STAFF PAPER

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REG IASB Meeting

Project	**Conceptual Framework**		
Paper topic	Recognition		
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Purpose of paper

1. This paper discusses recognition.

Summary of recommendations

2. This paper recommends that the *Conceptual Framework* should not include explicit recognition criteria. Instead, it should provide a narrative discussion of the thought process to go through in making recognition decisions, along the lines indicated in paragraph 19.

Structure of paper

3. This paper is structured as follows:

   (a) Background (paragraphs 4–12)

   (b) Staff analysis and question for the IASB (paragraphs 13-19)

   (c) Detailed feedback (appendix A)

   (d) Other comments (appendix B)

Background

What is recognition?

4. The existing *Conceptual Framework* defines recognition as follows:

> Recognition is the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the criteria for recognition set out in paragraph 4.38. It involves the depiction of the item in words and by a monetary amount and the inclusion of that amount in the balance sheet or income statement totals.[1]

5. There are four minor problems with this existing definition:

   (a) Most items are depicted by including them in line items, not by depicting them individually.

   (b) The cross-reference to the recognition criteria is unnecessary. It also means that the definition would not be met if recognition criteria in a particular Standard do not meet the recognition criteria in the *Conceptual Framework.*

   (c) The terminology is out of date. For example, it refers to the balance sheet instead of the statement of financial position

   (d) The paragraph refers only to the balance sheet and income statement. The Discussion Paper suggested introducing the notion of a primary statement, which would also include that the cash flow statement and statement of changes in equity. The staff plan to discuss the feedback on that suggestion at a future meeting.

6. To address these minor points, this paper adapts the existing definition to read as follows:

> Recognition is the process of incorporating in [a primary statement][2] an item that meets the definition of an element. It involves depicting the item

[1] See paragraph 4.37 of the existing *Conceptual Framework*

[2] Wording may change, depending on whether the notion of ‘primary statement’ is retained.

(either alone or as part of a line item) in words and by a monetary amount, and including that amount in totals in that primary statement.

7. Existing standards use the term 'initial recognition' in a related, but slightly different, sense. Initial recognition refers to the recognition that would occur if the entity produced financial statements on the date when an item first qualifies for recognition. For example, suppose that entity produces financial statements for the year to 31 December and that an asset qualifies for recognition on 15 October. Initial recognition occurs at 15 October, although the entity does not actually incorporate the asset in its statement of financial position until 31 December. The staff will consider in drafting whether this point needs to be clarified.

Existing requirements

8. The recognition criteria in the existing *Conceptual Framework* state that an entity recognises an item that meets the definition of an element if:

   (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.

Discussion paper

9. The Discussion Paper suggests that 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 both the asset (or the liability) and the changes in the asset (or the liability), even if all necessary descriptions and explanations are disclosed.

10. Although the Discussion Paper suggests that the IASB should not retain reliable measurement as a separate recognition criterion, it does suggest that the *Conceptual*

Framework could list the following as indicators 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.

(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.

(c) if identifying the resource or obligation is unusually difficult.

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

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

Overview of responses

11. Just over half of the respondents commented explicitly on recognition. Many respondents agreed that:

(a) the recognition criteria should refer to relevance and faithful representation.

(b) the *Conceptual Framework* should acknowledge that significant uncertainty and significant measurement difficulties might undermine relevance and make it difficult to provide a faithful representation. However, many respondents believe it would be clearer and more straightforward to retain probability and reliability of measurement as explicit recognition criteria. (Those responding on this issue were evenly divided between those who favoured retaining one or both of those criteria, and those who did not favour this. Requests to retain an explicit probability criterion were considerably more numerous than requests to retain an explicit reliability criterion.)

(c) cost-benefit considerations should play a role in recognition decisions, but some questioned whether the recognition section needs to refer to the cost constraint explicitly.

12. Appendix A provides more detailed feedback on the main issues. Appendix B summarises some other comments received.

Staff analysis

13. The Discussion Paper suggested the following approach:

    (a) The discussion of whether to recognise an asset or liability should refer directly to the qualitative characteristics described in Chapter 3 of the *Conceptual Framework*.

    (b) the *Conceptual Framework* should also supply guidance, in the form of indicators that explain when recognition might produce information that does not possess those qualitative characteristics. The indicators include some (but not all) cases where the existing *Conceptual Framework* would lead to a conclusion that a flow is not probable or that reliable measurement is not possible.

14. Many respondents supported the approach suggested in the Discussion Paper. However, many other respondents suggested either:

    (a) retaining the existing recognition criteria (probability and reliable measurement) unchanged, or

    (b) including recognition probability and/or reliability as more specific and practical filters intended to result in information that possesses the qualitative characteristics.

15. In the staff's view, the approaches described in the Discussion Paper and the approaches described in the previous paragraph are not that different, and have similar objectives but seek to achieve them by different means:

    (a) The existing *Conceptual Framework* sets up practical filters to deal with cases where recognition is not likely to provide information that possesses the qualitative characteristics of useful financial information.

(b) The DP refers more directly to the qualitative characteristics, but then provides guidance on how to apply them.

In essence, the question is how best to achieve the desired objective.

16. The staff also considered the latest draft of the recognition criteria being developed by the International Public Sector Accounting Standards Board (IPSASB).[3] The staff understands that IPSASB regards its definitions as final, subject to drafting, and expects to include them in its final conceptual framework by the end of this year. In accordance with that draft, an asset or liability would be recognised if it can be measured in a way that meets the qualitative characteristics of, and constraints on, information included in general purpose financial reports. The IPSASB draft does not provide indicators along the lines of those included in the IASB Discussion Paper.

17. In the staff's view:

(a) Just referring directly to the qualitative characteristics, without supplying supporting guidance, would not provide sufficient support for recognition decisions at the Standards level.

(b) Retaining probability as a practical recognition filter has disadvantages:

(i) It could lead to non-recognition of some financial instruments.

(ii) It would result in a gain on initial recognition in some circumstances. For example, suppose that, in exchange for receiving cash, an entity incurs a liability to pay a fixed amount if some unlikely event occurs. If the liability does not pass the filter, the entity will recognise a gain when it becomes entitled to receive the cash.

(c) Retaining reliable measurement as a criterion could be confusing if reliability is not identified as a qualitative characteristic. However, it might be feasible to provide a broadly equivalent result by referring to cases when an item is so difficult to measure that recognising it does not result in relevant information. As noted in Agenda Paper 10H *Reliability*, paragraph QC16 of the existing *Conceptual Framework* already captures the idea that

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[3] Agenda item 4A for IPSASB meeting March 2014
http://www.ifac.org/sites/default/files/meetings/files/Agenda%20Item%204A%20Combined-v1_0.pdf

if the level of uncertainty in an estimate is very large then the estimate might not provide relevant information.

(d) The cost constraint is relevant: recognition should be required only if the benefits exceed the costs of doing so. The Staff have yet to consider whether the cost constraint is best acknowledged solely by relying on the existing reference in chapter 3, or whether further references in other chapters would be helpful.

18. Neither the existing approach (setting up practical filters), nor the approach in the Discussion Paper (referring directly to the qualitative characteristics, supplemented with a list of indicators) is totally satisfactory. In the staff's view, a more effective approach would be not to set up bullet lists of recognition criteria at all, but instead to include a narrative description of the thought process to go through in making recognition decisions.

19. The main ingredients of that thought process could be as follows:

(a) Information about economic resources and obligations is relevant to users. Recognising assets and liabilities depicts economic resources and obligations, in a structured summary that is intended to be comparable and understandable. Failure to recognise an asset or liability makes that summary less complete. Hence, disclosure does not rectify failure to recognise an asset or liability.

(b) In deciding whether to recognise an asset or liability, it is necessary to assess whether it is possible to measure the asset or liability in a way that would provide relevant information to users. The following are examples of cases when it is possible that no measurement provides relevant information:

(i) if it is uncertain whether the asset or liability exists.

(ii) if an asset (or a liability) exists, but there is only a low probability that an inflow (or outflow) of economic benefits will result.

(iii) if all measurements that are available, or can be obtained, are exceptionally uncertain (as discussed below).

(c) In many cases, measurements must be estimated and are subject to uncertainty. As noted in paragraph 4.41 of the existing *Conceptual Framework*, the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their usefulness. To provide a faithful representation, amounts that are estimates or that are the results of allocations, systematic or otherwise, must be described as such, and if significant, the nature and degree of uncertainties must be disclosed.

(d) In exceptional cases, as noted in paragraph QC16 of the existing *Conceptual Framework*, the level of uncertainty in an estimate is so large that the estimate will not be particularly relevant, even if supporting disclosures are provided. The following are indicators that an estimate may not provide relevant information:

(i) if the range of possible outcomes is extremely wide and the likelihood of each outcome is exceptionally difficult to estimate.

(ii) if identifying the resource or obligation is unusually difficult.

(iii) if measuring the resource or obligation requires unusually difficult or exceptionally subjective allocations of cash flows that do not relate solely to the item being measured.

(e) The recognition of income and expenses depends on the recognition and initial measurement of assets and liabilities, and on changes in the carrying amount of assets and liabilities.[4] In deciding whether to recognise an asset or liability, it is necessary to consider whether the resulting income or expenses will provide relevant information and result in a faithful and understandable representation. For example, in some cases, recognising an asset or liability may not result in a faithful and understandable representation if a related asset or liability cannot be recognised.

(f) As for all decisions in setting standards, it will be necessary to consider whether the benefit of providing the information needed to recognise an

[4] A future paper on measurement will consider which factors to consider in deciding which measurement bases to use for assets and liabilities. Those decisions will affect the recognition of income and expense.

asset or liability justifies the cost of doing so. [The staff have yet to consider whether the cost constraint is best acknowledged solely by relying on the existing reference in chapter 3, or whether further references in other chapters would be helpful.]

Question for the IASB

Question 1
Does the IASB agree that the *Conceptual Framework* should not include explicit recognition criteria? Instead, it should provide a narrative discussion of the thought process to go through in making recognition decisions, along the lines indicated in paragraph 19.

Appendix A
Detailed feedback

A1. This appendix provides more detailed feedback on the following points

(a) Should an entity recognise all its assets and liabilities? (paragraphs A2–A11)

(a) Should the IASB keep the existing recognition criteria? (paragraphs A12–A14)

(b) Relevance (paragraphs A15–A18)

(c) Faithful representation (paragraph A19)

(d) Cost benefit (paragraph A20)

(e) Enhancing qualitative characteristics (paragraph A21)

(f) Uncertainty (paragraphs A22-A36)

(g) Reliability (paragraphs A37–A44)

Should an entity recognise all its assets and liabilities?

A2. A few respondents suggested that an entity should recognise all its assets and liabilities, with no exceptions. They argued that this promotes consistency and conceptual integrity in financial reporting.

A3. Most other respondents believed that it is neither relevant nor feasible for an entity to recognise all of its assets and liabilities. Completeness may be better served (as it is now) by disclosure (for example, of contingent assets and contingent liabilities) rather than by recognition. Some also stated that the purpose of the financial statements is not to show the reporting entity's value.

A4. A few respondents suggested that the *Conceptual Framework* should not include departures from the general principle that an entity should recognise all assets and liabilities. If limited exceptions are needed, they can be considered at a Standards level, using existing concepts in Chapter 3 of the *Conceptual Framework*. An explicit exception in the *Conceptual Framework* is unnecessary and may suggest to some that those concepts can be applied only when explicitly referenced.

A5. Others argued that the *Conceptual Framework* should provide criteria or guidance on when to recognise assets and liabilities, on the following grounds:

(a) delegating these decisions to specific Standards may lead to inconsistencies between Standards and create rules rather than principles.

(b) the Conceptual *Framework*'s guidance on recognition should be available for use not just by the IASB, but also by preparers and others who need guidance on when to recognise an asset or liability that no Standard covers. There should be no concerns about preparers using this guidance because the *Conceptual Framework* cannot override recognition criteria in Standards.

A6. Some respondents commented that the *Conceptual Framework* should include general high-level recognition principles. Individual Standards should contain exceptions, and applications of the general principles in particular cases, which depend greatly on the nature of the asset and the unit of account.

A7. Some respondents also commented on:

(a) whether recognition should be the default position if not all assets and liabilities are required to be recognised (paragraphs A8–A10); and

(b) whether to prohibit recognition in some cases (paragraph A11).

Recognition as default?

A8. A few respondents indicated that recognition of all assets and liabilities should be the default approach. They argued that, if the definitions of the assets and liabilities are valid, there must be a presumption to recognise all items that meet those definitions.

A9. A few other respondents stated that the *Conceptual Framework* should not include a rebuttable presumption that all assets and liabilities should be recognised, and should call for a genuine assessment of relevance and reliability for all assets and liabilities being considered for recognition. They also expressed a fear that relevance and faithful representation would not provide a sufficiently robust basis for a genuine assessment of whether to recognise an asset or liability.

A10. The fears expressed by some respondents about viewing recognition as the default approach were exacerbated by the suggestion in the Discussion Paper that only the IASB could exercise the decision that entities should not (or need not) recognise assets and liabilities. However, the concern should no longer be relevant, because in April the IASB decided tentatively that Preparers should not be restricted from applying particular aspects of the *Conceptual Framework*.

Should recognition be prohibited in some cases?

A11. The Discussion Paper stated that the IASB might (but need not) decide that an entity need not, or should not, recognise an asset or a liability, when the result of recognising it does not pass the tests of relevance and faithful representation. A few respondents commented that the IASB should:

(a) prohibit recognition in such cases.

(b) explicitly justify any decision to depart in a particular Standard from the recognition criteria in the *Conceptual Framework*.

(c) review whether the recognition criteria in existing Standards comply with the revised *Conceptual Framework*.

Should the IASB keep the existing recognition criteria?

A12. Some respondents favoured keeping both of the existing requirements: (1) that it is probable that the economic benefits will flow to / from the entity and (2) that reliable measurement is possible. They argued that:

(a) The IASB's analysis shows that recognition criteria need to link recognition to relevance and faithful representation. The recognition criteria in the current *Conceptual Framework* achieve that (see comments in paragraphs A22–A36 for probability and A37–A43 for reliability). Nothing in the Discussion Paper explained a need to change the existing recognition criteria.

(b) The proposed recognition criteria are not sufficiently objective or substantive to be a useful tool to enable the IASB to produce consistent solutions at the Standards level. They are vague, require a high degree of judgement and are likely to lead to diversity in practice.

(c) The principles underlying the guidance in paragraphs 4.25 and 4.26 of the Discussion Paper could be used to develop more robust recognition filters than those suggested in the Discussion Paper. The filters could address the availability of reliable measurement methods and include a probability test.

A13. Some respondents favoured the recognition criteria suggested in the Discussion Paper, on the following grounds:

(a) Relevance and faithful representation should be the prime drivers in deciding whether an asset or liability should be recognised. The cost of providing information should also be a relevant factor.

(b) The probability threshold can be removed from the *Conceptual Framework* if sufficient weight is given to criteria of faithful representation and cost benefit considerations to prevent measurement methods having to be developed for low probability items when it is clear that the benefits will not justify the cost.

(c) It would have been preferable to point out a clearer and more robust direction for future Standard setting, but this would require much more work. A clear direction would also increase the gap between the new *Conceptual Framework* and existing Standards. Thus, the solution proposed by the IASB is appropriate.

(d) The proposed recognition criteria are an improvement over the recognition criteria in the existing *Conceptual Framework*, since they would be likely to lead to the recognition of more assets and liabilities. This should, in theory, provide relevant information about, and a more faithful representation of, an entity's resources and obligations as well as the changes in these items.

A14. The following paragraphs discuss various aspects of the recognition approach suggested in the Discussion Paper:

(a) Relevance (paragraphs A15–A18)

(b) Faithful representation (paragraph A19)

(c) Cost benefit (paragraph A20)

(d) Enhancing qualitative characteristics (comparability, verifiability, timeliness and understandability) (paragraph A21)

(e) Uncertainty (paragraphs A22-A36)

(f) Reliability (paragraphs A37–A43)

(g) Other comments (appendix B)

Relevance

A15. Some respondents supported the proposal to include relevance as a recognition criterion, on the following grounds:

(a) If recognition results in information that is not relevant for decision making, there is no reason to go through the cost and effort to recognise the assets or liabilities.

(b) Recognition is not appropriate when the uncertainty about inflows or outflows of economic benefits makes an item so difficult to measure that recognising it does not result in relevant information.

A16. Some respondents opposed relevance as a recognition criterion, on the following grounds:

(a) The conceptual basis of the definitions of assets and liabilities is to provide information that is relevant. It is difficult to envisage how recognising an asset or liability could provide information that has no relevance to a user.

(b) The question of relevance is not about whether to recognise an asset, it is rather about how to measure the recognised asset in a way that results in information relevant to users' decisions.

(c) The challenge is how to define 'information that is relevant', and from whose perspective.

(d) The Discussion Paper suggests that one case that fails the relevance test is when information is incomplete or hard to understand, for example if related assets and liabilities are not recognised. The answer is to produce complete information in an understandable form, not to omit the item.

(e) The test of 'relevant information' may lead to the recognition of items that may more appropriately be dealt with in notes or supplementary reporting, such as some intangible items and goodwill.

(f) The judgemental decision on usefulness of the information should not be at the discretion of the entity. The entity should make best efforts to disclose all necessary descriptions and explanations, and not attempt to pre-determine what would be useful for users.

A17. A few respondents provided other comments on relevance:

(a) The consideration of relevance needs to refer specifically not only to the asset or liability but also to income or expenses resulting from changes in the asset or liability. Priority should be given to data types that users consider most important. There needs to be more focus on how to provide relevant information about future income and expense, and cash flows, by deciding when to recognise assets and liabilities, and how to measure them.

(b) Relevance means different things for different items. For example, the recognition of financial assets provides users with information to help predict future cash flows. For non-financial assets, users might look for information about how the entity is using its resources and its return on capital. These different objectives might necessitate different recognition guidance for different elements.

Indicators of lack of relevance

A18. As noted in paragraph 10, The Discussion Paper suggests that the *Conceptual Framework* could set out indicators of cases when recognising an asset or liability would not provide relevant information. Respondents provided the following comments on this suggestion:

(a) If the *Conceptual Framework* is to give lack of relevance as a reason for non-recognition, such guidance would be essential. These factors capture much, perhaps all, of the essential ideas of a low probability of flow and lack of reliable measurement, but without requiring that they would, in and of themselves, prevent recognition. One consequence is that questions of 'how probable is probable?' and 'how reliable is reliable?' will be addressed in individual Standards. Some may see this as an advantage as these issues are likely to be more tractable at the level of Standards. Others may consider that these should be dealt with in the *Conceptual Framework* for greater consistency.

(b) For financial statements to assist in assessing management's stewardship, it may be relevant to recognise assets that have been purchased even if similar assets generated internally are not recognised. This might most often arise for intangibles such as computer software, or for goodwill.

(c) It is useful to explain how the qualitative characteristics might be applied in recognition. However, indicators are not necessary to achieve this.

(d) The examples and indicators do not provide concepts. The Conceptual Framework should contain clear concepts.

(e) It is not clear how the indicators relate to relevance. For example, the indicators about measurement uncertainty seem to focus on faithful representation. Although information might not be relevant if no measure provides a faithful representation, uncertainty is not a measure of relevance.

(f) The Discussion Paper focuses on one particular aspect of relevance: when the level of uncertainty in an estimate is so large that the reliability of the estimate and its relevance is questionable. This overlaps with the question of whether a sufficiently faithful representation exists.

(g) In relation to probability and uncertainty:

(i) Probability could influence a decision on relevance, faithful representation and cost benefit. The indicators do not explain how probability is relevant for this assessment.

(ii) The *Conceptual Framework* should explain when uncertainty is so significant that recognition is not likely to occur.

(iii) The reference to low probability might be mistaken for a threshold, although the IASB does not propose a threshold.

(iv) The list of indicators, and related examples, focus on assets, but should also address liabilities and executory contracts.

(h) The indicator about meeting the financial statement objectives is not useful because it applies only to internally generated goodwill. Internally generally goodwill should not be recognised, but this is because it cannot be reliably measured rather than because it is not relevant to recognise it. Also, any exception for internally generated goodwill should be at the Standards level, not in the Conceptual Framework.

Faithful representation

A19. A few respondents commented on faithful representation:

(a) As noted in the Discussion Paper, if recognising an asset or a liability would provide relevant information, the treatment of faithful representation in paragraphs QC15-QC16 of the *Conceptual Framework* seems to show that any measurement basis could provide a faithful representation (if supporting disclosures are adequate). Thus, it would be redundant to include a separate recognition criterion referring to faithful representation. Nevertheless, a more careful description of faithful representation might make it more useful and justify its use in the criteria.

(b) A faithful representation may be possible for a portfolio, even if it is not possible for an individual item (for example, future life insurance for a named individual).

Cost benefit

A20. The Discussion Paper suggested that, if recognising an asset or liability would provide information that is not sufficiently relevant to justify the cost, the IASB might not require (or might prohibit) its recognition. Respondents generally did not object to the notion that the cost constraint should play a role in recognition decisions. A few respondents commented on the specific suggestions in the Discussion Paper:

(a) The cost constraint relates to both relevance and faithful representation, not just to relevance.

(b) The cost constraint should be considered in this assessment, but should not be mentioned specifically in the recognition criteria. The overarching concept is already included in the Conceptual Framework and is pervasive.

(c) It is not appropriate to introduce the notion of information that is 'not sufficiently relevant to justify the cost'. The cost of producing information does not affect its relevance. The IASB should distinguish the most relevant information and the information that best meets the cost benefit criterion. A change in technology might alter the cost benefit decision.

(d) The cost constraint is a valid consideration for immaterial items but is likely to be a measurement problem rather than a recognition problem.

Enhancing qualitative characteristics

A21. The Discussion Paper identified no need for recognition criteria relating to the enhancing qualitative characteristics of comparability, verifiability, timeliness and understandability. A few respondents commented on this conclusion:

(a) The enhancing qualitative characteristics are important ingredients in the relevance and usefulness of information. The IASB has not put forward a convincing argument to exclude them from the recognition criteria.

(b) Lack of comparability arises if in a business combination entities recognise assets or liabilities (for example, some long-term contracts such as life insurance) that otherwise are not recognised, or are measured differently.

(c) If reliable measurement is not retained as an explicit recognition criterion, verifiability may need more emphasis (see paragraphs A41–A42).

Uncertainty

A22. The Discussion Paper set out the IASB's preliminary views that:

(a) 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.

(b) the *Conceptual Framework* should not set a probability threshold for the rare cases when it is uncertain whether an asset or a liability exists. If there could be significant uncertainty about whether a particular type of asset or liability exists, the IASB would decide how to deal with that uncertainty when it develops or revises a Standard on that type of asset or liability.

(c) the recognition criteria should not retain the existing reference to probability.

A23. Agenda paper 10A discusses, among other topics, whether to delete from the definitions of an asset and of a liability the notion of an expected inflow or outflow of economic benefits. The rest of this section deals with the following subjects:

(a) Existence uncertainty (paragraphs A24–A31)

(b) Outcome uncertainty (paragraphs A32–A36)

Existence uncertainty

A24. The Discussion Paper distinguished existence uncertainty from outcome uncertainty. Feedback in this area focused on:

(a) whether to distinguish existence uncertainty from outcome uncertainty (paragraphs A25–A27).

(b) whether the *Conceptual Framework* should address existence uncertainty (paragraphs A28–A31).

Distinguishing existence uncertainty from outcome uncertainty

A25. Several commentators commented explicitly that it is useful to differentiate between existence uncertainty and outcome uncertainty.

(a) Referring to the distinction may acknowledge the variety of the practical limitations that constrain financial reporting, and may clarify thinking about how Standards might reflect particular circumstances.

(b) A discussion of the two kinds of uncertainty can assist management in decisions on how to deal with uncertainty in respect of recognition, measurement and disclosure. Similarly, if management differentiates existence uncertainty from outcome uncertainty in explaining the judgements and assumptions made, that can aid users' understanding.

(c) When there is uncertainty about existence, it is hard to avoid some kind of probability test. The *Conceptual Framework* should acknowledge that a probability criterion is needed in the case of existence uncertainty, but not in the case of measurement uncertainty.

(d) If it is uncertain whether an asset or a liability exists, there needs to be some threshold for recognition. Without a threshold, assets and liabilities could be excluded if it is not completely certain whether they exist.

(e) Existence uncertainty is inherent in the judgement about whether a right or obligation exists. Uncertainty about existence is rare in practice and can be addressed at the standards level.

A26. Some respondents stated that it can be difficult to distinguish the two types of uncertainties. Reasons for this difficulty include the following:

(a) It can be unclear what unit of account to consider. For example, in a tax dispute, it may not be clear whether the uncertainty relates to the existence of a tax liability for the particular transaction in dispute, or to the outcome of the total tax liability.

(b) When the recognition of assets and liabilities is tied to the recognition of changes in assets and liabilities, the questions of existence uncertainty and outcome uncertainty are not separate.

A27. The Discussion Paper stated that existence uncertainty is rare. Several respondents disagreed with this statement. They supplied the following examples of existence uncertainty:

(a) Litigation. Several respondents feared that if the *Conceptual Framework* does not retain a probability threshold that could apply for existence uncertainty, this may lead to a reopening of the approach to litigation. They noted that many objected to the IASB's proposals on litigation in 2005 in its uncompleted project to amend IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

(b) constructive obligations.

(c) cases where there is some doubt whether an entity controls a resource.

(d) non-monetary exchange transactions.

Should the Conceptual Framework address existence uncertainty?

A28. Several respondents agreed with the suggestion in the Discussion Paper that the *Conceptual Framework* should not set a probability threshold for cases when it is uncertain whether an asset or a liability exists. The IASB could decide how to deal with that uncertainty when it develops or revises a Standard on that type of asset or liability.

A29. Some respondents disagreed, stating that the *Conceptual Framework* should explain explicitly how to approach recognition when asset or liability existence is uncertain. They argued that:

(a) deciding how to deal with existence uncertainty should be principle-based and should not vary by transaction.

(b) dealing with existence uncertainty in individual Standards would lead to an unnecessary proliferation of Standards and to inconsistencies.

(c) preparers need guidance for assets and liabilities that no Standard covers.

(d) it is impossible to define precisely the degree of certainty needed to recognise a liability. This will lead to range of possible outcomes that will be negotiated between the preparer and the auditor. Prudence and conservatism help temper the expectations of management, empower the auditors to hold estimates in check, make these estimates more reliable and reduce moral hazard.

A30. Some respondents suggested thresholds for existence uncertainty, including 'virtually certain', 'probable' and 'more likely than not'. Views were mixed on whether any such threshold should:

(a) apply symmetrically for assets and liabilities, and for gains and losses.

(b) appear in the definitions or in the recognition criteria.

(c) be the same for both existence uncertainty and outcome uncertainty (see paragraph A36 on thresholds for outcome uncertainty).

A31. Other suggestions on existence uncertainty included:

(a) The decision on how to deal with existence uncertainty should rest with the entity's management, supported by an explanation of the judgements and assumptions made in the decision.

(b) Exchange transactions between unrelated parties could give evidence that an asset exists.

(c) Lack of evidence does not necessarily mean that the probability of existence is low. Strength of evidence is an auditing problem.

Outcome uncertainty

Background

A32. As noted above, the Discussion Paper suggested deleting the existing recognition criterion that states that the inflow or outflow of resources should be probable. However, the Discussion Paper suggested that the *Conceptual Framework* should set out the following indicators 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.

(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.

Summary of feedback

A33. Many respondents agreed that the recognition criteria should not retain the existing reference to probability. They argued that:

(a) It would not be possible to construct probability thresholds that result in useful information for all types of assets and liabilities. The *Conceptual Framework* should not include probability thresholds, but should give guidance on how to construct probability thresholds and recognition criteria on a Standards level. This could explain when recognition is unlikely to be appropriate, and how uncertainty affects relevance and reliability.

(b) Many uncertainties relate to measurement, and some are also questions of the appropriate unit of account. The remaining existence and recognition uncertainties are best dealt with in individual Standards.

(c) Uncertainty should be reflected in measurement, not in recognition criteria. Providing an estimate is a better approach than presenting a zero value. The use of expected values together with suitable disclosures about risk and uncertainty is capable of providing a faithful and useful representation.

(d) Users need the most information about the most uncertain measurements. Uncertainty about future benefit flows is a measurement problem, not a recognition one. The traditional answer to uncertainty has been prudence in measurement, which, properly applied, has considerable merits for risk averse users and for accountability.

(e) Probability of outflow can be removed as a recognition criterion if the practical implications are addressed, particularly whether a meaningful measurement of liabilities is possible for single or low probability items that will be settled (rather than transferred). Problems in individual estimation situations should not be a barrier to recognition, if bulk estimation ameliorates those problems sufficiently.

(f) A probability threshold creates a cliff effect (on-off switch) at the threshold.

(g) A probability threshold means that some entities will recognise an asset or liability while some others faced with similar fact patterns will not. This might harm comparability.

(h) Any thresholds set by the IASB will prevent management from considering carefully how to present relevant information. Management should apply prudence, with a higher threshold for assets than for liabilities, and materiality.

A34. Many other respondents argued that the recognition criteria should continue to refer to probability. They argued that:

(a) Probability has a significant effect on whether information is capable of faithful representation, and also on whether it is relevant. The probability criterion provides a practical and inexpensive ‘sense check’ to filter out items with low probability, which are not relevant to users and costly to identify and measure.

(b) Recognising assets and liabilities that have a low probability of generating inflows or outflows of economic benefits would:

(i) produce information that is not relevant to users, and is complex and less understandable, and lead to divergence in practice. Disclosures are more useful than a measurement that uses weighted averages or fair value;

(ii) require costly and perhaps complex systems, involve significant management time and judgement, and lead to an endless search for potential rights and obligations;

(iii) lead to frequent reversals in subsequent periods when the inflow or outflow does not occur. This will not provide relevant information.

(iv) result in a multitude of items being recognised at small amounts;

(v) lead to wider, and excessive, use of measurements based on expected value techniques, and of fair value measurements.

(vi) intensify measurement problems, because measurement may be sensitive to small changes in probability estimates and to the correlation of benefits or losses with returns from other items. This might lead to accounting that is imprudent, unreliable, difficult to verify and audit, and open to abuse. Some respondents had particular concerns about manipulation when preparers need to resort to the *Conceptual Framework* for guidance in areas that no Standard covers;

(vii) provide an illusion of ‘precision’ that does not exist. There is no faithful representation of a given probability (in the sense of something corresponding to the economic reality it purports to represent). There is only a calculated probability for which the assumptions, the estimated and actual numbers and the methods and calculations can be at best verified or at least judged to be reasonable.

(viii) lead to confusion until market practice drives the calibration of a new benchmark threshold at a new, but not necessarily better, equilibrium.

(ix) result in the recognition of some types of asset and liabilities that are not typically recognised today (outside business combinations). Some expressed concerns about particular items, such as various internally generated intangible assets, exploration projects by a mining entity, requirements to provide additional collateral if a rating downgrade occurs and, as noted in paragraph A27, litigation liabilities.

(c) Probability thresholds are important to continue to assist financial statement users to assess the uncertainty of accounting estimates.

(d) Retaining a probability threshold within the recognition criteria in the *Conceptual Framework* might lead to more consistent recognition decisions on the Standards level.

(e) The removal of the probability criterion would erode the accountant’s professional judgment and replace it with a legalistic interpretation which may not reflect the substance of the underlying transactions.

(f) The Discussion Paper overstates the range of assets and liabilities that would be filtered from recognition by the existing probable criterion. For example, for an obligation to provide a service of standing ready to meet any insurance claim or warranty claim that may arise under a contract with a customer, the economic benefit is the provision of the service, not the payment or receipt of cash that may or may not occur ultimately.

(g) The notion that the probability threshold can be transferred from recognition to measurement is flawed as the choice of measurement model may influence whether an asset or liability is recognised.

A35. Some respondents suggested a probability filter for some assets or liabilities, but not for all:

(a) Where a market price is available or well developed algorithms exist for calculating value, such as for most financial instruments, a probability filter would inappropriately exclude assets such as options.

(b) For non-financial assets, such as patents and research and development with nebulous benefits, a probability filter may be necessary. It is doubtful whether multiplying the estimated chance of success by the estimated pay off would provide a meaningful figure or more reliable information than relevant note disclosure.

(c) In considering whether to use a probability filter in a particular cases, relevant factors could include whether there is a large number of similar objects (for example, product warranties) or a single object (for example, a lawsuit), and the uncertainty in the probability amount of each outcome.

(d) It is not reasonable to remove the probability requirement from the recognition criteria simply to permit the recognition of options. It suffices to stipulate an exception for options in a particular Standard.

(e) Probability thresholds make sense for some assets such as deferred tax assets.

A36. Some respondents suggested thresholds the IASB could consider adopting for outcome uncertainty. These include 'probable', 'more likely than not', 'virtually certain', and 'reasonably possible'. Some drew attention to the wide range of such terms in existing Standards, and suggested that the IASB should reduce their number and define them more clearly. There were mixed views on whether any such thresholds should be applied symmetrically to assets and liabilities, and to gains and losses. (see also paragraph A30 on thresholds for existence uncertainty)

Reliability

A37. Some respondents suggest that the IASB should retain reliability of measurement as an explicit measure criterion. One user representative group commented:

> This is all very confusing! We certainly agree that financial statements should not include information ‘if the level of uncertainty in the estimate is too large’ (section 4.9; see also 4.26). Investors cannot rely upon such information. Indeed if such information is introduced in financial statements, investors will not know what information to trust (even if estimation uncertainty is disclosed in footnotes). Unreliable information will pollute the whole communication process.
>
> The confusing part is the terminology. The issue we are talking about here is reliability of information (to everyone but the IASB?). In the face of universal opposition (including the ICGN), the Board in 2010 removed the term ‘reliability’ from the Conceptual Framework and replaced it by ‘faithful representation’. Ever since, representatives of the IASB have said repeatedly that this is just a change of wording. Faithful representation is supposed to mean the same thing as reliability. Now, the IASB will have to admit that this is not the case. Reliability is suddenly part of relevance.
>
> This raises another issue: If estimation uncertainty is not an aspect of faithful representation, what does faithful representation mean in the current context? No one seems to know the answer to this question. Since we do not understand what it means for a measure to be a faithful representation, we are unable to comment on part (b) in question 8. We note that the document does not include any examples of measurements that are not faithful representations of assets or changes in assets. Such examples would certainly be helpful. *International Corporate Governance Network*

A38. Other proponents of retaining reliability as a recognition criterion provided the following arguments:

(a) Some elements of reliability exist in relevance and faithful representation. However, reliability is a more robust term, which the IASB could define clearly to avoid confusion in its application, and would provide a stronger basis for determining whether assets and liabilities should be recognised.

(b) Reliability is as important as relevance. Sometimes measurement uncertainty is so great that disclosure alone may be more appropriate than recognition. Requiring the recognition of items (or use of measurement bases) with a high degree of estimation uncertainty will confuse users and obscure financial performance, add costs and complexity for preparers, and result in information that is challenging to audit. This contributes to disclosure overload. Disclosures cannot compensate for large margins of errors in measurement, ie for the unreliability of measurement.

(c) Reliability is a key element of faithful representation. The *Conceptual* Framework should state explicitly that no measure will result in a faithful representation if it is not capable of reliable measurement.

(d) If reliability is replaced by faithful representation (defined as complete, neutral and free from error), anything will go as long as you can defend it using the faithful representation or relevance (decision-usefulness) argument. This opens the door to discretionary recognition of income and expenses caused by market price changes that have little to do with the entity's financial performance from a current operating perspective.

(e) Although the *Conceptual Framework* no longer defines reliability, there is no reason why the recognition criteria cannot still use that term.

A39. Many respondents did not comment explicitly on whether to retain reliable measurement as a recognition criterion. Some respondents explicitly opposed its retention. One respondent stated that it is difficult to measure many assets and liabilities that should not be recognised in financial statements, but this is also the case for some for which recognition is appropriate, such as pension deficits or life insurance liabilities. Some favoured the recognition criteria suggested in the Discussion Paper for reasons given in paragraph A13, but did not comment explicitly on reliability.

A40. Agenda paper 10H *Reliability* recommends that the IASB should not replace the qualitative characteristic of faithful representation with reliability, and should not include reference to reliability as either an additional qualitative characteristic or an aspect of either relevance or faithful representation. The following paragraphs discuss two notions linked to reliability: verifiability (paragraphs A41–A42) and prudence (paragraphs A43-A44).

Verifiability

A41. Some respondents suggested that if the recognition criteria do not retain the existing reference to reliability, the remaining recognition criteria must be robust enough to ensure a minimum level of verifiability of recognised assets and liabilities. Thus, the enhancing qualitative characteristic of verifiability should play a role.

A42. A few respondents provided other comments on verifiability:

(a) For an option, the existence of a contract that specifies the details of the contingency, and advanced valuation techniques in option pricing, ensure some minimum level of verifiability, even if there is only a remote possibility of a cash flow. Many other assets or liabilities lack this feature, for example if there is uncertainty about future states of nature that are not clearly defined in a contract (such as uncertainty about future regulation).

(b) The Discussion Paper states that although the term reliability no longer appears in the *Conceptual Framework*, 'much of that concept is covered by the existing *Conceptual Framework*'s fundamental characteristic of faithful representation and its enhancing characteristic of verifiability'. Verifiability, and implicitly enforceability, could be the starting point for further recognition criteria.

Prudence

A43. A few respondents suggested that prudence should play a role in recognition, on the following grounds:

(a) More caution needs to be applied in recognising assets than liabilities. This will improve the quality of financial reports for users and act as a barrier to a potential over-confident bias by preparers.

(b) Timely recognition is more relevant for losses than for gains.

(c) The role of uncertainty interacts with prudence. For example, IAS 37 states that it is extremely rare that a provision cannot be measured reliably. However, for internally generated intangible assets, the preparer must demonstrate that cost can be measured reliably.

A44. Agenda paper 10I *Prudence* discusses whether to reintroduce a reference to prudence in the *Conceptual Framework*.

Appendix B
Other suggestions received

This table summarises some other points raised by respondents. The Staff do not intend to ask the IASB to discuss these issues unless IASB members wish to raise them.

Suggestion received	*Staff reaction*
1. The *Conceptual Framework* should set recognition criteria not just for assets and liabilities, but also for equity instruments, and for income and expenses.	Will consider in drafting
2. If the business model plays a role in recognition, an asset could be recognised by some entities and not recognised by others. For example: (a) a forward contract to buy coal might be an unrecognised executory contract for an energy producer, but might be a recognised financial instrument for a commodities trader. (b) an item which is a specific bundle of rights to one entity with a trading business model may represent a different bundle of rights to another entity with a held-for-use business model.	Will consider in addressing whether this point has any consequences
3. A distinction needs to be made at a Standards level between recognition at a carrying amount of nil and non-recognition.	Will consider in drafting whether to explain that measurement at nil is conceptually equivalent to non-recognition. This may be particularly relevant for executory contracts.

Suggestion received	*Staff reaction*
4. There needs to be some disclosure of all assets and liabilities even if they do not qualify for recognition.	Disclosure would be required if the information is relevant, and if the costs of the disclosure do not exceed the benefits.
5. Any change to recognition and derecognition should not trigger more disclosure requirements.	Disclosure would be required if the information is relevant, and if the costs of the disclosure do not exceed the benefits.
6. For stand-ready obligations that create an exposure to an imminent event that may not occur, recognition overlaps with measurement. For example, consider insurance against an impending windstorm that has not yet occurred. Is this a recognition issue (recognition of possible future losses) or a measurement issue (measurement of the existing obligation)?	This point is too detailed to discuss in the *Conceptual Framework.*
7. Academic research suggests that differences exist in how capital market participants view recognised versus disclosed information. This has been attributed to various reasons including processing costs of footnote disclosures, reliability or quality of information, and behavioural biases. However, the research has limited direct evidence	When the IASB makes recognition decisions, it would need to determine how to assess relevance.

Suggestion received	*Staff reaction*
on the relevance of recognised versus disclosed items. Research on faithful representation is also scarce.	
8. The Discussion Paper set out a proposed objective of measurement in terms of the *Conceptual Framework's* overall objective of financial reporting. The approach to recognition should be explained and developed in the same way, rather than going directly to the qualitative characteristics.	Will consider in drafting
9. For the lottery ticket example in the DP both definition of an asset and criteria for recognition are met, but the measurement should be nil.	Will consider in drafting whether this example has any implications.