

STAFF PAPER

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Purpose of paper

1. The purpose of this paper is to discuss whether any changes are needed to the discussion of derecognition and modification of contracts in response to the feedback received on Chapter 5–*Recognition and derecognition* of the Exposure Draft *Conceptual Framework for Financial Reporting* (‘the Exposure Draft’).

Summary of staff recommendations

2. The staff recommend:
 - (a) confirming the derecognition concepts proposed in paragraphs 5.25–5.32 of the Exposure Draft; and
 - (b) retaining the discussion of contract modifications in paragraphs 5.33–5.36 of the Exposure Draft. However, when considering whether new rights and obligations that are added by a contract modification should be accounted for as new assets or liabilities, the staff recommend replacing the notion that those rights and obligation should be ‘distinct’ with a reference to the concepts on the unit of account in the elements chapter.

Structure of the paper

3. This paper is structured as follows:
 - (a) derecognition
 - (i) background (paragraphs 5–14); and
 - (ii) staff analysis and recommendations (paragraphs 15–73).
 - (b) modification of contracts
 - (i) Exposure Draft proposals (paragraphs 74);
 - (ii) summary of feedback (paragraphs 75–76);
 - (iii) staff analysis (paragraphs 77–80); and
 - (iv) staff recommendation (paragraphs 81–82).
4. The appendix sets out other comments received on derecognition and provides staff responses to those comments.

Derecognition

Background

Summary of Exposure Draft proposals

5. Paragraph 5.25 of the Exposure Draft described derecognition as follows:

Derecognition is the removal of all or part of a previously recognised asset or liability from an entity's statement of financial position. For an asset, this normally occurs when the entity loses control of all or part of the previously recognised asset; for a liability this normally occurs when the entity no longer has a present obligation for all or part of the previously recognised liability.
6. Paragraphs 5.26 of the Exposure Draft stated that accounting requirements for derecognition aim to represent faithfully both:

- (a) the assets and liabilities retained after the transaction or other event that led to the derecognition (including any asset or liability acquired, incurred or created as part of the transaction or other event); and
 - (b) the change in the entity's assets and liabilities as a result of that transaction or other event.
7. The Exposure Draft proposed an approach to derecognition that was based on meeting the two aims. It then set out:
- (a) a derecognition requirement (see paragraph 22), which would normally achieve both aims; and
 - (b) guidance on what to do if that requirement does not achieve both aims (see paragraph 23).

Feedback summary

8. Approximately half of the respondents to the Exposure Draft commented on the discussion on derecognition. Of those, over two thirds stated that they generally agreed with the proposed concepts. Some of those respondents that generally agreed did so without any further comment.
9. Some respondents explicitly agreed with the two aims of derecognition described in paragraph 5.26 of the Exposure Draft. No respondents disagreed with the two aims.
10. More than half of those who commented further expressed concerns regarding the proposals but nevertheless agreed with the proposed concepts. One common concern was that some respondents thought that the Board had adopted a combination of a control approach and a risks-and-rewards approach and they expressed a preference for one or the other approach. However, some other respondents expressed the same concerns but disagreed with the proposals in the Exposure Draft. We discuss the respondents' concerns in more detail in paragraphs 31–35.
11. There was some confusion among respondents about the proposals in the Exposure Draft. Some of the respondents who commented on the proposals thought that the Exposure Draft proposed one of the following:

- (a) a control approach to derecognition whereby an asset is derecognised when (and only when) the entity loses control of the asset and a liability is derecognised when the entity no longer has an obligation;
 - (b) a risks-and-rewards approach to derecognition whereby an asset or liability is derecognised when (and only when) the entity is no longer exposed to the risks and rewards of the asset or liability; or
 - (c) a combination of a control approach and a risks-and-reward approach.
12. Some of these respondents also expressed concerns that the proposed guidance might not be sufficient for the Board in setting future IFRS Standards and indicated that the Board should either:
- (a) provide more guidance on when the control approach should be used and when the risks-and-rewards approach should be used; or
 - (b) choose one approach to be applied in all circumstances.
13. A few respondents explicitly agreed with the statement in the Exposure Draft that the *Conceptual Framework* should not discuss when to apply partial or full derecognition as these issues are closely linked to determining the unit of account and selecting a measurement basis for the retained component.
14. We discuss the respondents' comments in more detail in the staff analysis.

Staff analysis

15. The feedback received indicates that some respondents thought that the Exposure Draft proposed the control approach or some combination of a control approach and a risks-and-rewards approach. Therefore, before we consider potential improvements to the Exposure Draft proposals, the first section of the staff analysis clarifies what the Exposure Draft proposals were, and how they compared to those approaches (paragraphs 19–30).
16. Even though some respondents might have interpreted the proposals differently to how they were intended, those respondents still expressed a view on what concepts they think the *Conceptual Framework* should include on derecognition. The second

section of this staff analysis identifies some themes from responses that we think apply to the proposals in the Exposure Draft (paragraphs 31–35).

17. The last section of the staff analysis considers potential improvements to the Exposure Draft proposals based on the direct feedback on those proposals, and the themes we identified in paragraphs 31–35 (paragraphs 36–73).
18. In summary, this staff analysis includes:
 - (a) clarifying what the Exposure Draft proposed (paragraphs 19–30);
 - (b) common themes from respondents that discussed control and risks and rewards (paragraphs 31–35); and
 - (c) potential improvements to the Exposure Draft proposals (paragraphs 36–73).

Clarifying what the Exposure Draft proposed

19. Some respondents that expressed general support for the proposed concepts, and some of those that disagreed with the proposed concepts, supported their position by referring to the proposals as the control approach, the risks-and-rewards approach or some combination of the two.
20. The body of the Exposure Draft did not mention either of those approaches explicitly. However, the Basis for Conclusions did refer to both these approaches explicitly and explained why the Exposure Draft did not discuss a control approach or a risks-and-rewards approach:
 - (a) Paragraph BC5.57 states that:

In the IASB's view, the control approach focuses more on the aim mentioned in paragraph [6(a)] and the risks-and-rewards approach focuses more on the aim mentioned in paragraph [6(b)]. The difficulties that the IASB has encountered in practice have arisen when those two aims conflict. The IASB views both aims as valid.

Accordingly, the Exposure Draft does not advocate using the control approach [in all circumstances]¹ or the risk-and-rewards approach in all circumstances. Instead, the Exposure Draft describes the alternatives available and discusses what factors the IASB would need to consider when developing particular Standards.

21. The following section explains:
- (a) the proposals in the Exposure Draft in more detail (paragraphs 22–23); and
 - (b) how those proposals compare to the control approach, the risks-and-rewards approach or an approach that combines the two (paragraphs 24–30).

Exposure Draft proposals

22. Paragraph 5.26 of the Exposure Draft (re-produced in paragraph 6) explained the two aims that derecognition is trying to achieve. Paragraph 5.27 of the Exposure Draft stated that those aims are normally achieved by:
- (a) derecognising any assets or liabilities that have been transferred, consumed, collected or fulfilled, or have expired and recognising any resulting income or expense; and
 - (b) continuing to recognise the assets or liabilities retained, if any, which become a separate unit of account. Accordingly, no income or expense are recognised on the retained component as a result of the derecognition of the transferred component.

For convenience, in this paper, we refer to the proposals in paragraph 5.27 of the Exposure Draft as the ‘default’ derecognition requirement.

23. Paragraphs 5.31 and 5.32 discussed how the proposed derecognition concepts might apply when it is difficult to achieve both aims. In particular, those paragraphs stated that:
- (a) derecognition of the asset or liability transferred may achieve the aims mentioned in paragraph 6 if supported by separate presentation, or explanatory disclosure, in the notes to the financial statements.

¹ Wording inserted by the staff in this paper for clarification.

- (b) if derecognition supported by separate presentation or explanatory disclosure is not sufficient, then there may be a need to continue to recognise not only the retained component, but also the transferred component and present them separately or provide explanatory disclosure.

For convenience, in this paper, we refer to the continued recognition of the transferred component as ‘the last resort’.

How do the proposals compare to the control approach and the risks-and-rewards approach?

- 24. The ‘default’ derecognition requirement is based on whether or not items continue to meet the definition of an asset or a liability following a transaction or other event. Therefore, the outcome of such a derecognition requirement, as discussed in paragraphs 25–27:
 - (a) might be the same as a ‘control approach’ if that approach is based only on the definitions of the elements.
 - (b) might not be exactly the same as a ‘control approach’ if that approach is intended to be the mirror image of the approach recognition.
- 25. Sub-paragraphs 24(a) and 24(b) describe two versions of a control approach. The first is based only on the definition of an asset or a liability. The second also considers other factors (such as relevance and faithful representation). We discuss this in more detail in paragraph 49.
- 26. Because the term ‘control approach’ emphasises only one of the two aims of derecognition, that the assets and liabilities retained after the transaction or other event that led to the derecognition are faithfully represented, the Exposure Draft did not use that term as a label for the default derecognition requirement.
- 27. The default derecognition requirement is the same as a control approach that is based on the definitions of the elements. However, because the default derecognition requirement might not achieve both aims of derecognition in all circumstances, the Exposure Draft proposed that in some cases continued recognition might be appropriate, even if the default derecognition requirement would result in derecognition.

28. If there is a conflict between the two aims of derecognition, the Exposure Draft proposed that separate presentation and/or explanatory disclosure might help achieve the two aims. The Exposure Draft proposed that continued recognition of the transferred component should be considered only in cases when derecognition supported by presentation and disclosure is still not sufficient to meet the two aims (paragraph 23(b)). Indeed, continued recognition would typically only be considered in situations when derecognition fails to represent faithfully the change in an entity's assets and liabilities (for example in some of the cases where the entity has retained exposure to the risks and rewards of the assets or liabilities).
29. However, continued recognition of the transferred component is not necessarily the same as the risks-and-rewards approach. A risks-and-rewards approach would require continued recognition until the entity is no longer exposed to the risks and rewards of the asset or liability. However, the Exposure Draft did not discuss when derecognition of assets or liabilities that are the subject of continued recognition should ultimately occur. Therefore, the Exposure Draft did not propose an alternative to the default derecognition requirement that is the risks-and-rewards approach.
30. In summary:
- (a) the Exposure Draft proposed a default derecognition requirement that would normally meet both aims of derecognition.
 - (b) the default derecognition requirement is based on whether an item continues to meet the definition of an element. However, the Exposure Draft did not label this as the control approach, because that label would put emphasis only on one of the two aims of derecognition.
 - (c) the Exposure Draft accepted that there might be cases when continued recognition might best meet the two aims of derecognition. However, continued recognition applying the Exposure Draft proposals is not the same as a risks-and-rewards approach.
 - (d) it follows from the points above that the Exposure Draft was not a combination of the control approach and risks-and-rewards approach either.

Common themes from respondents that discussed control and risk and rewards

31. Even though some respondents understood the proposals as either the control approach, the risks-and-rewards approach or a mixture of the two, and framed their responses accordingly, they still expressed a view as to what concepts they think the derecognition section of the *Conceptual Framework* should include.
32. Some respondents expressed a preference for the revised *Conceptual Framework* to adopt either the control approach in all circumstances or the risks-and-rewards approach in all circumstances:
 - (a) The majority of those respondents supported adopting a control approach. However, it is unclear whether some of the respondents who supported a control approach were supporting:
 - (i) an approach that requires derecognition when the entity loses control of the asset (or no longer has an obligation for the liability); or
 - (ii) an approach that mirrors recognition and thus includes other factors that are relevant for derecognition.
 - (b) A few respondents, mainly financial institutions, stated that the Board should adopt only the risks-and-rewards approach to derecognition because, in their view, the control approach is inappropriate for derecognition of financial assets. They stated, for example, that the control approach would result in inappropriate outcomes for secured finance arrangements and repurchase agreements. Under IAS 39 *Financial Instruments: Recognition and Measurement*, and the forthcoming IFRS 9 *Financial Instruments*, assets related to some types of transactions are not derecognised unless substantially all risks and rewards have been transferred.
33. Some respondents agreed with the statement in paragraph BC5.54 in the Basis for Conclusions that neither the control approach nor the risks-and-rewards approach would necessarily produce the most useful information in all circumstances.
34. Some of the respondents were concerned that the proposals did not explicitly refer to the risks-and-rewards approach. They expressed a view that the Board should ensure

that the risks-and-rewards approach should be available under the revised *Conceptual Framework*. They stated that Standards use the risks-and-rewards approach (IFRS 9 and IAS 39) and that this approach would be more appropriate for deciding whether to derecognise financial assets and financial liabilities.

35. Some respondents stated that if the revised *Conceptual Framework* does not require a single approach in all circumstances, then it should provide more guidance on what approach would be more appropriate under which circumstances. These respondents argued that without additional guidance the derecognition concepts would be of limited use when developing Standards.

Potential improvements to the Exposure Draft proposals

36. The following section considers the following:
- (a) Are the two aims of derecognition still appropriate (paragraphs 37–44)?
 - (b) Is the default derecognition requirement appropriate (paragraphs 45–50)?
 - (c) Should a single approach be applied in all circumstances (paragraphs 51–62)?
 - (d) Should continued recognition be a last resort (paragraphs 63–66)?
 - (e) Is the risks-and-rewards approach compatible with the proposed approach (paragraphs 67–71)?
 - (f) Should the *Conceptual Framework* discuss full derecognition and partial derecognition (paragraphs 72–73)?

Are the two aims of derecognition still appropriate?

37. Paragraph 5.26 explains that accounting requirements for derecognition aim to represent faithfully both:
- (a) the assets and liabilities retained after the transaction or other event that led to the derecognition (including any asset or liability acquired, incurred or created as part of the transaction or other event); and
 - (b) the change in the entity's assets and liabilities as a result of that transaction or other event.

38. In the staff's view, identifying the two aims of derecognition is a step forward, because it highlights the two most significant factors that drive the debates about derecognition. The circumstances that have proven difficult for the Board to address are those where it is difficult to meet both aims at once.
39. A Standard-setter from Japan agreed with the two aims but suggested that one of the two aims should be prioritised, otherwise standard-setting decisions could become ad-hoc depending on the circumstances under which specific Standards are being developed. In their view, for users to assess the prospects of future net cash inflows to an entity, information about the entity's financial performance is more important than information about the entity's financial position. Thus, if there is any conflict between the two aims, they suggested that the Board clarify that information about the change in the entity's assets and liabilities should be prioritised.
40. In the staff's view, both aims are valid and it is not possible to say that one is always more important than the other. Prioritising only one of the two aims would be inconsistent with the Board's tentative decisions in other areas of the *Conceptual Framework* which require the consideration of the effects of decisions on both the statement of financial position and statement of financial performance of the entity, but do not prioritise one over the other.
41. A Standard-setter from Indonesia agreed broadly with the two aims of the derecognition requirement, but suggested a refinement: the two aims of derecognition should also explicitly refer to relevance, in addition to faithful representation. Relevance is included as a criterion for recognition and also a fundamental qualitative characteristic of useful financial information.
42. In developing the proposals in the Exposure Draft, the Board did not explicitly consider whether the aims of derecognition should also refer to relevance, instead of only referring to a faithful representation. However, it can be argued, that the two aims of derecognition already identify the information that is relevant and therefore, an explicit reference to relevance might not be necessary. Also, that reference might create a need for the Board to establish which of the two aims provides more relevant information when making decisions on derecognition.

43. On the other hand, including a reference to relevance would ensure consistency throughout the *Conceptual Framework* and could be incorporated easily in the current proposals². It would also confirm explicitly that information arising from derecognition must be relevant.
44. However, the staff do not think that an explicit reference to relevance would necessarily change the way the Board would consider the two aims. Likewise, omitting a reference to relevance would not preclude the Board from considering what information is relevant. On balance, the staff recommend that the Board does not add a reference to relevance in the two aims of derecognition.

Questions 1–2 for the Board

- a) Do you agree that the two aims of derecognition are still appropriate?
- b) Do you agree not to add a reference to ‘relevance’ to the aims of derecognition?

Is the default derecognition requirement appropriate?

45. Paragraph 5.27 of the Exposure Draft stated that the two aims of derecognition are both normally achieved by the ‘default’ derecognition requirement:
- (a) derecognising any assets or liabilities that have been transferred, consumed, collected or fulfilled, or have expired and recognising any resulting income or expense; and
 - (b) continuing to recognise the assets or liabilities retained, if any, which become a separate unit of account. Accordingly, no income or expense are recognised on the retained component as a result of the derecognition of the transferred component.
46. Paragraphs 5.28–5.29 of the Exposure Draft included further guidance that stated that:
- (a) If an entity transfers a previously recognised asset or liability to another party that is acting as its agent, then the asset is still controlled by the transferor (the liability is still an obligation of the transferor) and

² For example, paragraph 5.26 of the Exposure Draft could be amended to read ‘Accounting requirements for derecognition aim to provide relevant information that faithfully represents both: ...’.

derecognition would not faithfully represent the transferor's assets, liabilities, income and expenses.

- (b) If an entity retains exposure to positive or negative variations in the amount of economic benefits produced by an economic resource, this may indicate that the entity retains control of that economic resource, in which case, derecognition is not appropriate.
47. Many respondents expressed general support for the proposed concepts. Some respondents expressed explicit support for the further guidance in paragraphs 5.28 and 5.29 in the Exposure Draft. However, as we noted in paragraph 32(a)(ii), some respondents suggested that derecognition should simply mirror recognition. They further stated that if the default derecognition requirement were to mirror recognition, and that requirement applied in all circumstances, a section on derecognition may not be necessary.
48. The default derecognition requirement proposed in paragraph 5.27 of the Exposure Draft focuses on whether the transaction or other event results in an item no longer meeting the definition of an asset or liability.
49. While meeting the definition of an asset and liability is necessary for recognition, not every item that meets the definitions will be recognised based on the concepts for recognition. This is because the concepts on recognition consider factors other than meeting the definition of an element to decide whether an asset or a liability should be recognised. It would follow that, applying the recognition concepts in reverse, those other factors might result in derecognition even if the item continues to meet the definition of an asset or liability. Paragraph 5.27 does not consider those factors.
50. Respondents that supported an approach to derecognition that mirrored recognition did so as a matter of principle. They did not provide arguments to refute the basis for the Exposure Draft proposals, and did not provide any new arguments as to why such an approach would be better than the default derecognition requirement. Therefore, the staff do not recommend any changes to the default derecognition requirement.

Questions 3–4 for the Board

Do you agree to confirm:

- a) the 'default' derecognition requirement in paragraph 5.27 of the Exposure Draft; and
- b) the further guidance in paragraphs 5.28 and 5.29 of the Exposure Draft?

Should a single approach be applied in all circumstances?

51. A few respondents explicitly welcomed the Board's proposal not to adopt a single approach to derecognition in all circumstances and agreed that it would depend on facts and circumstances how to best achieve the two aims of derecognition. However, many respondents to the Exposure Draft supported a single approach to derecognition that would apply in all circumstances although the Board had explained why, from its point of view, that was not appropriate.
52. As noted in paragraphs 31–35, some of these respondents supported only the control approach, and a few supported only the risks-and-rewards approach. However, for this section, we consider whether those respondents disagreed with the Board's rationale for not advocating *a single* approach in all circumstances.
53. The Exposure Draft acknowledged that achieving the two aims is straightforward if an entity disposes of an entire asset or an entire liability and retains no exposure to that asset or liability, but can be more difficult if an entity disposes of only part of an asset or a liability or retains some exposure. Furthermore, in the staff's view, for many transactions the outcome would be the same regardless of whether the entity applies the Exposure Draft proposals, a control approach or a risks-and-rewards approach.
54. However, the Exposure Draft stated that in some circumstances it might be difficult to achieve the two aims of derecognition by applying the default derecognition requirement. The Exposure Draft also acknowledged that in some circumstances there may be a need to continue recognising the transferred component of an asset or a liability. In other words, different approaches would lead to different derecognition outcomes when the two aims conflict.

55. The Exposure Draft identified examples of circumstances when the two aims conflict and, as a result, some thought is required to decide whether to derecognise, or continue recognising, the transferred component. The Basis for Conclusions on the Exposure Draft elaborated on these examples.
56. In both examples discussed in the Basis for Conclusions (a sale of receivables with recourse and a sale and repurchase agreement), derecognising the asset would result in accounting that faithfully represents any asset or liability retained. However, derecognition may sometimes misrepresent the extent of the changes in the entity's financial position:
- (a) sale of receivables with recourse—suppose that an entity sells some receivables to another party, but guarantees the third party against any credit losses it may incur on the receivables. If the entity derecognises the receivables and recognises its obligation under the guarantee as a liability, that may significantly reduce the total assets and total liabilities recognised in the statement of financial position, even though the credit risk is unchanged.
- Such a change in the presentation of the entity's financial position, or a change in how an asset or liability is depicted, may appear to portray a significant change in the entity's risk exposure and/or leverage when no significant change has occurred. In addition, if the receivables are measured at historical cost (such as amortised cost), derecognising the receivables in full and recognising the guarantee as a new liability could result in the recognition of a gain or loss on the receivables, even though the entity is still exposed to risks similar to those arising from the original contracts.
- (b) sale and repurchase agreement—suppose that an entity sells an asset and at the same time contracts to buy it back at a fixed price. Derecognising the asset could suggest that the entity's asset mix has changed significantly, even though the transaction is only temporary and will be reversed. In addition, if the asset is measured on a historical cost basis, derecognising the asset would lead to the recognition of income and expenses at the time

of the sale, and then a corresponding increase or decrease in the carrying amount of the asset when the repurchase is completed.

57. Even though many respondents supported a single approach—including either a control approach or a risks-and-rewards approach—that is applied in all circumstances, they did not demonstrate how adopting a single approach would alleviate the concerns identified by the Board in those two examples. Only a few respondents disagreed with the analysis in the examples, which we discuss in paragraphs 58–62.
58. For example, one respondent expressed a view that derecognition should not depend on whether an asset or liability was previously recognised, or whether the measurement of assets and liabilities previously recognised reflects changes in risk. Recognising the effects of changes in risk in a later period than the period in which those changes in risk occurred is not a valid reason against derecognising the financial asset.
59. In the staff’s view, derecognition decisions will necessarily depend on whether an asset or liability was previously recognised, as well as the associated measurement and unit of account of the item. This is because the information provided by derecognising an item will depend on how the item was recognised and measured in the past. For example:
- (a) the objective of some measurement bases is to treat different transactions and events differently. A historical cost measurement basis might reflect changes due to consumption as it happens, but it might not reflect changes in risk until there is a sale.
 - (b) depending on the unit of account and measurement basis, a gain or loss may be recognised on the retained component as well as the transferred component..
60. A few respondents disagreed that that the sale and repurchase arrangement described in paragraph BC5.52(b) in the Basis for Conclusions should result in the derecognition of the transferred asset under the default derecognition requirement. This was because, in their view, derecognition would not represent faithfully that

control of the asset has passed to the buyer only for a period of time or as the provision of security for a borrowing.

61. In the staff's view, the comment in paragraph 60 reflects challenges in how to faithfully represent the substance of the transaction. In previous debates about derecognition, there were often disagreements about what the underlying substance of the transaction was. This was particularly the case with financial instruments, where rights and obligations are often fungible and are often readily divisible into freely transferable components. In the staff's view, these different views are captured by the two aims of derecognition; one aim focuses on the faithful representation of the retained components, while the other aim focuses on the faithful representation of the changes in the rights and obligations.
62. In the staff's view, the most appropriate approach to derecognition will depend on how to best achieve the two aims when they conflict. It would also depend on the measurement basis and the unit of account for the previously recognised item when making decisions at a Standards-level. Therefore, although the Exposure Draft suggested one default derecognition requirement, in the staff's view, the Board should confirm that that approach might not be used *in all* circumstances.

Question 5 for the Board

Do you agree that the 'default' derecognition requirement might not be used in all circumstances?

Should continued recognition be a last resort?

63. A few respondents were concerned that the default recognition requirement would result in inappropriate outcomes for financial instruments. In particular, they referred to secured finance arrangements and repurchase agreements. Currently, assets related to these types of transactions are not derecognised unless significantly all risk and rewards have been transferred (ie the risks-and-rewards approach). In their view, there should not be an implicit preference for the default derecognition requirement. They would prefer continued recognition to be given equal weight.
64. However, a few respondents expressed a view that continued recognition should only be used in limited circumstances. In their view, continued recognition in most

circumstances has shortcomings that simply cannot be addressed appropriately using separate presentation and additional disclosures.

65. In the staff's view, continuing to recognise assets and liabilities when they have been transferred, consumed, collected or fulfilled or have expired would result in an entity including in its financial statements items that do not meet the definition of the elements. This would be particularly confusing for periods after the event that led to continued recognition took place.
66. Thus the staff continue to think that the Exposure Draft proposal—that continued recognition will be appropriate only when the default recognition requirement is not sufficient to meet the two aims of derecognition, even when supported by additional presentation and disclosure—remains valid.

Question 6 for the Board

Do you agree that, in cases when it is difficult to achieve both aims of the derecognition, continued recognition should be a last resort?

Is the risks-and-rewards approach compatible with the proposed approach?

67. Some respondents expressed concerns that the requirements for derecognition in IAS 39 and IFRS 9 might not be compatible with the proposals in the Exposure Draft. They stated, for example, that the control approach would result in inappropriate outcomes for secured finance arrangements and repurchase agreements. Under both IAS 39 and IFRS 9, assets related to some types of transactions are not derecognised unless substantially all risks and rewards have been transferred.
68. As noted in paragraph 22, the Exposure Draft proposed that continued recognition may be appropriate when the two aims conflict and cannot be achieved by separate presentation or explanatory disclosure. However, as discussed in paragraph 29, continued recognition of the transferred component is not necessarily the same as the risks-and-rewards approach because the Exposure Draft did not propose an additional set of criteria that would determine when derecognition of a transferred component should occur. This means that the Board would have to decide in these cases, on a Standards-level, what event should lead to derecognition.

69. In the staff’s view, this does not preclude the risks-and-rewards approach as a valid application of the Exposure Draft proposals. This is because the Board can under the proposals reach the conclusion that, for particular transactions, items should be continued to be recognised until the risks and rewards have been transferred.

Is further guidance needed on when to use which approach?

70. Some respondents requested more guidance on when derecognition or continued recognition would be most appropriate. However, as noted in paragraph 68 the most appropriate approach to derecognition will depend on the best way to achieve the two aims of derecognition, and it will also depend on the unit of account, and the measurement bases, of the items before and after the derecognition event.

71. Hence the particular approach to derecognition will be a Standards-level decision because of different units of account and measurement bases resulting from Standards-level requirements. As a result, whether, when, and how an entity derecognises an asset or a liability is closely linked to the accounting requirements applied to that previously recognised asset or liability. In the staff’s view, the proposals contain sufficient guidance for the Board to make those decisions at the Standards-level.

Should the Conceptual Framework discuss full derecognition and partial derecognition?

72. As explained in paragraph BC5.58 in the Basis for Conclusions, the Exposure Draft does not discuss partial or full derecognition as these issues are closely linked to determining the unit of account and selecting a measurement basis for the retained component.

73. Nevertheless, a few respondents asked the Board to include guidance on full and partial derecognition. However, these respondents did not present any new arguments or suggest what that guidance should include. Hence, we recommend confirming that the revised *Conceptual Framework* should not discuss full and partial derecognition.

Question 7 for the Board

Do you agree that no changes are required to the proposals in the Exposure Draft discussed in paragraphs 67–73?

Modification of contracts

Exposure Draft proposals (paragraphs 5.33–5.36, BC5.59)

74. Paragraphs 5.33–5.36 of the Exposure Draft discussed the modification of contracts as one particular case in which questions about derecognition arise. The Exposure Draft stated that a contract modification might reduce or eliminate existing rights and obligations and/or might add new rights or new obligations. Further, the Exposure Draft stated that whether the rights and obligations that are added by a modification of a contract are treated as part of the same unit of account as the existing rights and obligations will depend on whether they are distinct from those created by the original terms of the contract.

Summary of feedback

75. Some respondents supported including the proposed guidance on modification of contracts. However, one accounting firm suggested this guidance could be shortened.
76. Some respondents raised the following concerns regarding the ‘distinct’ concept in the context of modification of contracts:
- (a) the term ‘distinct’ is not defined;
 - (b) the term seems to be used in a broader sense, or with a different meaning, from existing IFRS Standards or in the 2013 revised Exposure Draft on *Insurance Contracts*; and
 - (c) the notion of ‘distinct’ may be helpful for contracts relating to non-financial items but not for financial items. These respondents did not specify a reason.

Staff analysis

77. In the staff’s view, the discussion on the modification of a contract provides an additional example of when questions about derecognition may arise. We also note that the proposals were generally supported by respondents.

78. However, we agree with those respondents who argued that the introduction of the term ‘distinct’ without describing it in more detail is not useful and might be confusing. This is because it is used in various ways in existing IFRS Standards. For example, IFRS 15 *Revenue from Contracts with Customers* uses this term to describe distinct goods and services when identifying separate performance obligations.
79. Furthermore, we also agree with respondents that the notion may not be helpful for financial instruments. For example, the rights and obligations in financial instruments relate to cash flows and those individual cash flows are indistinguishable and the contracts can be arranged in various ways. On the one hand, these characteristics could result in a conclusion that the rights and obligations to transfer cash between two counterparties should always be part of the same unit of account. On the other hand these characteristics could result in a conclusion that the rights and obligations to transfer cash should always be treated as separate units of account. Therefore, it would be unclear how the notion of ‘distinct’ in the Exposure Draft would apply to financial instruments without further developing that notion.
80. In the Exposure Draft proposals, the notion of ‘distinct’ is used to determine whether any new rights and obligations added by a modification should be treated as part of the same unit of account as the existing rights and obligations. In the staff’s view, the concepts developed in the unit of account chapter may be more useful for identifying rights and obligations that should be accounted for separately than retaining the notion of ‘distinct’. In particular:
- (a) Paragraph 4.58 of the Exposure Draft states that a unit of account is selected for an asset or a liability [when³] considering how recognition and measurement will apply, not only to that asset or liability, but also to the related income and expenses.
 - (b) Paragraph 4.62 of the Exposure Draft states that the objective of selecting a unit of account is to provide the most useful information that can be obtained at a cost that does not exceed the benefits. To meet this objective the information provided about the resulting asset, liability, income and expenses must be relevant. Treating a group of rights and obligations as a

³ As per IASB *Update*, October 2016.

single unit of account may provide more relevant information if, for example, those rights and obligations:

- (i) cannot (or are unlikely to) be the subject of separate transactions.
- (ii) cannot (or are unlikely to) expire in different patterns.
- (iii) are used together in the context of the business activities conducted by the entity to produce cash flows and are measured by reference to the estimates of their interdependent future cash flows.
- (iv) have similar economic characteristics and risks. Rights and obligations with different characteristics and risks are likely to have different implications for the prospects for future net cash inflows to an entity and so may need to be separated.

Staff recommendation

81. For the reasons set out in paragraphs 77–80 we recommend retaining the main discussion that:
- (a) modifications of contracts can:
 - (i) reduce or eliminate existing rights and obligations; and/or
 - (ii) add new rights and new obligations.
 - (b) to provide the most relevant information about modifications in the way that most faithfully represents their effect, it is necessary to consider their combined effect and not merely consider them separately. Hence, it may, or may not, be appropriate to treat any new rights and obligations as units of account separate from the retained rights and obligations.
82. However, when considering whether new rights and obligations that are added by a contract modification should be accounted for as new assets or liabilities, the staff recommend replacing the notion that those rights and obligation should be ‘distinct’ with a reference to the concepts on the unit of account in the elements chapter.

Question 8 for the Board

Does the Board agree with the staff recommendation in paragraph 81–82?

Appendix – Other comments on derecognition

A1. This appendix sets out other comments received on the derecognition proposals in the Exposure Draft and our responses to those comments.

	Respondent comment or suggestion	Staff response
A1	The discussion regarding full or partial derecognition was confusing because it referred to a component of an asset, whereas an asset is described elsewhere in the Exposure Draft as a bundle of rights.	The staff will consider this in drafting.
A2	Clarify the effects of the proposed derecognition guidance on the derecognition of financial assets, step-down transactions (ie when an entity reduces its holding in a subsidiary so that it has only significant influence or a simple equity interest) and the control model under IFRIC 12 <i>Service Concession Agreements</i> .	The staff think that guidance on these very specific cases would not be appropriate for the <i>Conceptual Framework</i> and would be better placed at Standards-level.
A3	Introducing a specific reference to the concept of ‘substance over form’ could help both in choosing between the control approach and the risks-and-rewards approach in situations when the two aims of derecognition—a faithful representation of the assets and liabilities retained and of the changes in them—conflict and in making decision about contract modifications. It would also would provide guidance in the <i>Conceptual Framework</i> on how to account for the substance of a bundle of related transactions, so that a decision on	The Exposure Draft proposed some guidance on substance over form in Chapter 2 <i>Qualitative Characteristics of useful financial information</i> . This guidance is consistent with the sections in the Exposure Draft on the unit of account and on reporting the substance of contractual rights and obligations.

Respondent comment or suggestion	Staff response
derecognition is not left to Standards-level.	
<p>A4 One respondent stated that, for the sale and repurchase agreement example, failing to derecognise the original asset ignores the fact that, absent other constraints, the entity does not control the transferred item and there is a risk of default by the transferee.</p>	<p>The staff agree, however, the change in risk could also be depicted by changing the presentation if an entity continues to recognise the asset. For derecognition, the example illustrates that the question is whether that change in risk is more faithfully represented as a lease or financing arrangement.</p>