STAFF PAPER

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Project	**Conceptual Framework**		
Paper topic	Derecognition		
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Purpose of paper

1. The purpose of this paper is to discuss issues related to derecognition. Specifically, this paper discusses:
   (a) control approach vs risks-and-rewards approach (paragraphs 3-9);
   (b) when an entity retains a component of an asset or a liability (paragraphs 10-28);
   (c) modification of contracts (paragraphs 29-37);
   (d) applying derecognition concepts to sale and repurchase agreements (Appendix A); and
   (e) definition of derecognition (Appendix B).

Summary of staff recommendations

2. The staff recommend that the *Conceptual Framework* should describe the approaches available, and discuss what factors to consider, in deciding at the Standards-level:
   (a) how best to portray the changes that result from a transaction in which an entity retains only a component of an asset or a liability, by either:
      (i) full derecognition (ie derecognise the original asset (or liability) entirely and recognise any retained right (or obligation) as a new asset (or liability));

(ii) partial derecognition (ie continue to recognise the component of the original asset (or liability) that is retained and derecognise the component that is not retained); or

(iii) continued recognition (ie continue to recognise the original asset (or liability) and treat the proceeds received or paid for the transfer as a loan received (or granted)); and

(b) how to account for modifications of contracts.

Control approach vs risks-and-rewards approach

Proposals in the Discussion Paper and feedback received

3. The Discussion Paper (DP/2013/1) *A Review of the Conceptual Framework for Financial Reporting* (hereinafter referred to as 'the Discussion Paper') stated that the aim of accounting requirements for a transaction that may result in derecognition should be to represent both:

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

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

4. Furthermore, the Discussion Paper stated that achieving these twin aims is straightforward if an entity disposes of an entire asset or an entire liability, but is more difficult if the entity retains a component that exposes the entity disproportionately to the remaining risks or rewards arising from the previously recognised asset or liability. The Discussion Paper went on to say that there were 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 a liability when it no longer meets the criteria for recognition (or no longer exists, or is no longer an asset or a liability of the entity). This implies that the derecognition criteria for an asset would focus on the control of the asset (rather than on legal ownership or on risks and rewards) and the derecognition criteria for a liability would focus on whether the entity still has the liability.

(b) a risks-and-rewards approach: an entity should continue to recognise an asset or a liability until it is no longer exposed to most of the risks and rewards generated by that asset or liability, even if the remaining asset (or liability) would not qualify for recognition if acquired (or incurred) separately at the date when the entity disposed of the other components. Thus, whether an entity recognises an asset or a 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 risks-and-rewards approach.

5. The IASB's preliminary view in the Discussion Paper was that in most cases, an entity should derecognise an asset or a liability when it no longer meets the recognition criteria (ie the control approach). However, if the entity retains a component of an asset or a liability, the IASB should determine when developing or revising particular Standards how the entity would best portray the changes that resulted from the transaction.

6. Respondent views regarding the control approach and the risks-and-rewards approach can be categorised as follows:

(a) The *Conceptual Framework* should adopt the control approach (possibly including risks and rewards as an indicator of control);

(b) The *Conceptual Framework* should adopt the risks-and-rewards approach; or

(c) The *Conceptual Framework* should discuss both approaches, including the relative merits of the control and risks-and-rewards approaches, and indicate when each should be used.

Staff analysis and recommendation

7. In the staff's view, it is possible to resolve some apparent conflicts between the control approach and the risks-and-rewards approach by considering the following points:

(a) Whether a transferee acquires an asset as principal or as agent. The staff think that, when an entity transfers an asset, the entity must first

consider whether the transferee is acting as an agent of an entity. If the transferee is acting as an agent of the entity, the asset continues to be the entity's asset and, therefore, derecognition does not occur. Agenda Paper 10D *Asset definition: control* includes a working draft of guidance on distinguishing a principal from an agent.

(b) In some cases, exposure, or rights, to variations in benefits (sometimes known as exposure to the significant risks and rewards of ownership) are an indicator of control. In Agenda Paper 10D, the staff recommend that guidance supporting the definition of control should refer to this point.

8. Careful consideration of those two points will not eliminate all apparent conflicts between the control approach and the risks-and-rewards approach. The remaining conflicts arise in cases when an entity retains a component of an asset or a liability, and are discussed further in the next section.

9. Many respondents to the Discussion Paper explicitly or implicitly stated that the derecognition concepts in the *Conceptual Framework* should enable the IASB to determine the general direction of the accounting for sale and repurchase agreements. Appendix A provides the staff's analysis.

When an entity retains a component of an asset or a liability

Proposals in the Discussion Paper and feedback received

Possible approaches

10. The Discussion Paper identified the following possible approaches to portray the changes resulting from a transaction in which an entity retains a component of an asset or a liability:

(a) enhanced disclosure;

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

(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.

11. The Discussion Paper suggested that the IASB would determine, when developing or revising particular Standards, which of these three approaches an entity should adopt to portray best the changes that resulted from the transaction.

12. Nearly one third of respondents commented on this issue. Of these respondents:

(a) some supported the IASB's preliminary view without further comments;

(b) some suggested that the *Conceptual Framework* should at least set out principles that would influence the choices between the alternatives; and

(c) many seemed to think that the IASB intended to select only one of the three approaches for inclusion in the *Conceptual Framework.*

13. Proponents of the control model seemed to explicitly or implicitly reject continued recognition (see paragraph 10(c)), whereas proponents of the risks-and-rewards model seemed to explicitly or implicitly support continued recognition under certain circumstances.

Full vs partial derecognition

14. The Discussion Paper explained that when derecognition occurs but some component of the asset or liability is retained, there are two approaches:

(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 component that is retained and derecognise the component that is not retained. On the retained component, no gain will arise and, unless that component is impaired, no loss will arise.

15. The IASB's preliminary view in the Discussion Paper was that the decision to use full or partial derecognition would depend on the unit of account and would be decided at the Standards-level.

16. Nearly one third of respondents commented on this issue. Of these respondents:

    (a) some supported the IASB's preliminary view without further comments;

    (b) some supported the full derecognition approach;

    (c) some did not support the full derecognition approach because it implicitly leads to revaluation of assets by the back door;

    (d) some stated that the *Conceptual Framework* should allow partial derecognition in certain circumstances;

    (e) some stated that the decision on whether to apply a full or partial derecognition approach depends on the unit of account; and

    (f) some stated that the decision on whether to apply a full or partial derecognition approach depends on whether the nature of the item has changed materially.

Staff analysis and recommendation

17. The staff think the discussions related to control or risks-and-rewards, the three possible approaches listed in paragraph 10 and full vs partial derecognition can be combined. The staff think there are three alternatives to derecognition when an entity retains a component of an asset or a liability:

    (a) full derecognition (ie derecognise the original asset (or liability) entirely and recognise any retained right (or obligation) as a new asset (or liability);

    (b) partial derecognition (ie continue to recognise the component of the original asset (or liability) that is retained and derecognise the component that is not retained); and

(c) continued recognition (ie continue to recognise the original asset (or liability) and treat the proceeds received (or paid) for the transfer as a loan received (or granted)).

Full derecognition

18. The full derecognition approach has the following characteristics:

    (a) the original asset (or liability) will be derecognised in full;

    (b) any retained right (or obligation) will be recognised as a new asset (or liability), and possibly presented separately from the original asset (or liability);

    (c) if the sum of (i) the proceeds received (or paid) for the transfer and (ii) the new carrying amount differs from the previous carrying amount, a gain or loss will arise.

19. Accordingly, the full derecognition approach is likely to be used in the following circumstances:

    (a) the transaction does not change the unit of account (ie the transaction does not split the original asset (or liability) into the transferred component and the retained component); and

    (b) the transaction changes the rights and obligations so significantly that it warrants a ‘fresh start’ and the recognition of gains or losses for both the ‘transferred component’ and the ‘retained component’.

Partial derecognition

20. The partial derecognition approach has the following characteristics:

    (a) the transferred component of the original asset (or liability) will be derecognised;

    (b) any retained component of the original asset (or liability) will continue to be recognised (but may need to be presented separately from other assets and liabilities that are similar to the original asset (or liability));

(c) if the proceeds for the transferred component differ from the carrying amount of the transferred component, a gain or loss will arise on that component; and

(d) a gain or loss will not arise from the retained component, unless that component is impaired.

21. Accordingly, the partial derecognition approach is likely to be used in the following circumstances:

(a) the transaction changes the unit of account (ie the transaction splits the original asset (or liability) into the transferred component and the retained component);

(b) the transaction does not change the rights and obligations significantly enough to warrant a ‘fresh start’ (ie the original asset (or liability) continues to exist); and

(c) while it is appropriate to recognise gains or losses for the transferred component, it is inappropriate to recognise gains or losses for the retained component.

Continued recognition

22. The continued recognition approach has the following characteristics:

(a) the original asset (or liability) will continue to be recognised in full (but may need to be presented separately from other assets and liabilities that are similar to the original asset (or liability));

(b) any proceeds received (or paid) upon transfer of the asset (or liability) will be recognised as a liability (or asset); and

(c) no gains or losses will arise from the transfer, unless the asset is impaired.

23. Accordingly, the continued recognition approach is likely to be used in the following circumstances:

(a) the transaction creates a new unit of account for the proceeds received (or paid);

(b) the transaction does not change the rights and obligations significantly enough to warrant a 'fresh start' (ie the original asset (or liability) continues to exist); and

(c) it is inappropriate to recognise any gains or losses from the transfer.

How to choose between the alternatives

24. As stated in paragraph 3, the aim of accounting requirements for a transaction that may result in derecognition should be to represent both:

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

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

25. In most cases, when an entity loses control of part of an asset, derecognising that part of the asset (or derecognising the entire asset and re-recognising the part retained) will represent faithfully:

    (a) the fact that the entity no longer controls part of the asset; and

    (b) the change in the entity's assets.

26. However, in some cases, derecognising an asset without providing further explanation may not faithfully represent the change in the circumstances. This might occur when, for example:

    (a) there is a significant reduction in recognised assets or liabilities with no significant decrease in the risk borne by the entity, for example, in some of the cases when an entity transfers a receivable but guarantees a purchaser against all or most of the future loan losses arising from that receivable; or

    (b) revenue, or a gain, arises on delivering an asset that may or must be returned to the vendor through means such as a forward contract, a written put option, purchased call option or lease.

27. The three alternatives have different implications. The staff think it would be difficult to determine conceptually in which cases each alternative should be used. Accordingly, the staff recommend that, if an entity retains a component of an asset or a liability, the IASB should determine when developing or revising particular

Standards how the entity would best portray the changes that result from the transaction.

28. In June 2014 the IASB decided that determining the unit of account is a Standards-level decision. The determination of the alternative for derecognition involves the identification of the unit of account and the staff recommendation in this paper is consistent with that decision.

Modification of contracts

Proposals in the Discussion Paper and feedback received

29. The Discussion Paper did not discuss modification of contracts. However, some respondents asked the IASB to clarify in the *Conceptual Framework* how to approach modifications of contracts leading to substantial changes, additional rights and obligations or the reduction of existing rights and obligations.

Staff analysis and recommendation

30. The staff think a modification of a contract can be accounted for using one of the following approaches:

    (a) continue to recognise and measure the original contract as if no modification had occurred, recognising and measuring the modification as a separate contract;

    (b) continue to recognise the original contract, incorporating the modified terms into an updated measurement of the original contract; or

    (c) derecognise the original contract and recognise a new contract under the modified terms.

Recognising an additional contract

31. A modification of a contract is likely to be accounted for by recognising an additional contract when the modification adds rights and obligations that are distinct from the original terms.

32. The staff notes that this approach is adopted in existing IFRSs, for example, in IFRS 15 *Revenue from Contracts with Customers*. This approach was also proposed in the Exposure Draft (ED/2013/7) *Insurance Contracts*.

Updating the original contract

33. A modification of a contract is likely to be accounted for as updating the original contract when the remaining rights and obligations are not distinct.

34. The staff notes that this approach is adopted in existing IFRSs, for example, in IFRS 15. This approach was also proposed in the Exposure Draft (ED/2013/7) *Insurance Contracts*.

Derecognising the original contract and recognising a new contract

35. A modification of a contract is likely to be accounted for as derecognising the original contract and recognising a new contract when the modification changes the terms of the contract (and thus the comprising rights and obligations) so significantly that it warrants a 'fresh start'.

36. The staff notes that this approach is adopted in existing IFRSs, for example, in IFRS 9 *Financial Instruments* and IFRS 15. This approach was also proposed in the Exposure Draft (ED/2013/6) *Leases* and the Exposure Draft (ED/2013/7) *Insurance Contracts*.

Choosing between the approaches

37. The staff think it would be difficult to determine conceptually in which cases each approach should be used and, accordingly, the staff recommend that such determination should be made at the Standards level.

Staff recommendations and question for the IASB

38. The staff recommend that the *Conceptual Framework* should describe the approaches available, and discuss what factors to consider, in deciding at the Standards-level:

    (a) how best to portray the changes that result from a transaction in which an entity retains only a component of an asset or a liability, by either:

(i) full derecognition (ie derecognise the original asset (or liability) entirely and recognise any retained right (or obligation) as a new asset (or liability));

(ii) partial derecognition (ie continue to recognise the component of the original asset (or liability) that is retained and derecognise the component that is not retained); or

(iii) continued recognition (ie continue to recognise the original asset (or liability) and treat the proceeds received or paid for the transfer as a loan received (or granted)); and

(b) how to account for modifications of contracts.

Question for the IASB
Does the IASB agree with the staff recommendation in paragraph 38?

Appendix A: Applying derecognition concepts to sale and repurchase agreements

A1. Many respondents to the Discussion Paper explicitly or implicitly stated that the derecognition concepts in the *Conceptual Framework* should enable the IASB to determine the general direction of the accounting for sale and repurchase agreements.

A2. This Appendix illustrates one way the IASB may determine the general direction of the accounting for repurchase agreements.

Features of a repurchase agreement

A3. Repurchase agreements generally involve two actions:

(a) the entity sells the asset to a buyer; and

(b) the entity repurchases that asset from that buyer.

A4. Some repurchase agreements (mainly those for financial assets) involve the repurchase of an asset that is not exactly the same as the asset that was originally sold (but is indistinguishable in all material aspects).

One transaction or two transactions

A5. The first issue is whether the two actions in paragraph A3 constitute one or two transactions.

A6. The staff think the two actions can be a viewed as a single unit of account. In June 2014, the IASB decided that the substance of the transaction should be one of the factors to consider when determining the unit of account. If the IASB determines that it would not be a faithful representation to separate these two actions as separate transactions, the staff think the IASB can conclude that these two actions constitute a single transaction.

Transfer of control

A7. If the two actions are accounted for as a single unit of account, the question is whether the entity has transferred control by the sale (the first of the actions mentioned in paragraph A3).

A8. The staff think control has not been transferred when the asset is transferred to the buyer. This is because the buyer is constrained in its ability to direct the use of the asset and obtain the economic benefits that flow from it.

A9. Because control has not been transferred to the buyer, the entity will continue to recognise the asset in its statement of financial position and recognise the proceeds it receives from the buyer as a liability.

A10. The staff notes that the IASB may decide to require entities to present assets subject to such arrangements separately from other assets that are not subject to such arrangements.

Appendix B: Definition of derecognition

B1. This appendix is for information only. The staff do not intend to ask the IASB to discuss it.

Proposal in the Discussion Paper and feedback received

B2. The Discussion Paper stated that IFRS 9 *Financial Instruments* defines derecognition as the removal of a previously recognised financial asset or financial liability from an entity's statement of financial position. Furthermore, the Discussion Paper stated that the existing *Conceptual Framework* does not define derecognition and does not describe when derecognition should occur.

B3. Respondents to the Discussion Paper provided the following comments related to the definition of derecognition:

(a) some respondents stated that a distinction between derecognition and nil carrying amount needs to be made; and

(b) some respondents asked the IASB to clarify that a movement of an item from an asset to a liability, or vice versa, does not result in derecognition and re-recognition (ie derecognition refers only to the fact that an item is no longer recognised at all).

Staff analysis and recommendation

B4. The comments in paragraph B3 arise because derecognition is not defined in the *Conceptual Framework*. The staff recommend defining derecognition in the *Conceptual Framework* as follows:

> Derecognition is the removal of all or a part of a previously recognised asset or liability from an entity's statement of financial position.

B5. Furthermore, the staff recommend including in the *Conceptual Framework* the following additional guidance:

(a) measuring an item at nil is not derecognition because that item has not been removed from the entity's statement of financial position; and

(b) similarly, a movement of an item from an asset to a liability, or vice versa, does not result in derecognition and subsequent recognition.