STAFF PAPER

February 2013

REG IASB Meeting

Project	**Conceptual Framework**
Paper topic	Draft Discussion paper Recognition and derecognition

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This paper is a very early draft of part of the Conceptual Framework discussion paper. It has been prepared by the staff for discussion by the IASB. Issues discussed and conclusions reached will be subject to change.

Section 3 Recognition and derecognition

What does this section cover?

This section discusses:

- When should an entity's statement of financial position report a resource as an asset, or report an obligation as a liability? (recognition)
- When should an entity remove an asset or liability from its statement of financial position? (derecognition)

Why is this section important? What problems will this section help address?

This section:

- Proposes to clarify how uncertainty affects the recognition of assets and liabilities.
- Updates the recognition criteria in the light of changes made to the qualitative characteristics.
- Introduces criteria for derecognition. The existing Conceptual Framework does not address derecognition

What do the staff recommend?

- Except as discussed below, an entity should:
    - recognise as assets all economic resources that the entity controls. An entity controls an asset if it has the present ability to direct the use of the asset so as to obtain the economic benefits that flow from the asset.

- recognise as liabilities all obligations that bind the entity.
- An entity should not recognise an asset or liability if it is not virtually certain that the entity controls the asset or is bound by the liability.
- The IASB might decide in a standards-level project that an entity need not, or should not, recognise an asset or liability:
  - If recognising the asset (or liability) would not provide users with information that is not sufficiently relevant to justify the cost.
  - If no measure of the asset (or liability) would result in a sufficiently faithful representation of the asset (or liability) and of changes in the asset or liability.
- An entity should derecognise an asset or liability when it no longer meets the recognition criteria. However, if the entity is still exposed to some or all of the risks and rewards associated with the asset or liability, the IASB should determine at a standards-level how the entity would best portray the change in those risks or rewards.

Recognition

1. The existing Conceptual Framework defines recognition as follows:

> Recognition is the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the criteria for recognition set out in paragraph 4.38. It involves the depiction of the item in words and by a monetary amount and the inclusion of that amount in the balance sheet or income statement totals.[1]

2. In practice, questions about recognition (and derecognition) relate mainly to assets and liabilities. Answers to those decisions affect the statement of financial position. They may also affect the timing for the recognition of income and expense in the statement of comprehensive income.

3. The following paragraphs discuss the following aspects of recognition:

   (a) Should an entity recognise all its assets and liabilities? (paragraphs 4-7)

   (b) Whose asset or liability? In other words, how should an entity determine whether an asset or liability is an asset or liability *of the entity*? (see paragraphs 8-21)

   (c) Should there be any further recognition criteria? (see paragraphs 22-46)

   (d) Summary of proposed recognition criteria (see paragraphs 47–51).

[1] 4.37

Should an entity recognise all its assets and liabilities?

4. Part of what users need to help them assess an entity's prospects for future net cash inflows is information about how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.[2] The most understandable way to provide a complete summary of an entity's resources and obligations is to recognise them all in the statement of financial position.

5. The failure to recognise items that qualify for recognition is not rectified by disclosure of the accounting policies used nor by notes or explanatory material.[3]

6. The recognition criteria in the existing framework state that an entity recognises an item that meets the definition of an element if:

    (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and

    (b) the item has a cost or value that can be measured with reliability.[4]

7. In addition, as with all other aspects of the Conceptual Framework, the cost constraint applies. Thus, if the IASB concludes for a particular standard that the benefits of recognising a particular asset or liability do not justify the costs, the IASB would not require its recognition (and to enhance comparability would perhaps prohibit its recognition).

Whose asset or liability?

8. The statement of financial position reports an entity's resources (its assets) and obligations (its liabilities). A complete depiction of the entity's financial position would recognise all assets and liabilities that are assets and liabilities of the entity. This paper proposes that:

    (a) When an entity controls an asset, the asset is an asset of the entity (see paragraphs 9-20).

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[2] OB4

[3] 4.37

[4] 4.38

(b) When an entity is bound by an obligation the liability is a liability of the entity (see paragraph 21).

Control

9. In the existing Conceptual Framework, control is part of the definition of an asset (an asset is a resource controlled by an entity…). However, identifying which party controls a resource defines which party has the asset, rather than whether the asset exists. Thus, this paper deals with control as part of the recognition criteria, rather than in the definition of an asset. In practice, this change is unlikely to change the population of recognised assets.

10. For an entity to control an asset, the economic benefits arising from the asset must flow to the entity (either directly or indirectly) rather than to another party. In order to obtain those benefits, the entity must have the ability to direct the use of the asset. Consequently, this paper proposes to define control of an asset as follows:

> An entity controls an asset if it has the present ability to direct the use of the asset so as to obtain the economic benefits that flow from the asset.

11. An entity has the ability to direct the use of an asset if it has the right to deploy that asset in its activities or to allow another party to deploy that asset in the other party's activities. In most cases, an entity's ability to direct the use of an asset is established through legally enforceable rights, for example legal ownership or contractually enforceable rights. However, sometimes an entity establishes its ability to direct the use of the asset by having physical access that is not available to others. This can be particularly relevant for assets such as know-how and customer lists.

12. When determining whether an entity has control over an economic resource, it is important to correctly identify the resource. For example, entities A, B and C may jointly own real estate on terms that provide them with 25%, 40% and 35% respectively of the economic benefits flowing from that property. In such cases, each party controls its proportionate interest in the underlying economic resource (the real estate in this example). No single party controls the underlying real estate in its entirety.

13. The concept of control is used in both IFRS 10 *Consolidated Financial Statements* and the IASB's Exposure Draft (ED) *Revenue from Contracts with Customers* published in November 2011.

14. The *Revenue from Contracts with Customers* ED uses the concept of control to determine when an entity has transferred an asset to another party and has, consequently, satisfied a performance obligation. That ED defines control of an asset in this context as follows:

> Control of a promised good or service (ie an asset) is the customer's ability to direct the use of and obtain substantially all of the remaining benefits from the asset

15. IFRS 10 uses the concept of control to determine when one entity should consolidate another entity. Control of an entity is defined in IFRS 10 as follows:

    (a) An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee; Thus, the principle of control sets out the following three elements of control:

        (i) power over the investee;

        (ii) exposure, or rights, to variable returns from involvement with the investee; and

        (iii) the ability to use power over the investee to affect the amount of the investor's returns.

    (b) An investor has power over an investee when the investor has existing rights that give it the current ability to direct the activities that significantly affect the investee's returns.

16. The definitions of control in the ED and in IFRS 10 differ from each other. However, they are based upon the same basic concepts as the definition of control proposed in this paper – that is, that the entity has the ability to direct the use of the asset (entity) so as to obtain benefits (returns).

17. The proposed definition of control is closer to the definition of control in the *Revenue from Contracts with Customers* ED than to the definition in IFRS 10. This reflects the fact that both the proposed definition and the definition in the

Revenue from Contracts with Customers ED deal with control of an asset; the definition in IFRS 10 defines control of an entity.

18. Although the definition of control proposed in this Discussion Paper is similar to the definition used in the *Revenue from Contracts with Customers* ED, it does not require that the customer acquires *substantially* all the remaining benefits of the asset. This is because of a decision the IASB took in the context of determining whether an asset has been transferred for the purpose of recognising revenue: the IASB tentatively decided that the unit of account should be the whole asset rather than the individual rights that make up that asset (for example, a machine rather than the individual rights over different components of the machine, such as rights to use it for various parts of its useful life, the right to sell it or the right to pledge it). However, there will be situations where the IASB does not specify the whole of an asset as the unit of account. Consequently, the definition proposed in this Discussion Paper omits the reference to substantially all the benefits associated with an asset.

Control: principal and agent

19. An agent is a party primarily engaged to act on behalf of and for the benefit of another party (the principal). If an entity holds a resource as agent, rather than as principal, the economic benefits arising from the resource flow to the principal rather than to the agent. Consequently, the agent does not control the resource and does not have an asset. (Accordingly, the agent also has no obligation to transfer the economic benefits derived from the asset).

20. If an entity holds a resource, and is bound by a separate requirement (such as a contractual requirement or legislation) to pass through to another party all the economic benefits flowing from that resource, the entity holds that resource as agent for the other party. Thus, the entity has no asset or liability.

Which party is bound by an obligation?

21. This paper proposes that an entity should recognise a liability if the entity is the party that is bound by the obligation, in other words if the liability is a liability of the entity. This condition is the counterpart of the control criterion proposed for identifying whether an asset is an asset of the entity. Identifying which party is

bound by an obligation will rarely be difficult because this will normally be evident from the documents or other evidence that establish that the obligation exists.

Further recognition criteria?

22. As a reminder, the existing recognition criteria lead to recognition of an item meeting the definition of an element if:

    (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and

    (b) the item has a cost or value that can be measured with reliability.

23. Some view those criteria as obstacles that block the recognition of items if future economic benefits are not probable, or if cost and value cannot be measured reliably. The following paragraphs discuss whether to include recognition criteria that refer to:

    (a) Uncertainty (see paragraphs 24-34)

    (b) Relevance and cost constraint (see paragraphs 35-36)

    (c) Faithful representation (see paragraphs 37-42)

    (d) Enhancing qualitative characteristics (comparability, verifiability, timeliness, understandability) (see paragraphs 43-46)

Uncertainty

24. The existing criteria do not permit recognition if it is not probable that any future economic benefit associated with the item will flow to or from the entity. This statement deals implicitly with two types of uncertainty:

    (a) Element uncertainty (paragraph 25)

    (b) Outcome uncertainty (paragraph 26)

25. Element uncertainty: Element uncertain exists if it is uncertain whether an asset or liability exists (or whether the entity is the party that controls the resource or is bound by the obligation). An example might be litigation: it might be uncertain whether an entity committed an act that, if committed, obliges the entity to pay a

fine. Should an entity recognise that asset or liability? If so, when? Possible criteria include:

(a) Only when it is virtually certain. As a precedent, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* currently uses this criterion for contingent assets. IAS 37 defines a contingent asset as a possible asset that arises from past events and whose existence will be confirmed by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the reporting entity. Once it becomes virtually certain that an inflow of economic benefits will arise, IAS 37 treats this item as an asset, not as a contingent asset.

(b) When it is probable. As a precedent, IAS 37 adopts this threshold for provisions. It also states that an outflow of resources or other event is probable if it is more likely than not to occur. However, other IFRSs do not contain an explicit definition of the term 'probable'.

26. Outcome uncertainty: outcome uncertainty refers to cases where the asset or liability exists, but the outcome is uncertain. Examples of outcome uncertainty include the following:

(a) Lottery ticket where the total number of tickets is known, hence the probability of winning is also known. The holder has an asset (the ticket) but does not know whether the ticket will win. (Note also that the issuer is certain that it will make a payment to holders of winning tickets, though it does not know which ticket will win. If a probability threshold is applied, the issuer would reach a different judgement for each individual ticket than it would for the whole pool of tickets.)[5]

(b) Traded option held. Cash flows will occur if the holder exercises the option (ie if the option is in the money at expiry). [6]

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[5] The lottery example is included as a simple illustration of the concepts involved. Most real life examples are much more complex.

[6] Some would argue that including a probability threshold would not prevent the recognition of a traded option as an asset because the holder can sell it readily before expiry of the option.

(c) Untraded option on unlisted equities, for which the terms of the option prohibit transfer to another party. In this case, the holder will receive cash only if the holder exercises the option at exercise (ie if the option is in the money at expiry).

(d) Investment in a partnership that does not permit the holder to transfer the investment to another party. In this case, the investor will receive cash only if the partnership makes a distribution, or if the partnership is liquidated, or if the other partners buy out the investor.

(e) Know-how generated by a research and development (R&D) project. This will generate cash if the project is successful. This case differs from the case of the lottery ticket because (i) the probability of success may be unknown and unknowable (and cannot subsequently be back-tested) (ii) there is a very wide range of possible outcomes (iii) if the outcome of the project is successful, its fair value may greatly exceed the costs incurred. At that point, a cost-based measure may not provide relevant information about that project.

(f) Shares in an entity whose only activity is carrying out R&D. Few would dispute that shares in an entity generally meet the definition of an asset. On the other hand, if there are concerns about recognising know-how generated by an R&D project, presumably the same concerns would arise for shares in an entity whose only asset is such a project.

(g) Litigation. The entity will have to pay out cash if it loses the litigation. It may be uncertain whether the entity has an obligation at all until the court determines whether this is the case (element uncertainty). It may also be uncertain how much the entity will have to pay if the court ultimately rules that the entity had an obligation (outcome uncertainty).

27. Some suggest that the IASB should retain some probability threshold for cases of outcome uncertainty. They think that users will not factor low probability outcomes into their estimates of the amount, timing and uncertainty of future cash flows. They think that in some cases there is a wide range of outcomes, including zero, and the probabilities of the different outcomes are unknown and arguably unknowable (eg a highly speculative R&D project or some litigation). In such

cases, measures derived from estimates of those probabilities, may, arguably, be neither relevant to users nor verifiable. They believe that retaining a probability criterion would be a practical and inexpensive way to filter these items out.

28. Some suggest applying different probability thresholds for different circumstances. For example:

   (a) Some would be more willing to recognise an item with an uncertain outcome if the measure of the item can be supported by current market prices, if the item was acquired externally for observable consideration or if failure to recognise the item would lead to a gain or loss.

   (b) Some support different recognition criteria than for liabilities. This is one feature of IAS 37, which sets different recognition criteria for contingent assets (virtually certain) than for liabilities.

   (c) Some might argue for different probability thresholds, depending on whether a gain (or loss) would result from recognition or from non-recognition. For example, some propose a lower threshold for recognising an asset (liability) acquired (incurred) in an exchange transaction, because non-recognition would lead to a gain or loss that, arguably, would not represent faithfully a change in financial position.

29. Setting different criteria in this manner conflicts with the need for neutrality.

30. Some suggest deleting the probability criterion. In their view, if an asset (or liability) exists, that existing resource (or obligation) should be recognised regardless of the likelihood that the inflow or outflow of economic benefits will ultimately occur. Uncertainty about the ultimate inflow or outflow will affect the measurement, but should not determine whether the entity recognises the asset or liability. In principle, if the statement of financial position is to provide a complete depiction of an entity's resources and obligations, the entity should recognise all the resources that it controls and all the obligations that bind it.

31. Retaining a criterion relating to the probability of outcome would mean that many options and guarantees would not qualify for recognition.

32. Existence uncertainty and outcome uncertainty are often related. When it is uncertain whether an asset or obligation exists, there may often be uncertainty about the outcome of the asset or liability.

33. Some measurement approaches may create an implicit recognition threshold. For example, if an item is measured at the most likely outcome, it will be measured at zero (in effect, the same as not being recognised) if the most likely outcome is zero.

34. This paper reaches the following conclusions on uncertainty:

    (a) Element uncertainty: An entity should not recognise an asset or liability if it is not virtually certain that the entity controls the asset or is bound by the liability. Relevant and understandable information would not result from recognising an asset or liability without a high degree of certainty that an asset or liability of the entity exists.

    (b) Outcome uncertainty: The recognition criteria should not include a probability threshold relating specifically to uncertainty of outcome. Including such a threshold could lead to a failure to recognise some items (for example, options) that are undoubtedly assets or liability but are judged, at a particular time, to have a low probability of resulting in an inflow or outflow of economic benefits. Furthermore, some such items may swing above and below the threshold as the probabilities change.

    (c) Uncertainty may make some rights or obligations so difficult to measure that recognising them might result in information that is not relevant, or does not provide a faithful representation. The following paragraphs discuss whether to include recognition criteria relating to relevance and to faithful representation.

Relevance and the cost constraint

35. Information is relevant to users it is capable of making a difference in the decisions made by users.[7] In most cases, recognising rights and obligations provides users with relevant information, but in some cases it may provide

[7] QC6

information that is not relevant, or that is not sufficiently relevant to justify the cost:

(a) If the level of uncertainty in an estimate is sufficiently large, that estimate will not be particularly relevant.[8] Some would argue that this is the case for some litigation, or for at least some research and development projects.

(b) Recognising particular rights and obligations may not be relevant or understandable if related rights and obligations are also not recognised. For example, some argue that relevant information does not result from recognising derivatives used to hedge normal purchases or sale of commodities if the underlying purchases or sales have not yet been recognised.

(c) In some cases, it may not be feasible, or may be too costly, to develop a measure that portrays the economic benefits an asset will produce, and a cost-based measure may have too little connection with the value of those economic benefits to provide relevant information. For example, some argue that measures of the economic benefits derived from knowledge gained in a research and development project are not feasible or are too costly. They also argue that a cost-based measure of such knowledge may be irrelevant because it is likely to be incomplete and perhaps arbitrary, and because the value of a successful project may significantly exceed cost.

(d) Entities currently recognise goodwill acquired in a business combination, but do not recognise internally generated goodwill. As explained in paragraphs BC313-BC323 of the *Basis for Conclusions* on IFRS 3 *Business Combinations*, goodwill meets the definition of an asset. That conclusion applies equally to internally-generated goodwill and to acquired goodwill. However, recognising internally-generated goodwill does not pass a cost-benefit test:

[8] QC16

(i) Benefit: General purpose financial reports are not designed to show the value of a reporting entity; but they provide information to help existing and potential investors, lenders and other creditors to estimate the value of the reporting entity.[9] Thus, recognising internally-generated goodwill is not necessary to meet the objectives of financial statements and so provides little or no benefit.

(ii) Cost: Measuring internally-generated goodwill would be costly. In contrast, measuring goodwill acquired in a business combination as a residual at a single date is not costly, although some cost is involved in carrying out subsequent impairment tests of the goodwill.

Similarly, measuring some internally-generated intangible assets may not pass a cost-benefit test.

36. This paper concludes that the IASB should not require recognition of an asset or liability if, in the IASB's view, recognition:

(a) would not result in relevant information; or

(b) would provide information that is not relevant, or not sufficiently relevant to justify the cost of preparing it.

Faithful representation

37. The existing Conceptual Framework prevents the recognition of an asset or liability whose cost or value cannot be measured reliably. Before its revision in 2010, the Conceptual Framework stated that information is reliable if it is free from material error and bias, and users can depend on it to represent faithfully what it either purports to represent or could reasonably be expected to represent. The Conceptual Framework expanded on that statement by explaining that to be reliable, information must:

(a) account for and present transactions in accordance with their substance and economic reality and not merely their legal form. [10]

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[9] OB7

[10] Former framework, paragraph 35

(b) be neutral, that is, free from bias.[11] The Conceptual Framework also argued, under the heading of prudence, for a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated.[12]

(c) be complete within the bounds of materiality and cost.[13]

38. The term *reliability* no longer appears in the Conceptual Framework, though much of the content of that concept is covered by the current Conceptual Framework's fundamental characteristic of faithful representation and its enhancing characteristic of verifiability. Paragraphs BC3.23-24 of the *Basis for Conclusions* on the *Conceptual Framework* explain that:

(a) the comments of respondents to numerous proposed standards indicated a lack of a common understanding of the term *reliability*. Some focused on *verifiability* or *free from material error* to the virtual exclusion of faithful representation. Others focused more on faithful representation, perhaps combined with neutrality. Some apparently thought that reliability referred primarily to precision.

(b) the term *faithful representation* encompasses the main characteristics that the previous framework included as aspects of reliability.

39. A perfectly faithful representation would be complete, neutral and free from error.[14] Of course, perfection is seldom, if ever, achievable. The IASB's objective is to achieve as faithful a representation as possible:

(a) Completeness suggests that, if all else is equal, an entity should recognise all its resources and obligations.

(b) Neutrality suggests that, if all else is equal, the recognition criteria should apply symmetrically to resources and to obligations, and that the criteria should apply symmetrically, regardless of whether a transaction

[11] Former framework, paragraph 36

[12] Former framework, paragraph 37

[13] Former framework, paragraph 38

[14] QC12

or other event that leads to recognition results in a gain, a loss or no gain and no loss.

(c) Freedom from error suggests that, if all else is equal, an entity should not recognise an asset or liability if either the process of determining whether to recognise that asset or liability, or its measurement, is likely to be unduly prone to error.

40. An estimate can be a faithful representation if the reporting entity has properly applied an appropriate process, properly described the estimate and explained any uncertainties that significantly affect the estimate. However, if the level of uncertainty in such an estimate is sufficiently large, that estimate will not be particularly useful.[15]

41. Therefore, in considering whether it is possible to provide a faithful representation of a resource or obligation, it is necessary to consider not just its description and measurement on the face of the statement of financial position, but also:

(a) related disclosures. A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations.[16]

(b) the depiction of the resulting income and expense. For example, if an entity acquires an asset in exchange for consideration, the failure to recognise the asset would result in an expense, and a reduction in the entity's profit. In some cases, that result could provide a misleading representation that the entity's financial position has deteriorated.

42. This paper concludes that the IASB should not require recognition of an asset or liability if, in the IASB's view, recognition would not result in a faithful representation of the entity's resources or obligations, or of changes in its resources or obligations.

[15] QC16

[16] QC13

Enhancing characteristics

43. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable.[17] If all else is equal, failure to recognise some of an entity's assets or liabilities is likely to make the entity's financial statements less comparable and understandable, and to provide less timely information to users.

44. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. Quantified information need not be a single point estimate to be verifiable. A range of possible amounts and the related probabilities can also be verified.[18]

45. On occasions, recognising a resource or obligation might make the statement of financial position less understandable if it is closely linked to another resource or obligation that is unrecognised.

46. This Discussion Paper does not propose recognition criteria relating to the enhancing characteristics.

Summary of proposed recognition criteria

47. Except as discussed below, an entity should

    (a) recognise as assets all economic resources that the entity controls.

    (b) recognise as liabilities all obligations that bind the entity.

48. The failure to recognise an asset or liability is not rectified by disclosure of the accounting policies used nor by notes or explanatory material.[19] The resulting depiction of the entity's resources and obligations would be incomplete, and thus not provide a fully faithful representation of the entity's financial position.

49. Thus, it is undesirable to set absolute barriers to recognition, because that may make it difficult to achieve a complete, neutral and faithful representation of an entity's resources and obligations, and of changes in them. Instead, this paper proposes that the Conceptual Framework should identify the following indicators

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[17] QC4

[18] QC26

[19] 4.37

of cases where the IASB might decide in a standards-level project that an entity need not, or should not, recognise an asset or liability:

(a) If recognising the asset (or liability) would provide users with information that is not relevant, or not sufficiently relevant to justify the cost.

(b) If no measure of the asset (or liability) would provide a sufficiently faithful representation of the asset (or liability), or of changes in the asset (or liability).

50. The following are some indicators that recognition might not be appropriate:

(a) If a resource (or obligation) exists, but there is only a low probability that an inflow (or outflow) of economic benefits will result. In some such case, the IASB might conclude that users would not factor information about that inflow (or outflow) directly into their valuation models. Moreover, in some cases where there is only a low probability of an inflow (or outflow), measures of the resource or obligation may be exceptionally sensitive to small changes in the estimate of the probability. In those cases, it may be difficult to be confident that a measure of the resource or obligation will provide a faithful representation, even when supplemented by disclosure.

(b) If the range of possible outcomes is extremely wide and the likelihood of each outcome is exceptionally difficult to estimate. (As an example, this might be the case for major litigation.[20]) In such cases, the most relevant information for users might relate to the range of outcomes and the factors affecting their likelihoods. Trying to capture that information in a single number as a measure for recognition in the statement of financial position may not provide any further value to users.

(c) If identifying the resource or obligation is unusually difficult. As an example, this may be the case for some intangible assets, particularly

[20] Litigation may also be subject to element uncertainty, as discussed earlier.

some of those generated internally rather than acquired in a separate transaction.

(d) If measuring a resource or obligation requires unusually difficult or exceptionally subjective allocations of cash flows that do not relate solely to the item being measured.

(e) If recognising an asset is not necessary to meet the objectives of financial statements. This is the case for internally-generated goodwill.

51. If an entity has an asset or liability but does not recognise it, it may be necessary to provide disclosure about that asset or liability, including perhaps disclosure about the factors that prevent recognition.

Questions for the IASB

Does the IASB agree that:

1. Except as discussed below, an entity should
   (a) recognise as assets all economic resources that the entity controls.
   (b) recognise as liabilities all obligations that bind the entity.
2. An entity should not recognise an asset or liability if it is not certain or virtually certain that the entity controls the asset or is bound by the liability.
3. The Conceptual Framework should identify the following cases where the IASB might decide in a standards-level project that an entity need not, or should not, recognise an asset or liability:
   (a) If recognising the asset (or liability) would not provide users with sufficiently relevant information to justify the cost.
   (b) If no measure of the asset (or liability) would provide a sufficiently faithful representation of the asset (or liability).

Derecognition

52. The IASB *Glossary of terms* defines derecognition as the removal of a previously recognised item from an entity's statement of financial position.

53. The existing Conceptual Framework does not define derecognition and does not describe when derecognition should occur. Because there is no agreed conceptual approach to derecognition, different standards have adopted different approaches. This risks causing inconsistency, with the further risk of adopting rules-based approaches rather than principles-based approaches.

54. The rest of this sub-section deals with the following:

    (a) Consequences of derecognition (paragraphs 55-57)

    (b) Objective of derecognition (paragraph 58)

    (c) Control approach or risks and rewards approach? (paragraphs 59-63)

    (d) Full or partial derecognition? (paragraphs 64-65)

    (e) Summary of proposed derecognition criteria (paragraphs 66-67)

Consequences of derecognition

55. Derecognition has the following consequences:

    (a) The entity no longer recognises the previously recognised asset or liability.

    (b) The entity may need to recognise other assets and liabilities that result from the transaction or other event that gave rise to the derecognition.

    (c) Income or expense may arise from the derecognition of the previous asset or liability and the recognition of any new asset or liability.

56. As noted in agenda paper 3B (Draft discussion paper: Elements – Definition of elements), many economic resources comprise a bundle of rights. In principle, an entity would recognise, measure and present some of these rights separately if such separation results in the most relevant information, and if the benefits of separation outweigh the costs. Similarly, when an entity transfers some rights associated with a resource and retains others, it would derecognise the rights that it no longer controls and continue to recognise the rights retained. For example, a

lessor derecognises the right of use granted to the lessor and continues to recognise the remaining rights associated with the underlying leased item.

57. When an asset or liability is transferred between entities within a consolidated group (a parent and its subsidiaries), the group as a whole continues to control the asset or be bound by the liability. Accordingly, in consolidated financial statements, the group continues to recognise the asset or liability.

Objective of derecognition

58. The aim of accounting requirements for a transaction that may result in derecognition should be to represent faithfully both:

(a) the resources and obligations remaining after the transaction, and

(b) the changes in the resources and obligations as a result of a transaction.

Control approach or risks and rewards approach?

59. Achieving that twin aim is straightforward if an entity disposes of an entire asset or entire liability. In that case, derecognition represents faithfully both the absence of rights and obligations relating to that item, and the elimination of all the previous rights or obligations. Similarly, if an entity disposes of a proportion (say 30%) of an asset, derecognition of that 30% will represent faithfully that the entity retains 70% of the asset and disposed of 30% of it.

60. However, achieving that twin aim is more difficult if the entity retains a component that exposes the entity disproportionately to the risks or rewards arising from the previously recognised asset or liability. There are two approaches to derecognition in such cases:

(a) A control approach: derecognition is simply the mirror image of recognition. Thus, an entity would derecognise an asset or liability when it no longer meets the criteria for recognition. This implies that the derecognition criteria would focus on control of an asset (rather than on legal ownership or on risks and rewards) and on whether the entity is still bound by a liability.

(b) A risk and rewards approach: an entity should continue to recognise an asset or liability until it is no longer exposed to most of the risks and rewards generated by the asset or liability, even if the asset or liability no longer meets the recognition criteria. Thus, whether an entity recognises an asset or liability depends, in some circumstances, on whether the entity previously recognised that asset or liability. As a result, some use the labels 'history matters' or 'stickiness' for a risk and rewards approach.

61. Proponents of a control approach argue that it treats identical rights or obligations in the same way, regardless of whether they were recognised previously. Proponents of a risks and rewards approach focus on cases such as the following, where they believe that derecognition would not represent faithfully the change in circumstances:

(a) a material reduction in recognised assets or liabilities with no significant decrease in the risks borne by the entity. An example is when an entity transfers a loan asset but guarantees the purchaser against some or all future loan losses arising from that asset (see example A).

(b) a material gain that arises on selling an asset, if the entity simultaneously contracts to reacquire part or all of the asset through means such as a forward contract (see example B), written put option, purchased call option or lease.

(c) recognition of revenue on delivering an asset that may or must be returned to the vendor.

62. Example A illustrates a case where an entity sells an asset but retains some of the risk through a guarantee.

Example A: Sale of receivables with partial recourse

Fact pattern

Entity A controls receivables with a carrying amount of CU1,000[21] and a fair value of CU1,000. It sells the receivables to Bank B for cash of CU1,050. Entity A guarantees Bank B against any losses that Bank B

[21] In this staff paper, currency amounts are denominated in "currency units" (CU).

suffers above CU140. The fair value of the guarantee is CU50.

Applying a control approach

Under a control approach, Entity A would derecognise the receivables, recognising cash of CU1,050 and a guarantee liability of CU50. Entity A reports the guarantee liability in the same way as if it had issued a stand-alone guarantee of loans that it had never previously controlled.

Applying a risks and rewards approach

Under a risks and rewards approach, Entity A would continue to recognise the receivables at CU1,000, and would recognise cash of CU1,050 and a deposit liability of CU1,050. Measuring the receivables at CU1,000 depicts the fact that Entity A is still exposed to some (though in this example not all) of the credit risk arising from the receivables.

63. Example B illustrates a sale combined with a repurchase.

Example B: Sale of a bond with repurchase agreement

Fact pattern

Entity A controls a quoted zero coupon bond with a carrying amount of CU800 (amortised cost, with an effective interest rate of 5%) and a fair value of CU1,000 (reflecting a market interest rate of 4%). It sells the bond to Bank B for cash of CU1,000, and contracts to buy back the bond for CU1,045 after 12 months (the difference of CU45 reflects market interest rates for a loan secured by such a bond). Assume that the fair value of Entity A’s commitment to repurchase the bond is nil.

Applying a control approach

Under a control approach, Entity A would first assess whether Bank B is holding the bond as agent for Entity A. If so, Entity A would conclude that it retains control of the bond, and Entity A would:

- continue to recognise the bond at CU800, both before and after the repurchase (together with accrued interest at 5%).

- recognise cash of CU1,000.
- recognise as a liability a loan of CU1,000, repayable in 12 months with interest at 4.5%.

If Entity A concludes that Bank B holds the bond as principal, not as agent, it would derecognise the bond, recognising:

- cash of CU1,000
- a repurchase obligation: a loan commitment liability, measured at nil in this fact pattern
- a gain of CU200.

On repurchasing the bond, Entity A would recognise the bond and measure it at CU1,045. It would derecognise the loan commitment liability.

The control approach reports assets and liabilities that are comparable with those that Entity A would have reported for a stand-alone forward contract to buy the bond for CU1,045 in 12 months.

Applying a risks and rewards approach

Under a risks and rewards approach, Entity A would:

- continue to recognise the bond at CU800 (plus accrued interest at 5%), both before and after the repurchase
- recognise cash of CU1,000
- recognise as a liability a loan of CU1,000, repayable in 12 months with interest at 4.5%.

Arguably, the risks and rewards approach portrays more clearly than the control approach the fact that that the transaction had virtually no effect on the amount, timing and uncertainty of the entity's cash flows, other than receiving cash of CU1,000 and repaying it a year later with interest. In this example, if Entity A concludes that Bank B holds the bond as agent, the control approach would result in the same accounting as the risks and rewards approach.

Full or partial derecognition?

64. When a transaction eliminates some but not all of the rights and obligations contained in an asset (or liability), two approaches might be considered:

(a) Full derecognition: derecognise the entire asset (or liability) and recognise the retained component as a new asset (or liability). If the carrying amount of the retained component differs from its previous carrying amount, a gain or loss will arise on that component.

(b) Partial derecognition: Continue to recognise the retained component and derecognise the component not retained.

65. The following are two examples where this question arises:

(a) When the terms of existing rights or obligations are changed by, for example an agreement between two parties to amend a contract or by a change in the law. The modification may eliminate some of the existing rights or obligations and it may create new rights or obligations.

(b) In a sale and leaseback transaction, as illustrated in example C.

Example C: Sale and leaseback

Fact pattern

Entity A controls a machine that has a remaining useful life of 10 years and a carrying amount of CU800. Entity A sells the machine to Lessor B for its fair value of CU1,000, and simultaneously contracts with Lessor B to lease the machine back for the first 6 years for lease rentals at a current market rate and with a present value of CU600.

Applying a full derecognition approach

If Entity A derecognises the entire machine, it will:

- Recognise a new asset: the right to use the machine for years 1-6, measured at CU600

- Recognise the lease obligation, measured at CU600
- Recognise cash of CU1,000
- Recognise a gain of CU200 on disposal of the machine.

Applying a partial derecognition approach

If Entity A derecognises only part of the machine, it will:

- Continue to recognise the retained component of the asset: the right to use the machine for years 1-6. For this example, assume that the retained component is measured at CU480 = CU800 * (6/10).
- Derecognise the right to use the machine from years 7-10, recognising a gain of CU80 = (CU1,000 – CU800) * (4/10).
- Recognise cash of CU1,000
- Recognise a loan received, measured at CU600.

As example C illustrates, the full and partial derecognition approaches differ in how they measure the retained component, and in whether they recognise any gain (or perhaps loss) on that component. It is likely to be a standards-level decision to determine whether to apply a full derecognition approach or a partial derecognition approach, because that decision depends on the unit of account.

Summary of proposed derecognition criteria

66. The derecognition criteria need to reflect how best to portray both an entity's rights and obligations, and changes in those rights and obligations. Therefore, an entity should derecognise an asset or liability when it no longer meets the recognition criteria. However, if the entity is still exposed to some or all of the risks and rewards associated with the asset or liability, the IASB should determine at a standards-level how the entity would best portray the change in those risks or rewards. Possible approaches include:

(a) Enhanced disclosure

(b) Presenting any rights or obligations retained on a line item different from the line item used for the original rights or obligations, to highlight the greater concentration of risk.

(c) Continuing to recognise the original asset or liability, and treating the proceeds received or paid for the transfer as a loan received or granted.

67. It would be a standards-level decision, depending on the unit of account, to determine which of the following approaches to use when an entity transfers components of an asset or liability to another party, or modifies the terms of an asset or liability:

(a) Full derecognition approach: derecognise the entire asset or liability and recognise a new asset or liability.

(b) Partial derecognition approach: continue to recognise the components retained.

Questions for the IASB

1. Does the IASB agree that:

(a) an entity should derecognise an asset or liability when it no longer meets the recognition criteria. However, if the entity is still exposed to some or all of the risks and rewards associated with the asset or liability, the IASB should determine at a standards-level how the entity would best portray the change in those risks or rewards.