International Accounting Standards Board

Financial Accounting Standards Board

This document is provided as a convenience to observers at IASB/FASB joint international working group meeting on leasing, to assist them in following the working group's discussion. It does not represent an official position of the IASB or the FASB. IASB and FASB Board positions are set out in their respective Standards.

Note: These notes are based on the staff paper prepared for the IASB/FASB working group. Paragraph numbers correspond to paragraph numbers used in the staff paper. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Meeting:	**Joint International Working Group on Leasing** **15 February 2007, London**
Topic:	**ASSET AND LIABILITY DEFINITIONS – EXISTING VERSIONS AND WORKING DRAFTS OF PROPOSED REVISIONS (Agenda Paper 4)**

Introduction

1. The definitions of an asset and a liability are central to the analysis of the contractual rights and obligations that arise in leasing contracts. The existing conceptual definitions of those terms are in the IASB *Framework for the Preparation and Presentation of Financial Statements* (the Framework) and in FASB Concepts Statement No. 6, *Elements of Financial Statements* (CON 6). The Boards currently are undertaking a conceptual framework project to converge and improve the Framework and Concepts Statements, and as part of that project, the existing asset and liability definitions will be revised. Those revisions are not intended to result in radically different concepts of assets and liabilities, but rather are intended to converge the existing definitions and to improve upon them by clarifying their meanings in order to avoid some of the more common misunderstandings and misinterpretations of them.

2. The purpose of this paper is educational in nature to help working group members become familiar with not only the existing definitions but also the working drafts of their revisions. An understanding of both the existing definitions and the Boards' most recent thinking on their revisions is needed to analyse lease contracts and the nature of the assets and liabilities of lessees and lessors that arise from those contracts.

3. This paper begins by briefly reviewing the existing definitions of an asset in the Framework and CON 6. It then considers the working draft of the proposed asset definition and explains the Boards' reasons for the changes that are being considered.

4. Following that, the paper considers the existing definitions of a liability and the working draft of the proposed liability definition. The Boards' work on the asset definition is more advanced than that on the liability definition, so this paper focuses primarily on the asset definition. However, because the draft liability definition is intended to mirror the asset definition, the discussion of the asset definition sets the stage for the proposed liability definition.

5. Please note the following caveats:

   a. Neither the existing definitions nor the working definitions address when an asset or liability should be recognised. The Boards have existing conceptual criteria for determining whether and when an asset or liability should be recognized in financial statements. However, the Boards have yet to consider whether those criteria should be revised and, if so, how they should be revised in applying the working definitions;

   b. The working definitions are still a "work-in-progress"– the Boards have not yet reached tentative conclusions on the revised definitions;

   c. The Boards will seek comments on the proposed definitions, first in a discussion paper and later as an Exposure Draft. Only after those comments have been considered will the Boards decide whether to confirm the proposals as amendments to the Framework and CON 6;

Existing definitions of asset

6. The existing IASB and FASB definitions of an asset are as follows:

IASB

An asset is 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. (Framework, paragraph 49)

FASB

Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. (CON 6, paragraph 25)

Working draft of proposed asset definition

7. This section begins with the proposed working definition of an asset. It then explains the need to change the existing definition, describing the differences between the working definition and the existing IASB and FASB definitions and how the working definition is intended to overcome shortcomings in the existing definitions.

Current working version of proposed asset definition

An asset is a present economic resource to which the entity has a present right or other privileged access.

a. *Present* means that both the economic resource and the right or other privileged access to it exist on the date of the financial statements.

b. An *economic resource* is something that has positive economic value. It is scarce and capable of being used to carry out economic activities such as production and exchange. An economic resource can contribute to producing cash inflows or reducing cash outflows, directly or indirectly, alone or together with other economic resources. Economic resources include non-conditional contractual promises that others make to the entity, such as promises to pay cash, deliver goods, or render services. Rendering services includes standing ready to perform or refraining from engaging in activities that the entity could otherwise undertake.

c. *A right or other privileged access* enables the entity to use the present economic resource directly or indirectly and precludes or limits its use by others. *Rights* are legally enforceable or enforceable by equivalent means (such as by a professional association). Other privileged access is not enforceable, but is otherwise protected by secrecy or other barriers to access.

The Need to Change the Existing Definition

8. Assets are the most fundamental real-world economic phenomena that financial reporting seeks to portray. If the definition of an asset is too vague or subject to interpretation, then the foundation of financial reporting is at risk of being undermined. Therefore, the definition should be as robust as possible.

9. The following are some of the shortcomings that have been observed of the existing IASB and FASB definitions of an asset, together with explanations of how the proposed new definition seeks to mitigate these shortfalls.

10. *Likelihood*—Likelihood (“expectation” in the case of the IASB and “probability” in the case of the FASB) was referred to in the existing definitions in response to constituents’ concerns on earlier proposals that the definition would require that an item be certain in order to qualify as an asset. Since few things in life are certain, they observed that few items that are commonly thought to be assets would qualify in accordance with the definition. Accordingly, the Boards included likelihood with the intent of indicating that the item in question need not be certain (that is, it could be less than certain) to meet the definition.

11. Both the IASB and FASB definitions have been misunderstood and misinterpreted as implying that there must be a high expectation (IASB) or high probability (FASB) of future economic benefits before the definition is met. Thus, some think

that when there is a low probability, or expectation, of future economic benefits, the asset definition is not met. That is not the intent, as is made clear by a footnote to the FASB definition in CON 6, which states:

> *probable* is used with its usual general meaning, rather than in a specific accounting or technical sense … and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.… Its inclusion in the definition is intended to acknowledge that business and other economic activities occur in an environment characterized by uncertainty in which few outcomes are certain….[1]

12. To avoid this continued misinterpretation, the working definition does not depend on an assessment of likelihood. It is sufficient that the economic resource in question be capable of producing net cash inflows or reducing net cash outflows. If there is any question of likelihood to be considered, that might be in assessing whether an asset qualifies for recognition or in measurement (recognition and measurement will be considered at a later date), not in the definition of an asset.

13. *Future economic benefits*—This phrase, used in both the IASB and FASB definitions, focuses on identifying a future flow of economic benefits to demonstrate that an asset exists. That is not the right focus. Financial statements can be viewed as reporting on things that exist (sometimes referred to as *stocks*) and changes in things that exist (sometimes referred to as *flows*). The definition of an asset should focus on stocks—the things that are capable of producing net cash inflows or reducing net cash outflows. An asset is not an inflow, but rather an inflow is a consequence of it. The problem is that the existing FASB definition defines a 'stock' by reference to a 'flow.'

14. To avoid this misinterpretation, the working definition replaces *future economic benefits* with *present economic resources*. The use of *economic resources* rather than *economic benefits* indicates that the item is a stock, rather than a flow, and the use of *present* rather than *future* indicates that the item must presently exist.

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[1] See CON 6, paragraph 25, footnote 18.

15. *Past transaction or event*—In applying both the IASB and FASB definitions, some place undue emphasis on identifying the past transaction or event that gave rise to an asset. Though that identification might be helpful, it can be a distraction and lead to debates about which event is the triggering event instead of focusing on whether the economic resource and the access to it exist at the balance sheet date. How the economic resource and access to it were obtained does not affect whether something under consideration meets the definition of an asset at the present time. Although an observed transaction or other event might provide a signal that an asset might be present and provide a clue as to its nature, the failure to observe such a transaction or other event does not demonstrate that an asset is not present. Conversely, just because a transaction or other event has occurred, that does not mean an asset has resulted from it.

16. To avoid undue emphasis on seeking out a past transaction or event, the working definition focuses on what is necessary for an asset to exist 'at the present' (i.e., a *present* right or other privileged access to a *present* economic resource). This also has the advantage that the economic resource and access to it must exist today—so they cannot be economic resources or access that will not arise until the future or that existed in the past, but no longer exist at the balance sheet date.

17. *Control*—In applying the existing definitions, some view *control* of a resource (IASB), or of probable future economic benefits (FASB), as being used in the same sense as that used to determine whether one has control in a business combination or for purposes of consolidation accounting.

18. Replacing the term "control" avoids the problem that the term can mean different things in different contexts. "Rights or other privileged access"—a term derived from the UK *Statement of Principles for Financial Reporting* (UK SOP),[2] better reflects the manner in which an entity is associated with economic resources in today's complex business world. This term reflects both an entity's ability to use a particular resource and its ability to deny or limit others' use of the resource.

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[2] Accounting Standards Board, *Statement of Principles for Financial Reporting*, October 1999.

19. *Contractual promises*—The amplifying texts supporting the existing IASB and FASB definitions are not clear regarding the application of the definitions to contractual promises. CON 6 suggests that contractual promises may be assets, but does not indicate which features might distinguish between those promises that are assets and those that are not. The IASB Framework is silent on this matter.

20. To clarify this, the working definition explicitly states that an economic resource can result from contractual arrangements. Contracts generally involve exchanges of promises—one party promises to do something for another party in exchange for a promise from that party to do something else in return. Such promises are capable of producing cash inflows or reducing cash outflows and, therefore, may be economic resources to their holders.

21. However, not all contractual promises may be economic resources. Contractual promises may be:

   a. Conditional—Its performance is subject to the occurrence of an event that is not certain to occur.

   b. Unconditional—Its performance is subject to nothing other than the passage of time.

   c. Mature—Its performance is not subject to any event, including the passage of time.

   Conditional promises are not economic resources because their performance is subject to an event that is not certain to occur, but unconditional and mature promises may be economic resources because their performance is not subject to an uncertain event.

22. Nonetheless, a conditional promise generally is accompanied by a related—but somewhat different—unconditional promise. For example, a fire insurance policy on a home may be seen as involving two promises from the insurance company. One is an unconditional promise to provide insurance coverage during the policy's

term, and the other is a conditional promise to pay damage claims *if* a fire occurs. Unless a fire occurs, the policyholder only has an asset relating to the unconditional promise of coverage for the remainder of the policy term. However, if a fire occurs, the policyholder has two assets, one for payment of the claim for fire damage, and another for coverage for the remainder of the policy term.

23. The fire insurance example illustrates an unconditional promise that does not require the promisor or the insurance company to take a particular action, but rather to "stand ready" to do so. Specifically, the promise to provide insurance coverage for the policy term is a contractual promise to stand ready. CON 6 acknowledges promises to stand ready to provide services, but only in the context of liabilities (paragraph 36). While such promises give rise to liabilities for their promisors, it also should be acknowledged that they give rise to assets for their promisees or the recipients of the promises.

Liabilities definition

24. The rest of this paper sets out the existing liability definitions and the proposed working definition of a liability. Because the existing liability definitions parallel the existing asset definitions, the shortcomings of the liability definitions generally parallel those of the asset definitions. For that reason, an explicit discussion of those shortcomings is not included here.

Existing definitions of liability

25. The existing IASB and FASB definitions of a liability are as follows:

IASB

A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits. (Framework, paragraph 49)

FASB

Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. (CON 6, paragraph 35)

Draft proposed definition of a liability

A liability is a present economic burden for which an entity has a present obligation.

a. *Present* means that both the economic burden and the obligation exist on the date of the financial statements.

b. An *economic burden* is something that has negative economic value. It is capable of requiring the sacrifice of economic resources. An economic burden can require cash outflows or reduce cash inflows, directly or indirectly, alone or together with other economic burdens. Economic burdens include non-conditional contractual promises that the entity makes to others, such as promises to pay cash, deliver goods, or render services. Rendering services includes standing ready to perform or refraining from engaging in activities that the entity could otherwise undertake.

c. An *obligation* requires the entity to bear the present economic burden directly or indirectly. Obligations are legally enforceable or enforceable by equivalent means (such as by a professional association).