# STAFF PAPER

**8 October 2013**

## Conceptual Framework Round-table Meeting [London]

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| ***Project*** | ***Conceptual Framework*** |
| Paper topic | Asset and liability definitions, recognition and derecognition |


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### Purpose of this paper

1. At this round-table meeting we would like to discuss your thoughts on topics discussed in Sections 2-4 of the *Conceptual Framework* Discussion Paper.

2. There are four topics that we would particularly like to discuss with you:

   (a) the asset and liability definitions (Section 2);

   (b) additional guidance on one aspect of the liability definition—obligations that are conditional on the entity’s future actions (Section 3);

   (c) recognition criteria for assets and liabilities (Section 4); and

   (d) derecognition criteria for assets and liabilities (Section 4).

3. This paper summarises each of these topics. Further detail is in the Discussion Paper. Except where stated, references in this paper are to paragraph numbers in the Discussion Paper.

## Asset and liability definitions (Section 2, paragraphs 2.6-2.36)

4. The existing asset and liability definitions are:

   (a) *an asset:* a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity; and

   (b) *a liability:* a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.[1]

5. The existing definitions have proved over many years to be useful tools for solving many questions in standard-setting. They focus on economic phenomena that exist in the real world (resources and obligations), that are relevant to users of financial statements and that are understandable.

6. Nevertheless, the IASB believes that the definitions could be improved:

   (a) by confirming more explicitly that:

      (i) an asset is a resource (rather than the inflow of economic benefits that the resource may generate); and

      (ii) a liability is an obligation (rather than the outflow of economic benefits that the obligation may generate).

   (b) by clarifying how the definitions are affected by uncertainty about the future inflows or outflows.

7. Questions about uncertainty arise because the existing definitions include the notion that future economic benefits (or a future outflow of resources) must be 'expected'. Questions have arisen about the meaning of the term 'expected'. For example, is it intended to convey a requirement that the probability of an inflow or outflow of economic benefits must meet some minimum threshold? If not, is it intended to reflect the mathematical sense of an 'expected value', which refers to

[1] Paragraph 4.4 of the existing *Conceptual Framework*

a probability-weighted average of the possible outcomes (the mean of a statistical distribution)?

8. The IASB's preliminary view is that the definitions of assets and liabilities should not retain the notion that an inflow or outflow is 'expected'. If this term is interpreted as conveying a requirement that the probability of an inflow or outflow must meet some minimum threshold, the definitions would exclude many items that the IASB thinks are clearly assets and liabilities, such as many purchased and written options. Admittedly, the IASB might decide that some assets or liabilities should not be *recognised* if there is only a low probability that they will result in an inflow or outflow of economic benefits (see paragraph 21(b) of this paper). However, this decision would be a matter of recognition, not definition.

9. Accordingly, the IASB proposes to clarify that:

   (a) an asset must be capable of producing economic benefits. Those economic benefits need not be certain. The probability that a resource will produce economic benefits need not reach any minimum threshold before that resource meets the definition of an asset; and

   (b) a liability must be capable of resulting in a transfer of economic resources. The transfer need not be certain. The probability of an obligation resulting in a transfer need not reach any minimum threshold before that obligation meets the definition of a liability.

**Discussion question 1—uncertainty about future inflows or outflows**

The IASB's preliminary view is that the definitions of assets and liabilities should not retain the notion that an inflow or outflow is 'expected'. An asset must be capable of producing economic benefits. A liability must be capable of resulting in a transfer of economic resources.

Do you agree? Why or why not? If you do not agree, what do you suggest and why?

10. The Discussion Paper suggests the following definitions to implement the above conclusions:

Asset and liability definitions

| | Existing definition | Suggested definition |
|---|---|---|
| **Asset (of an entity)** | A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. | A present economic resource controlled by the entity as a result of past events. |
| **Liability (of an entity)** | A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. | A present obligation of the entity to transfer an economic resource as a result of past events. |
| **Economic resource** | [No existing definition] | A right, or other source of value, that is capable of producing economic benefits. |

| **Discussion question 2—asset and liability definitions** |
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| Do you agree with the suggested definitions? Why or why not?<br><br>If you do not agree, what changes do you suggest, and why? |

## Additional guidance on the liability definition—obligations that are conditional on the entity's future actions (Section 3, paragraphs 3.63-3.97)

11. Section 3 of the Discussion Paper considers various topics on which the IASB could add further guidance to the *Conceptual Framework* to support the suggested asset and liability definitions. We would particularly like to discuss your views on one of the topics—obligations that are conditional on the entity's future actions. The future actions might involve, for example, exceeding a specified threshold, retaining employees until they meet vesting conditions, or operating in a specified market on a future date.

12. There is little guidance on this matter in the existing *Conceptual Framework* and the principles underlying different Standards can appear inconsistent. As a result, the IASB, the IFRS Interpretations Committee and others have had difficulty in reaching conclusions on whether and when some transactions give rise to liabilities. Additional guidance could establish principles on which the IASB could develop future requirements.

13. As noted above, the IASB proposes to define a liability as a 'present' obligation to transfer an economic resource. The present obligation must have arisen 'as a result of past events'. The Discussion Paper suggests that an obligation can be viewed as having arisen from past events if the amount of the liability will be determined by reference to benefits received, or activities conducted, by the entity before the end of the reporting period. Activities conducted by the entity could include, for example, making sales, earning profits or even operating on a particular date. The important criterion is that the *amount* of the liability is determined by reference to that activity.

14. However, there are different views on whether that activity is sufficient to create a present obligation if the resulting requirement to transfer an economic resource is also conditional on the entity's future actions. Three views are considered in the Discussion Paper:

(a) *View 1:* The past event *is not* sufficient. A present obligation must also be *strictly* unconditional. If the entity could, at least in theory, avoid the transfer of resources through its future actions, it does not have a present obligation.

(b) *View 2:* The past event *is not* sufficient. A present obligation must also be *practically* unconditional. Even if the entity has the theoretical ability to avoid a future transfer through its future actions, it nevertheless has a present obligation if it does not have the practical ability to take these actions. Actions that an entity might not have the practical ability to take could include, for example, significantly curtailing operations or leaving specific markets.

(c) *View 3:* The past event *is* sufficient. The entity has received a resource or conducted an activity in exchange for which another party will be able to demand a transfer of resources if the entity takes further specified actions. The entity no longer has complete discretion to avoid the future transfer. On taking the further actions, it will be required to transfer a resource because of the past receipt or activity (or to exchange resources on more onerous terms because of the past receipt or activity).

15. The Discussion Paper includes six examples that illustrate the consequences of these three different views for a range of transactions.

16. The IASB has tentatively rejected View 1. It does not think that an entity should omit from its financial statements liabilities that have arisen from past events and that the entity has no practical ability to avoid. The IASB has not yet reached a preliminary view in favour of either of Views 2 or 3.

**Discussion question 3—obligations conditional on the entity's future actions**

Which of the three views set out in paragraph 14 of this paper do you support? Why?

If you do not support any of those three views, what approach do you suggest and why?

## Recognition (Section 4, paragraphs 4.1—4.27)

17. Recognition is the process of including in the financial statements an item that meets the definition of an element and satisfies any further specified criteria.

18. The recognition criteria specified in the existing *Conceptual Framework* require that:

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

    (b) the item has a cost or value that can be measured with reliability.[2]

19. In practice, questions about recognition relate mainly to assets and liabilities. The IASB thinks that if some assets or liabilities are not recognised, the resulting depiction of the entity's resources and obligation is incomplete and thus provides a less faithful representation of the entity's financial position. The failure to recognise an asset or a liability is not rectified by disclosure of the accounting policies used nor by the notes or explanatory material.

20. Hence, in the IASB's preliminary view, an entity should recognise all its assets and liabilities, unless the IASB decides when developing or revising a particular Standard that an entity need not, or should not, recognise an asset or a liability because:

    (a) recognising the asset (or the liability) would provide users of financial statements with information that is not relevant, or is not sufficiently relevant to justify the cost; or

    (b) no measure of the asset (or the liability) would result in a faithful representation of the asset (or the liability) and of changes in the asset (or the liability), even if all necessary descriptions and explanations are disclosed.

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[2] Paragraph 4.38 of the existing *Conceptual Framework*.

21. The *Conceptual Framework* could provide further guidance to help the IASB to assess when recognising an asset or liability might not provide relevant information. The Discussion Paper states that such guidance could suggest, for example, that recognition might not provide relevant information:

(a) if the range of possible outcomes is extremely wide and the likelihood of each outcome is exceptionally difficult to estimate. This might be the case in, for example, some major litigation. In such cases, the most relevant information might relate to the range of outcomes and factors affecting their likelihoods. In some cases, a single number as a measure for recognition may not provide any further relevant information.

(b) if an asset (or a liability) exists but there is only a low probability that an inflow (or outflow) of economic benefits will result. In some such cases, the IASB might conclude that users of financial statements would be unlikely to include information about that inflow (or outflow) directly in their analysis. Moreover, in some such cases, measures of the asset or the liability may be exceptionally sensitive to small changes in the estimate of the probability and there may be little evidence to support such estimates.

(c) if identifying the asset or liability is unusually difficult. For example, this may be the case for some intangible assets, particularly some of those that are generated internally instead of being acquired in a separate transaction.

(d) if measuring the asset or liability requires unusually difficult or exceptionally subjective allocations of cash flows that do not relate solely to the asset or liability being measured.

(e) if recognising an asset is not necessary to meet the objective of financial reporting. This is the case for internally generated goodwill.

**Discussion question 4—recognition**

Do you agree with the IASB's preliminary views on recognition of assets and liabilities (paragraph 20 above)?

If you do not agree, what changes do you suggest, and why?

## Derecognition (Section 4, paragraphs 4.28-4.51)

22. Derecognition of an asset or a liability is the process of removing, from the statement of financial position, a previously-recognised asset or liability. A transaction that results in the derecognition of one asset or liability may also result in the recognition of other assets or liabilities. Income or expense may also arise.

23. The existing *Conceptual Framework* does not describe when derecognition should occur. Different Standards have adopted different approaches.

24. Questions about derecognition arise if an entity, on disposing of a previously recognised asset or liability, retains a component that exposes it disproportionately to the remaining risks or rewards arising from that asset or liability. The Discussion Paper considers two approaches:

    (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 liability of the entity. This implies that the derecognition criteria for an asset would focus on whether the entity still controls the asset, rather than on legal ownership or on risks and rewards.

    (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.

25. In the IASB's preliminary view:

    (a) the derecognition criteria need to reflect how best to portray both an entity's rights and obligations *and* changes in those rights and obligations.

    (b) in most cases, an entity will achieve the best portrayal if it applies the control approach, ie by derecognising an asset or liability when it no longer meets the recognition criteria or no longer exists or is no longer an asset or liability of the entity. This approach treats identical rights and obligations in the same way, regardless of whether the entity recognised them previously.

(c) however, if the entity retains control of a component of the asset or the liability, the IASB should determine, when developing or revising particular Standards, how the entity would best portray the changes that resulted from the transaction. Possible approaches include:

   (i) derecognising the original asset or liability and giving enhanced disclosure of the retained rights and obligations;

   (ii) derecognising the original asset or liability and presenting the retained rights or obligations on a different line item, to highlight the greater concentration of risk; or

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

| **Discussion question 5—derecognition** |
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| Do you agree with the IASB's preliminary views on derecognition of assets and liabilities (paragraph 25 above)?<br><br>If you do not agree, what changes do you suggest, and why? |