the proposals, if a continuing involvement exists the transaction should be treated as a financing to the extent of the *maximum* potential amount of that continuing involvement. A number of respondents have criticised this focus on the maximum potential amount; in their view, the focus should be on the expected amount. It would appear from Appendix D of the exposure draft that two Board members take a similar view.

11 The ASB believes that the IASB's approach on this issue is correct; if a portfolio of receivables is factored but the originator guarantees all the factor's losses, there has been no sale. We further believe that, were this aspect of the proposals to be changed to an expected amount approach, the proposals would be fundamentally flawed and could not be supported. We are happy to expand on our reasoning if it would be helpful to you.

12 Quite apart from what we consider to be strong conceptual reasons for not adopting an expected amount approach, we would be concerned about introducing an approach that will be to allow entities to cease to recognise large parts of their existing balance sheets (which is what an expected amount approach would do) when the future direction of accounting in this area has not been determined and before a comprehensive analysis of all the issues involved has been carried out.

Recognition and derecognition - The 'pass through' provisions

13 Under existing IAS 39 and SIC-12, securitisations are generally accounted for by derecognising the securitised assets from the orginator's individual entity financial statements, and then consolidating the SPE. That involves the continued recognition of the securitised assets on the originator's consolidated balance sheet. Under the IASB's pass-through provisions, this would change: some securitisation SPEs will be deemed to have transferred to their note holders most or all of the securitised assets (ie the SPE will be deemed to be virtually empty), so consolidation of the SPE by the originator would no longer result in the securitised assets being recognised on the originator's consolidated balance sheet.

14 The ASB is concerned that, under the provisions as currently drafted, very few securitisation SPEs will in fact be treated as being virtually empty. We have reached this conclusion because it seems to us that, in the case of most securitisation SPEs, cash does not simply come in from the securitised assets and, pound-for-pound, penny-for-penny, get paid out again to note holders. For example, the SPE will often have a variety of protection mechanisms (for example, excess spread, reserve fund, liquidity arrangements, and credit enhancement facilities) that will break the link between cash in and cash out.

15 If our analysis is correct and few securitisations will be virtually empty under the proposals as drafted, the IASB could of course change the proposals so that more securitisation vehicles will be deemed to be virtually empty. However, we would not support this approach because we do not believe that most securitisation SPEs *are* virtually empty (or, to be precise, we do not believe that, in the case of most securitisations, the securitised assets are held by the note holders). We recognise that treating them as empty enables the achievement of an accounting result that we think is right (the derecognition of the securitised assets from the originator's individual and consolidated financial statements), and we recognise that this is an interim standard and that compromises may be necessary in the interests of expediency. Nevertheless, we think this is one compromise that should not be made: securitisation SPEs are not empty and suggesting otherwise establishes a principle that the unscrupulous might use to derecognise 'genuine' subsidiaries and other activities whose financing is closely related to the returns.

16 We suggest that the IASB may wish to consider moving the pass-through provisions from IAS 39 to SIC-12, and using them to identify when a SPE should be consolidated on a net basis rather than on a line-by-line basis. This would achieve the same effect as the current proposal, without introducing the potentially dangerous notion that such SPEs are empty. We would welcome the opportunity to discuss with the IASB the potential for introducing—and closely regulating—the notion that a parent's interest in some of its subsidiaries may be an interest in the net assets; this may contain the seed of a possible long-term solution to this issue.

Classification of instruments between equity and liabilities

Classification by substance

17 The ASB is in broad agreement with the proposal that capital instruments should be classified between equity and liabilities on the basis of the substance of their contractual arrangements. However, we are not sure exactly what the IASB intends by its references to the substance in the

existing standard and are even less sure now that the preference shares with an accelerating dividend example has been deleted from paragraph
22.

18 Although the deletion has caused much confusion amongst UK respondents, we think it means that the IASB is of the view that preference shares of the type described in the now deleted example are *not* liabilities. This concerns us greatly because we think such preference shares *are* liabilities. In our view, economic compulsion is often (but not always) an issue that needs to be taken into account in determining the substance of an instrument.

19 It appears that the IASB is using the notion of substance in a way that is not consistent with how many have used it in the past. Some commentators have suggested that the references in the IASB's proposals to substance could be deleted without having any impact on the classifications the standard expects to be made. We hope that is not the case. An approach that ignores substance would in our opinion be fundamentally flawed.

Split accounting

20 The ASB agrees that split accounting should be used to account for compound instruments.

21 A number of respondents have reported that, had Enron been adopting split accounting, a convertible bond that it issued in January 2001 for US$1,250 million would have been accounted for by recognising a liability of US$600 and crediting US$650 million to equity. Respondents have highlighted this example because they think it shows that split accounting is inappropriate. We do not think it shows that, although we think the example emphasises the need for appropriate disclosures to be made to support the use of split accounting. At the moment, the only disclosure requirement in IAS 32 that would have revealed the full extent of Enron's liability in the event of non-conversion is the paragraph 47 'terms and conditions' disclosure. However, we suspect that this disclosure requirement is too broadly drawn to be a useful split accounting disclosure and therefore suggest the IASB considers including a specific disclosure requirement that will underpin the split accounting approach more effectively.

'Shares to the value of' features and derivatives in own shares

22 Again, the ASB broadly agrees with the proposals in these areas except that we do not like the reliance placed in paragraph 29E on established practice and intention when determining how to classify derivatives with

more than one settlement alternative. In our view, neither established practice nor Intention is in itself indicative of the substance of the transaction. We suggest that, in the interim (ie pending the IASB's proposed comprehensive review of the equity/liability issue) it might be best simply to require any derivative with an issuer settlement option to be classified as a liability. We recognise that this proposal is not supported by the Framework, but that is also true of proposal 'the shares to the value of'. What our suggestion would do is draw a very clear and simple line. To the extent that the line might be in the wrong place, at least it would involve too many (rather than too few) instruments being treated as liabilities.

Off setting of balance sheet items

23 IAS 32's requirements on offsetting balance sheet debits and credits are tougher than those in FRS 5 in some respects, and not as tough in others.

24 IAS 32 requires an intention on the part of the reporting entity to offset, which will have important implications in the UK where the existence of an enforceable master netting agreement is sufficient to justify offset. In general terms, we have tried in the past to avoid basing accounting standards on management intention, so this proposal concerns us.

25 We also note that, although that IAS 32's offset requirements are like the US requirements in most other respects, the US requirements (FIN 39.10) state that entities can offset fair value amounts recognised for derivative contracts executed with the same counter party under a master netting agreement even if there is no intention to set off. We would never advocate following an approach simply because it is less onerous than another, but we wonder whether the existence of FASB's exemption indicates that the arguments that support the use of intention for non-derivatives are not as persuasive in the case of derivatives that are being carried at fair value. For example, IAS 32.37 suggests that the IASC originally had the prediction of future cash flows in mind when it developed its offset requirements. However, that was in the context of a largely cost-based measurement system and it is debatable whether, if fair value amounts are involved, the arguments are quite the same.

26 The UK is one of the jurisdictions in which the legal enforceability of master netting agreements is able to survive the insolvency of the counterparty. We believe that, where a master netting agreement is able to survive the insolvency of the counterparty, it is perfectly logical to take that agreement into account when determining which balance sheet items to offset, even if there is no current intention to activate the agreement.

We would be pleased to expand on our comments if that would be helpful.

Yours sincerely

Mary Keegan

Mary Keegan
Chairman