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International Accounting Standards Board

INFORMATION FOR OBSERVERS

IASB Meeting:	**13 November 2008, London**
Project:	**Conceptual Framework**
Subject:	**Phase B: Elements: Working Definitions of an Asset and a Liability**
	(Agenda Paper 6B)

Introduction

1. As part of Phase B of the Conceptual Framework project, the IASB and FASB (the Boards) are developing improved and converged definitions of an asset and a liability. As the definitions are fundamental tools in financial reporting, a clearly written definition will be more understandable and will facilitate communications with constituents. This paper seeks counsel from the IASB's Standard Advisory Council on the working definitions of an asset and a liability. We[1] hope that this consultation will help ensure the development of robust definitions of an asset and a liability.

2. The element definitions are the first step of a multi-step process to determine how to account for an asset and a liability. The Boards' discussions to date, and this paper, focus on the

[1] "We" is used in this paper to refer to the staff working on Phase B of the Conceptual Framework project. These views do not necessarily represent the views of the Boards, which are reached only after due process, or of other staff members.

existence of an asset and a liability, and NOT on whether it should be recognized or how it should be measured. Recognition and measurement involve other matters that will be considered in later parts of the project. Therefore, conclusions reached as to what items meet the working definitions do not necessarily mean that all assets and all liabilities (as defined) would be recognized in financial statements.

3. In conjunction with the joint project on Financial Instruments with Characteristics of Equity, the Boards will be considering how to distinguish a liability from equity. Further changes to the working definition of a liability may be required.

Purpose of this Paper

4. This paper summarizes the need to change, and improve on, the existing definitions of an asset and a liability, and discusses each of the key aspects of the proposed working definitions that the Boards think will achieve the desired improvements. To learn whether the improvements are desirable and can be achieved, this paper raises questions and provides items for you to test applying the working definitions to ascertain whether the items are or are not assets or liabilities. In the break-out sessions at the meeting, we will ask groups to discuss the application of the working definition of an asset or a liability and views of the working definitions. The Boards also seek to learn of any potential negative consequences that SAC members may foresee, and if any, whether and how those can be overcome.

Structure of the Paper

5. Part 1 of this paper sets out the existing and proposed definitions of an asset and a liability. Part 2 explains the need to change the existing definitions. Part 3 contains questions on which we would appreciate your views. Appendix C to the paper sets out existing definitions of the IASB, FASB, other national accounting standards setters and others, that the Boards and their staff have considered.

Part 1—Existing and Proposed Definitions of an Asset and a Liability

6. The existing definitions of an asset and a liability are as follows:

IASB Framework	FASB Concept Statement 6
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. [paragraph 49]	**Assets** are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. [paragraph 25]
A **liability** is 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. [paragraph 49]	**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. [paragraph 35]

7. Based on the shortfalls identified and proposed changes, outlined in Part 2 of this paper, the Boards have developed working definitions of an asset and a liability. Compared to earlier versions considered, this pair of working definitions follow a parallel structure and use parallel terms where appropriate. Though one or two terms may not be ideal, the terms identify and describe the concepts that we think will result in the definitions being more effective tools. The Boards are seeking counsel on the following working definitions which were discussed by the Boards in October 2008[2]:

An ***asset*** of an entity is a present economic resource to which the entity has a right or other access that others do not have.	A ***liability*** of an entity is a present economic obligation for which the entity is the obligor.
(a) *Present* means that on the date of the financial statements both the economic resource exists and the entity has the right or other access that others do not have. (b) An *economic resource* is something that is scarce and capable of producing cash inflows or reducing cash outflows, directly or indirectly, alone or together with other economic resources. Economic resources	(a) *Present* means that on the date of the financial statements both the economic obligation exists and the entity is the obligor. (b) An *economic obligation* is an unconditional promise or other requirement to provide or forgo economic resources, including through risk protection.

[2] For ease of reference, a copy of the working definitions is included on the last page of this paper.

that arise from contracts and other binding arrangements are unconditional promises and other abilities to require provision of economic resources, including through risk protection. (c) A *right or other access that others do not have* enables the entity to use the economic resource and its use by others can be precluded or limited. A right or other access that others do not have is enforceable by legal or equivalent means.	(c) An entity is the *obligor* if the entity is required to bear the economic obligation and its requirement to bear the economic obligation is enforceable by legal or equivalent means.

Part 2—Need to Change the Existing Definitions

8. Assets and liabilities are the most fundamental real-world economic phenomena that financial reporting seeks to portray. If the definitions of an asset and a liability are too vague or subject to interpretation, then the foundation of financial reporting is at risk of being undermined. Therefore, it is necessary that these definitions be as robust as possible. The following paragraphs outline some of the shortfalls of the existing IASB and FASB asset and liability definitions and explain how the proposed working definitions seek to overcome those shortfalls.

9. *Likelihood*—Likelihood ("expected" in the case of the IASB and "probable" in the case of the FASB) was included in the existing definitions in response to constituents' concerns on earlier proposals that the definitions would require that an item be certain in order to qualify as an asset or a liability. Since few things in life are certain, the Boards observed that few items that are commonly thought to be assets or liabilities would qualify in accordance with the definitions. 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 definitions.

10. Both the IASB and FASB definitions have been misinterpreted as implying that there must be a high likelihood of future economic benefits or sacrifice of economic benefits for the definitions to be met. Thus, some think that when there is a low likelihood of future

economic benefits or sacrifice of economic benefits, the asset or liability definition is not met. That is not the intent.[3]

11. To avoid this continued misinterpretation, the working definitions clarify that they do not depend on an assessment of a degree of likelihood. The Boards think it is sufficient that an economic resource be capable of producing cash inflows or reducing cash outflows—that is, the probability of positive cash flows is greater than zero. Or that an economic obligation is to provide or forego economic resources. If there is any question of likelihood to be considered, that might be a factor in assessing whether a particular asset or liability qualifies for recognition or in determining its measurement, not in the definition of an asset or a liability.[4]

12. *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 or a liability exists. The Boards think that is the wrong 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 Boards think that the definitions should focus on stocks—the things, both tangible and intangible, that are capable of producing cash inflows or reducing cash outflows, or the things to provide or forego economic resources. An asset is not an inflow, but rather an inflow may result from it. A liability is not an outflow, but rather an outflow will result from it. The problem is that the existing FASB definition defines a 'stock' by reference to a 'flow.'

13. Additionally, an asset or a liability is something that exists in the present rather than in the future. However, the wording in the existing definitions suggests otherwise by equating the asset with *future* economic benefits and the liability with *future* sacrifice of economic benefits. These are sometimes misinterpreted as meaning that the asset is the ultimate future inflow or a liability is the ultimate future outflow. This can lead to a conclusion that some items, such as lottery tickets, are not assets, because the *future* economic benefit is associated

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3 Footnotes to the FASB Definitions in CON 6, paragraph 25 and 35, footnote 18 and 21, attempts to explain that, but perhaps not as effectively as it might.

4 As noted previously (see paragraph 2 of this paper), recognition and measurement will be considered in later parts of the conceptual framework project.

with a future event—the drawing of the winning ticket. That argument confuses the cash prize with the right to participate in the lottery drawing for the prize.[5]

14. To avoid this misinterpretation, the working definition of an asset 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. Similarly, the working definition of a liability drops the reference to *future sacrifice of economic benefits* to focus on *present economic obligation*.

15. *Past transaction or event*—The Boards think that references to "past event" (IASB), or "past transactions or events" (FASB), were included in the existing definitions primarily to exclude future assets and liabilities from meeting the definitions. However, in applying both the IASB and FASB definitions, some place undue emphasis on identifying the past transaction or other event that gave rise to an asset or a liability. 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, in context of the asset definition, 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 it 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 a liability has resulted from it. For example, a cash outflow could have been incurred to settle a liability rather than to create an asset.

16. To avoid undue emphasis on seeking out a past transaction or event, the working definitions focus on what is necessary for an asset and a liability to exist 'at the present' (i.e., a *present* right or other access that others do not have to a *present* economic resource and a *present* economic obligation to which the entity is presently the obligor). This also has the advantage that the economic thing and the link to it must exist today—so they cannot be something of

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[5] The measure of such an asset might be very small, or immaterial, if the likelihood of future cash inflows is remote or the future cash flow is small. Nonetheless, that does not mean that an asset does not exist.

the entity that will not arise until the future or that existed in the past, but no longer exist at the financial statement date.

17. *Control of a resource*—In applying the existing asset 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 for purposes of consolidation accounting. The Boards think that was not the intention.

18. In today's complex business world, the Boards think the term "rights or other access that others do not have" better reflects the manner in which an entity is associated with economic resources than control. It is not necessary that an entity controls the economic resource—merely that it has some rights or other access that others do not have. This term is based on the concept of "rights or other privileged access" derived from the UK *Statement of Principles for Financial Reporting*[6] and reflects an entity's ability to use a particular economic resource and the fact that others' use of the resource is limited or precluded.

19. Rights are the most common mechanism that society uses to distinguish who has access to specific resources (i.e., to distinguish who is linked to a resource). Rights can be legally enforceable, but can also be enforceable by other equivalent means, such as those arising within a self-regulatory structure such as a professional organization. An example is the right to practice as an accountant, when that right is conferred on a qualified individual or firm by a professional accounting organization. If such rights are enforced similarly to how rights would be legally enforced (even though the consequences of enforcement might differ somewhat), they are regarded as the equivalent of legally enforceable rights.

20. An entity also can access an economic resource in the absence of rights. For example, an entity might have no enforceable right to secret know-how, or an unpatented invention, but access to it by others is precluded by secrecy. Similarly, economic barriers might keep customers tied to an entity or keep competitors away, even though the entity has no enforceable rights. This is the case, for example, when there are significant training or other costs that exceed the benefits of switching to a competitors' services or when there are significant barriers to market entry. The preclusion or limitation of access by others to an

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

economic resource also demonstrates an entity's association with that economic resource—it demonstrates the existence of *other access that others do not have*.

21. *Obligation of an entity*—To follow a parallel structure to the asset definition of requiring an economic resource and that that economic resource be of the entity, the challenge in the liability definition is finding a term to describe how the economic obligation is of the entity. After evaluating various terms and descriptions, *obligor* was selected as a workable term to describe the how an entity is linked to the economic obligation. Obligor is a strong term. By definition, an "obligor" in law is "a person who is bound to another by contract or legal procedure.[7]" This definition is a faithful description of the intended role of the link in the liability definition. For constituents with contract experience, obligor will be a familiar term. For others, this term, like other terms and descriptions considered, might be a new term to learn. We think that using a new term will be helpful in drawing attention to and communicating the fundamental concepts in the element definitions—being the economic resource or obligation and how each is linked to the entity.

22. To explain the meaning of *obligor*, the supporting text describes an obligor as *the entity is required to bear the economic obligation and its requirement to bear the economic obligation is enforceable by legal or equivalent means.* That description first focuses on identifying what binds an entity to the economic phenomenon, such as being cited in a valid contract or other binding arrangement. Second, the enforceability description focuses on identifying whether there is an *ability* to make the cited party (the entity), rather than another party, take the action (or inaction) specified in the arrangement.

23. In some cases, enforceable obligations also include constructive obligations—those that are created, inferred, or construed from the facts in a particular situation, and equitable obligations—those that stem from a duty to another entity to do that which an ordinary conscience and sense of justice would deem fair, just, and right. Constructive obligations may be enforceable against the entity by the operation of legal doctrines, such as promissory estoppel. Equitable obligations might be enforceable if they are supported by courts of equity. However, obligations that arise merely from ethical, moral or economic compulsion

[7] Accessed *Oxford English Dictionary Online* in August 2008.

do not qualify, because management of an entity could decide not to honour these kinds of obligations and another party could not enforce them against the entity. Only obligations that are enforceable against the entity by legal or other equivalent means should qualify for financial reporting purposes.

24. *Contractual promises*—The existing IASB and FASB frameworks are not as clear as they could be regarding the application of the definitions to contractual promises. The proposed asset and liability definitions and amplifying text will explain that unconditional promises qualify as present economic resources and present economic obligations when their performance is presently required (although performance is, perhaps, not yet required or due).

25. 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 insurance company only has a liability and 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 insurance company has two liabilities and the policyholder has two assets, one for a claim for fire damage, and another for coverage for the remainder of the policy term.

26. *Uncertainty*—The existing IASB and FASB frameworks do not provide guidance on how uncertainty should be considered. Uncertainty is a real-world economic phenomenon and results from situations where evidence is lacking or facts are unclear. When ascertaining whether an item meets the definition of an asset or a liability, uncertainties can affect whether:

    a. an item is an *economic resource* or an *economic obligation*;

    b. it is *the entity's* economic resource or obligation; or

    c. it is a *present* economic resource or obligation of the entity.

    Uncertainty can affect one, some, or all of the requirements of the definitions. As a result, we might have insufficient information to know whether an asset or a liability exists.

27. In the conceptual framework, the Boards decided that uncertainty should be dealt with in how the definitions are to be applied. In a practical manner, the definitions should be applied by using a judgemental approach and neutrally weighing the facts and circumstances at the statement date to neutrally judge whether an asset or a liability[8] exists. Such an approach results in more relevant information being identified. At a standards level, additional guidance can be developed on how these judgements can be made in a comparable manner.

28. *Distinguishing risks from liabilities*—To provide additional guidance in the framework, the Boards also agreed that the existence of a present economic obligation distinguishes a liability from general business risks. In concept, a present economic obligation exists when:

   (a) an entity is committed to a particular action(s) that is capable of resulting in cash outflows; and

   (b) there is a mechanism to enforce that economic obligation against the entity.

29. In considering different risk scenarios, the Boards decided that though an entity may be subject to the requirements in statutes, laws and regulations, a government or other party cannot enforce those requirements *until* the entity violates the statute, law or regulation or an event occurs that triggers the requirements. Thus, statutes, laws and regulations are examples of mechanisms and are not, by themselves, present obligations.

Part 3—Questions

Question 1: *Do you agree that the working definitions of an asset and a liability overcome shortcomings in the existing definitions, and thus, are an improvement? If not, what aspects do you think are not an improvement and what changes would you make to the working definitions?*

Question 2: *Do you agree that the working definitions of an asset and a liability communicate more clearly and facilitate a more disciplined analysis than the existing definitions? If not, what changes would you make?*

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[8] This approach is consistent with the methodology being followed in the IASB's IAS 37 project on *Liabilities*.

Applying the definitions

In considering your responses to the above questions, we ask that you consider how the working definitions would apply to both simple and complex items to ascertain whether they meet the working definition of an asset and a liability. Appendix A and B lists some possible items to test the application of the asset and liability definition, respectively.

In the break-out sessions at the meeting, we will ask some groups to discuss the application of the working definition of an asset to some of the items in Appendix A and other groups to discuss the application of the working definition of a liability to some of the items in Appendix B. Each group will be asked to report back to the committee on the results of their discussions.

Thank you for your time and effort in assisting us with developing a robust definition of an asset and a liability. Your contributions are much appreciated.

APPENDIX A — Do these items meet the working definition of an asset?

(1) Cash in bank and other deposits

(2) Account receivable

(3) Offer of future discounts to potential customers

(4) Non-contracted future sales by an established business

(5) Raw material inventory, Plant and machinery, Freehold interest in land

(6) Property lease

(7) Warranty held on machinery

(8) Air

(9) Non-patented invention

(10) Internally-developed list of customers

(11) Established customer relationships

(12) Non-compete agreement held

(13) Stadium naming rights (grantor's perspective)

(14) Insurance contract issued with renewal option

(15) Lawsuit—On June 30, 200X, an entity has served papers of a claim for damages on another party.

(16) Other?

APPENDIX B — Do these items meet the working definition of a liability?

(1) Bank overdraft by depositor

(2) Account payable

(3) Discretionary employee bonuses

(4) Future purchases by an established business

(5) Warranty written on machinery

(6) Written non-compete agreement

(7) To obey the law

(8) Forward contract to purchase corn

(9) Refunds—stated policy or no stated policy to provide refunds to customers

(10) Announced redundancy plan or product recall

(11) Non-vested employee benefits (discretion to avoid)

(12) Fit for purpose good—A statute requires that light fixtures must work for at least 1000 hours. If not, the seller must repair or replace it. An entity sells a light fixture.

(13) Environmental rehabilitation—A law states that mine shafts deeper than 10 metres must be entirely filled in by 31 December 2020 or the miner will be fined. On 31 December 2008, Miner has three shafts that are each 5 metres deep and two shafts that are 16 metres deep.

(14) Contaminated hamburger—A law states that vendors must compensate each customer who buys a contaminated hamburger. On the statement date, a vendor sold one hamburger.

(15) Lawsuit—On June 30, 200X, an entity has been served papers of a claim for damages by another party. The entity is otherwise unaware of any past wrongdoing.

(16) Other?

APPENDIX C— Existing Asset and Liability Definitions

Definer	Asset	Liability
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. (paragraph 49(a))	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. (paragraph 49(b))
FASB	**Assets are probable future economic benefits** obtained or controlled by a particular entity as a result of past transactions or events. (paragraph 25)	**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. (paragraph 35)
Australia	**"Assets" are future economic benefits** controlled by the entity as a result of past transactions or other past events; and "control of an asset" means the capacity of the entity to benefit from the asset in the pursuit of the entity's objectives and to deny or regulate the access of others to that benefit. (paragraph 14)	**Liabilities** are the **future sacrifices of economic benefits** that the entity is presently obliged to make to other entities as a result of past transactions or other past events. (paragraph 48)
Canada	**Assets are economic resources** controlled by an entity as a result of past transactions or events and from which future economic benefits may be obtained. (paragraph 29)	**Liabilities** are **obligations** of an entity arising from past transactions or events, the settlement of which may result in the transfer or use of assets, provision of services or other yielding of economic benefits in the future. (paragraph 32)

Working Definitions of an Asset and a Liability

Definer	Asset	Liability
Germany	**An asset is a resource** controlled by an enterprise as a result of past events. (paragraph 66)	A **liability** is a **present obligation** to an external party arising from past events. The outflow of resources is expected as a result of the settlement of the obligation. (paragraph 70)
Japan	**Assets are economic resources or their equivalents** that the reporting entity controls as a result of past transactions or events. (paragraph 4)	**Liabilities** are **obligations** or their equivalents to give up or deliver the economic resources that the reporting entity controls, as a result of past transactions or events. (paragraph 5, footnote reference omitted)
New Zealand	**Assets are service potential or future economic benefits** controlled by the entity as a result of past transactions or other past events. (paragraph 7.7)	**Liabilities** are the **future sacrifices of service potential** or of future economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events. (paragraph 7.10)
United Kingdom	**Assets are rights or other access** to future economic benefits controlled by an entity as a result of past transactions or events. (paragraph 4.6)	**Liabilities** are **obligations** of an entity to transfer economic benefits as a result of past transactions or events. (paragraph 4.6)
CFA Institute – Comprehensive Business Reporting Model[9]	An enterprise must recognize **an economic resource as an asset** in the financial statements when all of the following conditions are met: a. The resource is a present right or other access to a future benefit that will flow to the company and will contribute directly or indirectly to future net cash inflows; b. The right to the future benefit is controlled by the	An **economic obligation** must be recognized as a **liability** in the financial statements when all of the following conditions are met: a. The obligation exists currently; b. There is a nonzero probability that the obligation will be settled by an outflow of assets, issuance of another liability, or other settlement that will result in a change in the share of net

9 *A Comprehensive Business Reporting Model: Financial Reporting for Investors*, CFA Centre for Financial Market Integrity, September 2005. Note that this definition mixes both the definition of an asset and recognition criteria. This definition is not repeated in the July 2007, final report. Rather, that report comments on the IASB/FASB working definition as follows, "… we believe that the definitions proposed by the staffs of the FASB and IASB for assets and liabilities, which are currently under consideration by the two boards, provide a sound starting point for addressing recognition." "We believe that as a practical matter, assets should be identifiable and separable, capable of being transferred to others. We do not believe that hard to identify, vaguely defined, or ambiguous items, such as goodwill, should be recognized in the balance sheet."

Definer	Asset	Liability
	company; c. There is a nonzero probability that the benefit will occur; d. The right to the future benefit is separable from the company; that is, it can be transferred to an external party; e. The right to the future benefit is the result of past events; and f. The fair value of the right to future benefits can be measured. (page 19)	assets available to current shareowners; c. There are sufficient penalties to the enterprise from nonperformance that the enterprise has no realistic alternative to settlement; d. It does not meet the definition of equity; and e. The economic attributes and fair value of the obligation can be measured. (page 19)
FASAB[10]	**An asset is a resource** that embodies economic benefits or services that the federal government can control. (page 17)	A **liability** is a present obligation of the federal government to provide assets or services to another entity at a determinable date, when a specified event occurs, or on demand. (pages 7 and 17)
GASB[11]	**Assets are resources** with present service capacity that the government presently controls.	**Liabilities** are present obligations to sacrifice resources or future resources that the entity has little or no discretion to avoid. (pages 11 and 13)

[10] Federal Accounting Standards Advisory Board, July 2006 Exposure Draft, *Proposed Statement of Federal Financial Accounting Concepts: Definition and Recognition of Elements of Accrual-Basis Financial Statements.*

[11] Governmental Accounting Standards Board, June 2007, Concepts Statement No. 4, *Elements of Financial Statements.*

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Proposed Working Definition of an Asset and a Liability

An ***asset*** of an entity is a present economic resource to which the entity has a right or other access that others do not have.	A ***liability*** of an entity is a present economic obligation for which the entity is the obligor.
(d) *Present* means that on the date of the financial statements both the economic resource exists and the entity has the right or other access that others do not have. (e) An *economic resource* is something that is scarce and capable of producing cash inflows or reducing cash outflows, directly or indirectly, alone or together with other economic resources. Economic resources that arise from contracts and other binding arrangements are unconditional promises and other abilities to require provision of economic resources, including through risk protection. (f) A *right or other access that others do not have* enables the entity to use the economic resource and its use by others can be precluded or limited. A right or other access that others do not have is enforceable by legal or equivalent means.	(d) *Present* means that on the date of the financial statements both the economic obligation exists and the entity is the obligor. (e) An *economic obligation* is an unconditional promise or other requirement to provide or forgo economic resources including through risk protection. (f) An entity is the *obligor* if the entity is required to bear the economic obligation and its requirement to bear the economic obligation is enforceable by legal or equivalent means.