STAFF PAPER

March 2014

IASB Meeting

Project	**Conceptual Framework**
Paper topic	Feedback summary: derecognition

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Purpose of paper

1. This paper summarises the feedback received on the derecognition section of the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting*.
2. This paper provides a high level summary of the comments received. Where appropriate, we will provide more a detailed breakdown of the comments for future meetings.

Overview

3. Respondents were split on the approach to be used for derecognition (ie the control approach, the risks-and-rewards approach or a combination of these approaches).

Structure of this paper

4. This paper is structured as follows:
   (a) Control approach vs risks-and-rewards approach (paragraphs 5-18)
   (b) When an entity retains components (paragraphs 19-26)
   (c) Full or partial derecognition (paragraphs 27-30)
   (d) Other comments (paragraph 31).

Control approach vs risks-and-rewards approach

Background

5. The Discussion Paper explained two approaches to derecognition:

   (a) a control approach: derecognition is simply the mirror image of recognition. Thus, an entity would recognise 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 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 of 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 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 label 'history matters' or 'stickiness' for a risks-and-rewards approach.

6. The Discussion Paper explained the IASB's preliminary view that 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. In some cases, as further discussed in paragraph 19, that might involve continuing to recognise the original asset or liability.

Summary of feedback

7. The existing *Conceptual Framework* does not define derecognition and does not describe when derecognition should occur. A few respondents explicitly welcomed the suggestion in the Discussion Paper that the *Conceptual Framework* should include a discussion on derecognition.

8. Some respondents supported the IASB's preliminary view without further comments.

9. Respondents' views regarding the control approach and the risks-and-rewards approach can be categorised as follows:

   (a) pure control approach (paragraphs 10-12)

   (b) control approach that incorporates the risks-and-rewards approach (paragraphs 13-14)

   (c) control approach with exceptions (paragraph 15)

   (d) including both approaches in the *Conceptual Framework* (paragraph 16)

   (e) pure risks-and-rewards approach (paragraphs 17-18).

Pure control approach

10. A few respondents stated that the *Conceptual Framework* should adopt the control approach and exceptions should not be made at the Standards level. Proponents of this view argued that derecognition should strictly mirror recognition and, if a different approach is applied, a retained component may not meet the recognition criteria. One of these respondents felt that derecognition should not be a problem if the definitions and recognition criteria were clear.

11. A few respondents stated that experience has shown that it may difficult for the IASB to adopt a pure control approach:

   (a) The derecognition model for financial assets was reviewed in 2009 and, following extensive consultation and due process, the IASB concluded that the existing derecognition approach was more appropriate than the pure control approach. Although the control approach may work for the derecognition of non-financial items, it would not work for the derecognition of financial items.

(b) In the Revenue Recognition project, the IASB reintroduced risks and rewards as an indicator of transfer of control.

12. A few respondents stated that the concept of principal and agent is fundamental to the evaluation of control.

Control approach that incorporates the risks-and-rewards approach

13. Some respondents stated that the *Conceptual Framework* should adopt the control approach with the clarification that risks and rewards is a factor to be considered in determining control. Proponents of this view stated that the control approach and the risks and rewards approach are not competing views but rather they complement each other.

14. A few of these respondents made other comments:

    (a) Risks and rewards should be considered when the entity has continuing involvement.

    (b) The current IAS 39 model for derecognition is based on the risks-and-rewards approach and there is no need to reconsider it.

    (c) The IASB should clarify that the transfer of all risks and rewards would result in the loss of control.

Control approach with exceptions

15. A few respondents suggested that the *Conceptual Framework* should adopt the control approach and any exceptions should be made at the Standards level. Proponents of this view suggested that, in general, derecognition should mirror recognition, but there are certain situations where the IASB may need to depart from this principle. Some of these respondents indicated that, in the case of repurchase agreements, the risks-rewards-approach produces an accounting outcome that more faithfully represents the substance of the transaction. See paragraph 26 for discussion of repurchase agreements.

Including both approaches in the Conceptual Framework

16. A few respondents suggested that the *Conceptual Framework* should refer to both the control approach and the risks-and-rewards approach. The *Conceptual Framework*

should discuss the relative merits of these approaches and indicate when each should be used.

Pure risks-and-rewards approach

17. A few respondents suggested that the *Conceptual Framework* should adopt a pure risks-and-rewards approach.

18. A few respondents commented on specifics of the risks-and-rewards approach, as described in the Discussion Paper:

    (a) The description of the risks-and-rewards approach would create confusion because it uses the phrase ‘most of,’ which may be subjective.

    (b) The approach used in the former UK standard FRS 5 *Reporting the Substance of Transactions* was preferred. FRS 5 prohibited derecognition only when there is no significant change in the entity’s exposure to risks and rewards, rather than when it retains most of the risks and rewards.

When an entity retains components

Background

19. The Discussion Paper raised 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 the 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.

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

Summary of feedback

21. Nearly one third of respondents commented on this issue. Within those respondents:

(a) Some respondents supported the IASB's preliminary view without further comments.

(b) Some respondents suggested that the *Conceptual Framework* at least set out principles that would influence the choice between the alternatives (ie the choice should not be a pure Standards-level decision).

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

(d) A few respondents disagreed with the IASB's preliminary view and suggested that the *Conceptual Framework* include only one of the three approaches.

Alternative (a): enhanced disclosure

22. Regarding Alternative (a):

(a) A few respondents supported this alternative. Those who gave a reason stated that the other alternatives would add unnecessary complexities to financial statements.

(b) A few respondents did not support this alternative. A few within these respondents stated that note disclosures should not be substituted for the recognition of elements in financial statements.

(c) A few respondents did not think additional disclosure is necessary if derecognition occurred when an asset or liability no longer met the recognition criteria.

(d) A few respondents suggested that enhanced disclosure should be required, regardless of the accounting approach chosen.

Alternative (b): presenting any rights or obligations retained on a separate line item

23. Regarding Alternative (b):

(a) A few respondents supported this alternative. Those who gave a reason stated that it is consistent with the control approach.

(b) A few respondents did not support this alternative. Those who gave a reason stated that:

    (i) this alternative is too bank-oriented.

    (ii) the costs could not be justified.

(c) The IASB should develop general presentation guidance on concentration of risk. This general guidance would cover retained rights and obligations.

Alternative (c): continued recognition, treating the proceeds as a loan

24. Regarding Alternative (c):

(a) A few respondents supported this alternative. One of these respondents agreed that this alternative may impair comparability but argued that this is not a serious issue.

(b) A few respondents noted that this alternative has the advantage of being simple to apply but may not reflect the economic reality of the transaction.

25. A few respondents did not support this alternative. Those who gave a reason stated that it is:

(a) inconsistent with the control approach.

(b) too bank-oriented.

Repurchase agreements

26. Many of those who commented on derecognition specifically referred to how the *Conceptual Framework* would apply to repurchase agreements. Within those respondents:

(a) A few respondents asked the IASB to clarify in the *Conceptual Framework* how the derecognition notion would be applied to repurchase agreements.

(b) Some respondents were opposed to applying the control approach to repurchase agreements. A few respondents explicitly stated that the risks-and-rewards approach should be applied to repurchase agreements.

Full or partial derecognition

Background

27. The Discussion Paper explained that there are two approaches when derecognition occurs and certain rights or obligations are retained:

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

28. The Discussion Paper explained that the two approaches may come into question in the following cases:

    (a) when the terms of existing rights or obligations are changed by an agreement between two parties to amend a contract or by a change in the law.

    (b) in a sale-and-leaseback transaction.

29. The Discussion Paper explained the IASB's preliminary view that the approach to be used if an entity retains components of an asset or a liability when derecognition occurs should be decided when developing or revising particular Standards depending on the unit of account.

Summary of feedback

30. Nearly one third of respondents commented on this issue. Within those respondents:

    (a) Some respondents supported the IASB's preliminary view without further comments.

    (b) A few respondents supported the full derecognition approach.

(c) A few respondents did not support the full derecognition approach because it implicitly leads to revaluation of assets by the back door.

(d) A few respondents stated that the *Conceptual Framework* should support partial derecognition so that it can be applied at the Standards level.

(e) Some respondents noted that the decision on whether to apply a full or partial derecognition approach depends on the unit of account and suggested that the *Conceptual Framework* should include broad principles on the factors to consider when determining the appropriate unit of account.

(f) A few respondents stated that whether to use full or partial derecognition should depend on whether the nature of the item has changed materially.

(g) Some respondents asked the IASB to clarify in the *Conceptual Framework* how to approach modifications of contracts (or riders) leading to substantial changes, additional rights and obligations or the reduction of existing rights and obligations.

(h) A few respondents suggested the IASB should address scenarios in which an entity sells an asset but immediately repurchases a similar asset (eg sale-and-leaseback transactions).

Other comments

31. A few respondents provided other comments:

(a) There is no clear distinction between derecognition, amortisation and impairment.

(b) A distinction between derecognition and nil carrying amount needs to be made.

(c) The IASB should clarify that a movement of an item from an asset to a liability, or vice versa, does not mean derecognition and subsequent recognition. Derecognition refers only to the fact that an item is no longer recognised at all.

(d) Many examples and guidance in Section 4 of the Discussion Paper relate to financial instruments. The IASB should include other examples, such as inventory, tangible assets and intangible assets.