Australian Government
Australian Accounting Standards Board

# Staff Paper

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| **Project:** | **Not-for-Profit Private Sector Financial Reporting Framework** | **Meeting:** | M188 |
| **Topic:** | **Tier 3 – Financial Instruments: Derecognition** | **Agenda Item:** | 12.2.4 |
| | | **Date:** | 14 June 2022 |
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| | | **Decision-Making:** | High |
| | | **Project Status:** | Initial deliberations |

## Objective of this paper

1 The objective of this agenda paper is for the Board to **decide** its preliminary views on Tier 3 reporting requirements for a not-for-profit (NFP) private sector entity's derecognition of its financial instruments for inclusion as part of a discussion paper (DP)[1].

2 In analysing the topic and making the staff recommendations, staff had regard to the current requirements in Australian Accounting Standards, approaches taken by selected other jurisdictions,[2] feedback from Australian stakeholders, findings from academic research and other literature, and the findings from staff review of a sample of financial statements. Staff have noted relevant aspects of its environment findings as part of its analysis of each topic considered.[3]

## Summary of staff recommendations

3 Staff recommend that the Tier 3 reporting requirements for financial instruments should:

(a) for financial assets – adopt the derecognition criteria specified by the *IFRS for SMEs*; and

(b) for financial liabilities – not specify requirements for exchanges of debt instruments or modifying the terms of an existing financial liability.

## Derecognition of financial assets and financial liabilities (Proposed simplification 9)

4 AASB 9 requires a financial asset or liability to be recognised when the entity becomes a party to the contractual provisions of the financial instrument. Staff think this requirement is straightforward to understand and apply. As staff have not become aware of any recognition

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1 For succinctness, in general, references to 'AASB 9' in this paper are to the suite of Tier 1 financial instrument-related standards, rather than to AASB *9 Financial Instruments* in particular.

2 The selected other jurisdictions/pronouncements considered were the *IFRS for SMEs*, United Kingdom FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*, United Kingdom FRS 105 *The Financial Reporting Standard applicable to the Micro-entities Regime*, Hong Kong *Small and Medium-sized Entity Financial Reporting Framework and Financial Reporting Standard* (HK SME-FRF & FRS), New Zealand *Public Benefit Entity Simple Format Reporting – Accrual (Not-For-Profit)* (NZ Tier 3 reporting requirements) and CPA Canada Handbook Section 3856 *Financial Instruments*. Staff did not consider the applicable USA requirements given their expected complexity.

3 For further reference, Agenda Paper 5.2.1 of the AASB May 2022 meeting included summaries of the staff research in this regard. A copy of this agenda paper is included as supplementary material to this agenda item – refer Agenda Paper 12.2.1.1.

application challenges, staff have not presently proposed any simplification of the recognition requirements for a Tier 3 pronouncement.[4]

5 However, as noted in Table 1 of Agenda Paper 12.2.1, staff think the AASB 9 derecognition provisions can be complex to apply. This is because there may be a modification or part extinguishment of the instrument to account for, rather than derecognition of an instrument in its entirety. Consequently, staff have identified the derecognition of financial assets and liabilities as aspects that could be subject to simplifying measurement criteria and interpretation in a Tier 3 pronouncement.

## Derecognition of financial assets

***Current requirements and staff research/outreach findings***

6 AASB 9 require a financial asset (or part thereof) to be derecognised when:

(a) the contractual rights to the cash flows from the financial asset expire, or

(b) the entity transfers – whether legally or in-substance – its contractual rights to cash flows from the financial asset, and the transfer meets specified conditions.

7 The Standard explains what constitutes a transfer of a financial asset and specifies the conditions to qualify for derecognition when an asset has been transferred. These conditions require management judgement to be applied in assessing:

(a) whether the entity has assumed an obligation to pay forward cash flows received;

(b) the extent to which the risks and rewards of ownership of the financial asset have been transferred;

(c) whether control of the asset has passed to another entity; and

(d) the extent to which the entity retains a 'continuing involvement'[5] in the transferred financial asset.

8 Staff note:

(a) the preliminary outreach has not suggested that the derecognition of financial assets is an issue of concern specifically to smaller NFP private sector entities. Staff expect that this is because smaller NFP private sector entities could be expected to not commonly transfer, rather than settle, a financial asset;[6] and

(b) the staff review of the requirements of selected other jurisdictions indicates that simpler derecognition criteria apply to smaller entities. For example, the *IFRS for SMEs* specifies a principle for derecognition that does not rely on 'pass-through' and 'continuing involvement' provisions. This acknowledged IASB stakeholder feedback that the IAS 39 'pass-through' and 'continuing involvement' tests for the derecognition of financial

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4 Staff note that the IFRS Interpretations Committee (IFRS IC) in September 2021 published the tentative agenda decision *Cash Received via Electronic Transfer as Settlement for a Financial Asset* for comment. Some of the feedback received on the tentative agenda decision suggests that it is possible that that trade date/settlement date accounting might be revisited by the IASB, whether as part of its work following its post-implementation review of IFRS 9 classification and measurement or another project. The IFRS IC is discussing how to finalise its tentative agenda decision at its June 2022 meeting. Outcomes of that discussion, and future decisions of the IASB, may inform whether simplification action is necessary with regards to the recognition of financial instruments in a Tier 3 pronouncement.

5 The extent of an entity's continuing involvement in the transferred asset is the extent to which the entity remains exposed to changes in the value of the transferred asset (AASB 9.3.2.16).

6 However, staff note that the Board received feedback as part of ED 318 *Illustrative Examples for Income of Not-for-Profit Entities and Right-of-Use Assets* recommending clarification of the 'pass through' derecognition conditions and the principal/agent assessment for NFP transactions including donations.

assets are especially burdensome for SMEs. The IASB considered these criteria complex and related to derecognition transactions in which SMEs are typically not engaged.[7]

***Proposed simplification and staff analysis***

9 Table 1 in Agenda Paper 12.2.1 noted that staff consider simplification of the derecognition criteria for a financial asset to be necessary having regard to the complexity and judgement involved in applying the 'transfers of a financial asset' criteria of AASB 9. As a simplification of recognition criteria and interpretation, and in recognition of the expected infrequency of transfers of financial assets by smaller NFP private sector entities and the abilities of smaller NFP private sector entity preparers, staff think that the Tier 3 reporting requirements could simplify the AASB 9 derecognition criteria for transfers of a financial asset either by:

(a) **Option A:** Requiring that an entity derecognises a financial asset only when either the contractual rights to the cash flows from the financial asset expire or are settled, or the entity otherwise loses control of the asset.

(b) **Option B:** Requiring that an entity derecognises a financial asset (in part or in full) only when either:

(a) the contractual rights to the cash flows from the financial asset expire or are settled; or

(b) the conditions for derecognition specified by AASB 9 are satisfied.

(c) **Option C:** Adopting the derecognition criteria specified by the *IFRS for SMEs*. That is:

"An entity shall derecognise a financial asset only when either:

(a) the contractual rights to the cash flows from the financial asset expire or are settled;

(b) the entity transfers to another party substantially all of the risks and rewards of ownership of the financial asset; or

(c) the entity, despite having retained some significant risks and rewards of ownership, has transferred control of the asset to another party and the other party has the practical ability to sell the asset in its entirety to an unrelated third party and is able to exercise that ability unilaterally and without needing to impose additional restrictions on the transfer – in this case, the entity shall:

(i) derecognise the asset; and

(ii) recognise separately any rights and obligations retained or created in the transfer.

The carrying amount of the transferred asset shall be allocated between the rights or obligations retained and those transferred on the basis of their relative fair values at the transfer date. Newly created rights and obligations shall be measured at their fair values at that date. Any difference between the consideration received and the amounts recognised and derecognised in accordance with this paragraph shall be recognised in profit or loss in the period of the transfer."[8]

10 The three proposed options each take a different approach to addressing the complexity of the AASB 9 criteria. Staff consider the proposed options are all consistent with the Tier 3 principles

7 *IFRS for SMEs*.BC99 and BC101(b)

8 *IFRS for SMEs*.11.33

agreed by the Board at its August 2021 meeting.[9] However, each option reflects a different threshold of acceptable cost-benefit trade-off:

(a) Option A focuses primarily on the derecognition events that are expected to be common to smaller NFP private sector entities. This option gives the most weight to recognising that Tier 3 requirements cannot be expected to address all possible scenarios to the same extent as Tier 1 Australian Accounting Standards. Staff think the Option A proposed derecognition principle broadly aligns with how NZ Tier 3 reporting requirements approach this topic.[10]

(b) Option B also focuses primarily on the derecognition events that are expected to be common to smaller NFP private sector entities but provides for transfers of financial assets to be accounted for consistently with AASB 9. This option acknowledges that Tier 3 requirements cannot be expected to address scenarios to the same extent as Tier 1 Australian Accounting Standards, but gives weight to the view that a smaller entity engaging in a complex financial transaction should be required to apply complex accounting to that transaction.

(c) Option C acknowledges both derecognition events that are expected to be common to smaller NFP private sector entities, and less common transfers of financial assets. This option provides an alternative to Option B by explicitly addressing derecognition in instances of asset transfers within a self-contained stand-alone Tier 3 pronouncement. The derecognition criteria "appears" more aligned with AASB 9 than that of Option A. However, it may be necessary to develop guidance to explain when "substantially all of the risks and rewards of ownership of the financial asset" have been transferred.

11 Option A and Option C are simpler to understand and apply compared to Option B as under these options:

(a) the derecognition of the original financial asset is treated as a separate transaction to the recognition of any 'new' assets and liabilities in the related transaction; and

(b) a transferred financial asset is considered for derecognition in its entirety, rather than possibly only in part. However, some securitisation and factoring transactions may qualify for partial derecognition under Option B before the financial asset is derecognised under Option A or Option C.

***Staff recommendation***

12 On consideration of the Board's agreed approach to simplification as set out in the flowchart included in Appendix A to Agenda Paper 12.1, on balance, staff recommend **Option C**. Staff think that of the three options, Option C:

(a) best maintains consistency with Tier 2 Australian Accounting Standards while recognising the Board's intent to develop a Tier 3 pronouncement as a proportionate response for smaller entities; and

(b) imposes the least costs to preparers as it clearly sets out the conditions to qualify for derecognition when the contractual rights to the cash flows from the financial asset are transferred rather than expire or are settled.[11]

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9 The Tier 3 principles are set out in the flowchart included in Appendix A to Agenda Paper 12.1.

10 Staff note that the NZ Tier 3 reporting requirements describe the derecognition event (e.g. the "amount is collected or written off", "when sold, otherwise disposed of, or written off") rather than using the word "control".

11 The Board decided not to propose a 'risk and rewards' model for revenue recognition or for leases. Staff think that Option C is consistent with those Board decisions. This is because 'risk and rewards' is part of the AASB 9 derecognition model, while for revenue recognition and for leases it would represent a return to superseded requirements.

13 In addition, compared to Option A, Option C clearly requires the entity to consider whether new rights and obligations need to be recognised at the time of the derecognition of the original asset. As such, it might be regarded as better than Option A in facilitating consistency in reporting and avoiding any significant misrepresentation of the net financial position of the entity. However, Option C appears more visually complex than Option A. Option A also appears more apparently consistent with the derecognition requirements applying to non-financial assets.[12]

14 Staff do not recommend Option B (AASB 9) because, consistent with the staff recommendations in Agenda Paper 12.2.1, staff support developing Tier 3 as a self-contained pronouncement to the extent possible. However, staff note that Option B may be a preferred approach where it is consistent with the Board's decisions in Agenda Paper 12.2.1 regarding how to account for various financial instruments.

**Question for Board members:**

Q1 Do Board members agree, for the purposes of the Discussion Paper, that Tier 3 accounting requirements should, for financial assets, adopt the derecognition requirements of the *IFRS for SMEs* (Option C)?

If not, do Board members prefer developing derecognition requirements for financial assets that are consistent with Option A, or Option B?

## Derecognition of financial liabilities

***Current requirements and staff research/outreach findings***

15 Under AASB 9, a financial liability (or part thereof) is derecognised when the obligation is discharged, cancelled or expires. In addition, paragraph 3.3.2 of AASB 9 specifies that:

> '"An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability."[13,14]

16 Exchanges and modifications that are not 'substantial' impact the carrying amount of the original financial liability.

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12 AASB 116 *Property, Plant and Equipment* specifies that the carrying amount of property, plant and equipment is derecognised (a) on disposal; or (b) when no future economic benefits are expected from its use or disposal (AASB 116.67).

13 The terms of a financial liability are substantially different if the discounted present value of the cash flows under the new terms, including any fees paid net of any fees received and discounted using the original effective interest rate, is at least 10 per cent different from the discounted present value of the remaining cash flows of the original financial liability (AASB9.B3.3.6).

14 AASB 9 does not include similar specification in respect of financial assets. The IFRS Interpretations Committee discussed whether to undertake a narrow-scope project to clarify the requirements in IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Recognition and Measurement* about when a modification or exchange of financial assets results in derecognition of the original asset. However, the Interpretations Committee decided not to consider such a project as it determined it could not resolve it in an efficient manner because of the broad nature of the issue. (Refer IFRS IC Agenda Decision *IFRS 9 Financial Instruments and IAS 39 Financial Instruments: Recognition and Measurement—Derecognition of modified financial assets* (May 2016))

17 Staff note that:

(a) a few entities in the sample of financial statements reviewed held bank loan liabilities, or credit card debt. There was generally little disclosure about the terms of these financial liabilities;

(b) the preliminary outreach conducted has not indicated that the derecognition of financial liabilities is an issue of concern; and

(c) the staff review of the requirements of selected other jurisdictions indicates that some jurisdictions (*IFRS for SMEs*, UK FRS 102) similarly specify that only exchanges involving substantially different terms or the substantial modification of terms of a financial liability should be treated as extinguishing the original financial liability; however, unlike AASB 9 "substantial" is not defined. Other jurisdictions (HK, NZ, UK FRS 105) either do not specifically address the derecognition of financial liabilities, or do not specify requirements in instances of an exchange or modification. Staff note that the different approach to exchanges and modifications is consistent with whether the jurisdiction requires amortised cost measurement using the effective interest method or not.

***Proposed simplification, staff analysis and recommendation***

18 Table 1 in Agenda Paper 12.2.1 noted that staff consider simplifying the derecognition criteria for a financial liability to be necessary noting the judgement required in interpreting the 'substantial' criteria for derecognition of a financial liability in AASB 9. In addition, staff evaluated the need for the AASB 9 criteria having regard to the following Board decisions/ staff recommendations:

(a) the Board decision from the May 2022 meeting to measure financial liabilities (other than derivatives) at cost; and

(b) the staff recommendation not to require the effective interest method for measuring interest expense (refer Agenda Paper 12.2.2 – proposed simplification 5).

19 Staff **recommend** that, as a simplification of recognition criteria and interpretation, the Board simplify the complexity of the reporting requirements for the derecognition of financial liabilities by not specifying requirements for exchanges of debt instruments or the modification of the terms of an existing financial liability. Staff think that the accounting resulting from these previous decisions/staff recommendations suggests that addressing instances of debt instrument exchanges or term modifications is unnecessary. This is because staff think the accounting impact at the date of the modification or exchange would not change unless part of the principal amount owed is no longer repayable. Under the staff proposal, there will generally be no gain or loss arising at the time of the exchange of financial liabilities or modification of the financial liability. The gain or loss is, in effect, 'deferred' and recognised over the remaining life of the instrument.

20 If the Board preferred requiring interest expense to be measured using the effective interest method, staff continue to recommend simplifying the complexity of the reporting requirements for the derecognition of financial liabilities by not specifying requirements for exchanges of debt instruments or the modification of the terms of an existing financial liability. This is because staff think the simplification would be consistent with the Tier 3 principles agreed by the Board at its August 2021 meeting and:

(a) provides consistency with the staff recommendation that transfers of a financial asset should be considered for derecognition in its entirety (refer paragraphs 11 – 12);

(b) is likely to be reflective of the manner in which management manages the obligation;

(c) provides a financial result that is likely to be more understandable, and therefore more useful, to users. In any event, staff think the difference between treating a modification

as a derecognition event, or not, is in many cases unlikely to materially impact the financial performance of a smaller NFP private sector entity; and

(d) eliminates an aspect of management judgment and reduces costs of applying the derecognition requirements.

**Question for Board members:**

Q2 Do Board members agree, for the purposes of the Discussion Paper, that Tier 3 reporting requirements should not specify requirements for exchanges of debt instruments or the modification of the terms of an existing financial liability?

If not, do Board members prefer developing a requirement, consistent with AASB 9, that only exchanges between an existing borrower and lender of debt instruments with substantially different terms, and substantial modifications of the terms of an existing financial liability or a part of it, should be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability?