STAFF PAPER

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ASAF meeting

Project	**Conceptual Framework**		
Paper topic	Recognition and derecognition		
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Purpose of this meeting

1. The purpose of the discussion at this meeting is to get your initial feedback on the recognition and derecognition proposals in the IASB's Exposure Draft *Conceptual Framework for Financial Reporting* (the 'Exposure Draft').

2. Recognition and derecognition is a major area of the Exposure Draft that we have not previously discussed with the Accounting Standards Advisory Forum ('ASAF') members. We think it is important to get your initial thoughts on this subject. As we have only recently issued the Exposure Draft, we understand that your final comments may differ from those expressed at this meeting. We hope that the discussion will be useful to you as you develop your comment letters on the Exposure Draft.

3. Appendix A to this paper includes relevant paragraphs from the Exposure Draft; Appendix B—from the Basis for Conclusions on the Exposure Draft.

Questions for ASAF members

4. During this session we would like you to discuss the following questions (these questions are included in the Invitation to comment on the Exposure Draft):

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Question 1—Recognition criteria

Do you agree with the proposed approach to recognition? Why or why not? If you do not agree, what changes do you suggest and why? (see paragraphs 5.9–5.24 of Appendix A and paragraphs BC5.5–BC5.48 of Appendix B)

Question 2—Derecognition

Do you agree with the proposed discussion of derecognition? Why or why not? If you do not agree, what changes do you suggest and why? (see paragraphs 5.25–5.36 of Appendix A and paragraphs BC5.49–BC5.59 of Appendix B)

Appendix A—Extracts from the Exposure Draft

The following are extracts from the Exposure Draft *Conceptual Framework for Financial Reporting*.

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Chapter 5—Recognition and derecognition

5.1 This chapter discusses:

(a) the recognition process (paragraphs 5.2–5.8);

(b) recognition criteria (paragraphs 5.9–5.24); and

(c) derecognition (paragraphs 5.25–5.36).

The recognition process

5.2 Recognition is the process of capturing, for inclusion in the statement of financial position or the statement(s) of financial performance, an item that meets the definition of an element. It involves depicting the item (either alone or as part of a line item) in words and by a monetary amount, and including that amount in totals in the relevant statement. (Chapter 7 discusses how recognised amounts are presented and disclosed in the financial statements.)

5.3 Recognising assets, liabilities, equity, income and expenses depicts economic resources and claims, and changes in those resources and claims, in a structured summary that is intended to be comparable and understandable. An important feature of that summary is that the amounts recognised in a statement are included in the totals and, if applicable, subtotals, that give structure to the statement.

5.4 Recognition links the elements, the statement of financial position and the statement(s) of financial performance as follows:

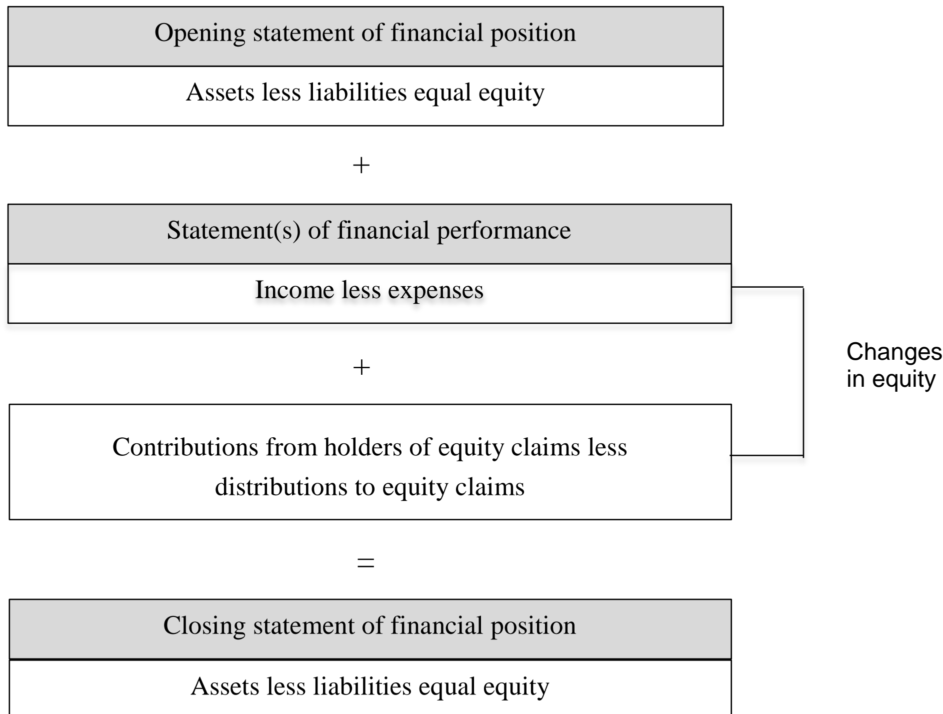
(a) in the opening and closing statements of financial position, total assets less total liabilities equal total equity;

(b) recognised changes in equity during the period comprise:

(i) income less expenses recognised in the statement(s) of financial performance; plus

(ii) contributions from holders of equity claims, less distributions to holders of equity claims.

5.5 This linkage is illustrated in the following diagram:



5.6 The linkage between the statements arises because the recognition of one element (or a change in one element) requires the recognition of an equal amount in one or more other elements (or changes in one or more other elements). For example, income and expenses are recognised in the statement(s) of financial performance only if an increase or decrease in the carrying amount of an asset or a liability is also recognised. Hence, for example:

(a) the recognition of income occurs simultaneously with:

  (i) the initial recognition of an asset, or an increase in the carrying amount of an asset; or

  (ii) the derecognition of a liability, or a decrease in the carrying amount of a liability.

(b) the recognition of expenses occurs simultaneously with:

  (i) the initial recognition of a liability, or an increase in the carrying amount of a liability; or

  (ii) the derecognition of an asset, or a decrease in the carrying amount of an asset.

5.7 Only items that meet the definition of an asset, a liability or equity are recognised in the statement of financial position and only items that meet the definition of income or expenses are recognised in the statement(s) of financial performance. However, the purpose of financial statements is not to show the value of the entity and, therefore, not all assets and liabilities are recognised. The criteria for recognising assets and liabilities are discussed in paragraphs 5.9–5.24. The need for disclosures about unrecognised assets and liabilities is discussed in paragraphs 7.2–7.3.

5.8 The recognition of assets or liabilities arising from transactions or other events sometimes results in the simultaneous recognition of both income and related expenses. For example, the sale of goods for cash results in the recognition of both income (from the recognition of an asset for the customer consideration) and expenses (from the derecognition of the asset comprising the goods that were sold). The simultaneous recognition of income and related expenses is sometimes referred to as the matching of costs with income. The concepts in this [draft] *Conceptual Framework* lead to such matching when it arises from the recognition of changes in assets and liabilities. However, these concepts do not allow the recognition in the statement of financial position of items that do not meet the definition of assets or liabilities.

Recognition criteria

5.9 Failure to recognise items that meet the definition of an element makes the statement of financial position and the statement(s) of financial performance less complete and can exclude useful information from financial statements. On the other hand, in some circumstances, the recognition of some items that meet the definition of an element can provide information that is not useful. An entity recognises an asset or a liability (and any related income, expenses or changes in equity) if such recognition provides users of financial statements with:

(a) relevant information about the asset or the liability and about any income, expenses or changes in equity (see paragraphs 5.13–5.21);

(b) a faithful representation of the asset or the liability and of any income, expenses or changes in equity (see paragraphs 5.22–5.23); and

(c) information that results in benefits exceeding the cost of providing that information (see paragraph 5.24).

5.10 It is not possible to define precisely when recognition of an item that meets the definition of an element will provide useful information to the users of financial statements. What is useful to users depends on the item and the specific facts and circumstances. Consequently, judgement is required when deciding whether to recognise an item and recognition requirements may need to vary between Standards.

5.11 If an item meeting the definition of an element is not recognised, disclosures may be needed. It is important to consider how to make such disclosures sufficiently visible to compensate for the absence of the item from the summary provided by the statement of financial position or the statement(s) of financial performance.

5.12 It is important when making decisions about recognition to consider the information that would be given by not recognising an asset. For example, if no asset is recognised when expenditure is incurred, an expense is recognised. Over time, recognising those expenses may, in some cases, provide useful information, such as information about trends, at a lower cost than recognising an asset.

Relevance

5.13 Information about assets, liabilities, equity, income and expenses is relevant to users of financial statements. However, if one or more of the following factors applies, recognition may not provide relevant information:

(a) if it is uncertain whether an asset exists, or is separable from goodwill, or whether a liability exists (see paragraphs 5.15–5.16);

(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 (see paragraphs 5.17–5.19); or

(c) if a measurement of an asset or a liability is available (or can be obtained), but the level of measurement uncertainty is so high that the resulting information has little relevance and no other relevant measure is available or can be obtained (see paragraphs 5.20–5.21).

5.14 Deciding whether recognition will provide relevant information requires the exercise of judgement. It will often be a combination of the factors described in paragraph 5.13, instead of any single factor, that causes information to lack relevance. Moreover, other factors may also cause information to lack relevance.

Existence uncertainty and separability

5.15 Some assets, for example, rights to benefit from items such as know-how and customer or supplier relationships, are not contractual or other legal rights. It may therefore be uncertain whether there is an asset or whether it is separable from the business as a whole (that is, it may be unclear whether there is an asset distinct from goodwill). In some such cases, uncertainty about the existence of an asset combined with the difficulty of separately identifying the asset may mean that recognition may not provide relevant information.

5.16 For some liabilities, it may be unclear whether a past event causing an obligation has occurred. For example, if another party claims that the entity has committed an act of wrongdoing and should compensate the other party for that act, it may be uncertain whether the act occurred or whether the entity committed it. In some such cases, the uncertainty about the existence of an obligation, possibly combined with a low probability of outflows of economic benefits and a high level of measurement uncertainty, may mean that the recognition of a single amount would not provide relevant information. Whether or not the liability is recognised, disclosures about the uncertainties associated with the liability may be needed.

Low probability of a flow of economic benefits

5.17 An asset or a liability can exist even if there is a low probability that there will be an inflow or outflow of economic benefits (see paragraphs 4.13 and 4.27).

5.18 Even if the probability of an inflow or outflow of economic benefits is low, recognition of the asset or the liability may provide relevant information, especially if the measurement of the asset or the liability reflects the low probability and is accompanied by explanatory disclosures. For example, if an asset is acquired, or a liability is incurred, in an exchange transaction for an observable price, its cost reflects the low probability that economic benefits will flow and that cost may be relevant information.

5.19 However, users of financial statements may, in some cases, not find it useful for an entity to recognise assets and liabilities with very low probabilities of inflows and outflows of economic benefits.

Measurement uncertainty

5.20 To be recognised, an asset or a liability must be measured. In many cases, measurements must be estimated and are subject to uncertainty. The use of reasonable estimates is an essential part of the preparation of financial statements and does not necessarily undermine their usefulness. A faithful representation is achieved if amounts that are estimates are described as such, and the nature and level of uncertainties, if material, are disclosed in the notes to the financial statements.

5.21 As noted in paragraph 2.13, for some estimates, a high level of measurement uncertainty may contribute to the resulting information having little relevance, even if the estimate is properly described and disclosed. For example, a measurement may not provide relevant information if:

(a) the range of possible outcomes is extremely wide and the likelihood of each outcome is exceptionally difficult to estimate. In such cases, the most relevant information for users of financial statements may relate to the range of outcomes and the factors affecting their likelihoods. When that information is relevant (and can be provided at a cost that does not exceed the benefits), disclosure of that information in the notes to the financial statements may be appropriate, regardless of whether the entity also recognises the asset or the liability. However, in some cases, trying to capture that information in a single number may not provide any further relevant information. In such cases, if no relevant measure is available, or can be obtained, recognition would not provide relevant information.

(b) 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.

Faithful representation

5.22 Faithful representation of assets, liabilities, equity, income and expenses involves not only recognition, but also the measurement, presentation and disclosure of information about the items recognised (see Chapters 6–7).

5.23 Hence, when assessing whether the recognition of an asset or a liability can provide a faithful representation of the asset or the liability, it is necessary to consider not merely its description and measurement on the face of the statement of financial position, but also:

(a) the depiction of resulting income, expenses or equity; for example, if an entity acquires an asset in exchange for consideration, the failure to recognise the asset would result in an expense and reduce the entity's profit and equity. In some cases, for example, if the entity does not consume the asset immediately, that result could provide a misleading representation that the entity's financial position has deteriorated.

(b) whether related assets and liabilities are recognised. If related assets and liabilities are not recognised, recognition may lead to an 'accounting mismatch', which may not provide an understandable or faithful representation of the overall effect of the transaction or other event giving rise to the asset or the liability, even if explanatory disclosure is provided in the notes to the financial statements.

(c) related disclosures: a complete depiction includes all information necessary for a user of financial statements to understand the phenomenon being depicted, including all necessary descriptions and explanations. Hence, related disclosures can enable a recognised amount to form part of a faithful representation of an asset, liability, equity claim, income or expenses.

Cost

5.24 As with all other areas of financial reporting, cost constrains recognition decisions. There is a cost to recognising an asset or a liability. Preparers of financial statements incur costs in obtaining a relevant measure. Users of financial statements also incur costs in analysing and interpreting information. In some cases, the cost of recognition may outweigh the benefits.

Derecognition

5.25 Derecognition is the removal of all or part of a previously recognised asset or liability from an entity's statement of financial position. For an asset, this normally occurs when the entity loses control of all or part of the previously recognised asset; for a liability this normally occurs when the entity no longer has a present obligation for all or part of the previously recognised liability.

5.26 Accounting requirements for derecognition aim to represent faithfully both:

(a) the assets and liabilities retained after the transaction or other event that led to the derecognition (including any asset or liability acquired, incurred or created as part of the transaction or other event); and

(b) the change in the entity's assets and liabilities as a result of that transaction or other event.

5.27 Those aims are normally achieved by:

(a) derecognising any assets or liabilities that have been transferred, consumed, collected or fulfilled, or have expired and recognising any resulting income or expense.

(b) continuing to recognise the assets or liabilities retained, if any (the retained component), which become a separate unit of account. Accordingly, no income or expenses are recognised on the retained component as a result of the derecognition of the transferred component.

5.28 If an entity transfers a previously recognised asset or liability to another party that is acting as its agent (see paragraph 4.23), then the asset is still controlled by the transferor (the liability is still an obligation of the transferor) and derecognition would not faithfully represent the transferor's assets, liabilities, income and expenses.

5.29 If an entity retains exposure to positive or negative variations in the amount of economic benefits produced by an economic resource, this may indicate that the entity retains control of that economic resource, in which case, derecognition is not appropriate.

5.30 It may sometimes be difficult to achieve both aims mentioned in paragraph 5.26, for example:

(a) if the retained component contains a disproportionate exposure to variations in economic benefits, derecognition may faithfully represent the fact that the entity no longer has the components that have been transferred, but may not faithfully represent the extent of the change in the entity's assets or liabilities as a result of the transaction.

(b) sometimes, at the same time as transferring an asset, the entity enters into another transaction (for example, a forward contract, a written put option, or a purchased call option) under which the entity must or may reacquire the asset. Because the component that has been transferred must or may be reacquired, derecognising it may misrepresent the extent of the change in the entity's financial position.

5.31 In some of the circumstances described in paragraph 5.30, derecognition may achieve the two aims described in paragraph 5.26 if supported by separate presentation, or explanatory disclosure, in the notes to the financial statements; for example, to highlight any greater concentration of risk in the retained component.

5.32 However, if derecognition supported by separate presentation, or explanatory disclosure, is not sufficient to achieve those two aims, there may be a need to continue to recognise not only the retained component, but also the transferred component. In applying this approach:

(a) no income or expenses are recognised on either component as a result of the transaction;

(b) a liability (or asset) is recognised and measured initially at the amount of any proceeds received (or paid) upon transfer of the asset (or liability); and

(c) separate presentation, or explanatory disclosure, is needed to depict the fact that the entity no longer has any rights or obligations under the transferred component.

Modification of contracts

5.33 One case in which questions about derecognition arise is when a contract is modified. Modifications of contracts may do one or both of the following:

(a) reduce or eliminate existing rights and obligations. The discussion in paragraphs 5.25–5.32 is relevant in deciding whether to derecognise those rights or obligations.

(b) add new rights or new obligations.

5.34 If a modification to a contract adds rights and obligations that are distinct from those created by the original terms of the contract, it may be appropriate to treat the additions as new assets or liabilities.

5.35 If the rights and obligations added to a contract by a modification are not distinct from those arising under the original terms of the contract, it may be appropriate to treat the new rights and obligations as part of the same unit of account as the existing rights and obligations.

5.36 Some modifications of contracts both reduce or eliminate existing rights and obligations and add new rights and obligations. To provide the most relevant information about such modifications in the way that most faithfully represents their effect, it is necessary to consider their combined effect and not merely consider them separately.

Appendix B—Extracts from the Basis for Conclusions

The following are extracts from the Basis for Conclusions on the Exposure Draft *Conceptual Framework for Financial Reporting*.

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Chapter 5—Recognition and derecognition

Recognition process (paragraphs 5.2–5.8)

BC5.1 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 [of the existing *Conceptual Framework*]. 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]

BC5.2 There are three 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 are inconsistent with 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.

BC5.3 To address these minor points, the Exposure Draft adapts the existing definition to read as follows:

> Recognition is the process of capturing, for inclusion in the statement of financial position or statement(s) of financial performance, an item that meets the definition of an element. It involves depicting the item (either alone or as part of a line item) in words and by a monetary amount, and including that amount in the relevant statement.

BC5.4 The IASB also proposes to explain in the *Conceptual Framework* how recognition links the statement of financial position and the statement(s) of financial performance.

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1 See paragraph 4.37 of the existing *Conceptual Framework*.

Recognition criteria (paragraphs 5.9–5.24)

Existing requirements

BC5.5 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.

BC5.6 In addition, as with all other aspects of the existing *Conceptual Framework*, the cost constraint applies. Thus, an asset or a liability is not recognised if the benefits of recognition do not justify the costs.

BC5.7 The existing criteria have caused some problems, which are discussed in the following paragraphs.

Problems with probability criterion

BC5.8 Some existing Standards do not apply a probability recognition criterion, for example, IFRS 9 *Financial Instruments*. Those that do apply such a criterion use different probability thresholds. These include ‘probable’, ‘more likely than not’, ‘virtually certain’ and ‘reasonably possible’. The use of the different terms indicates a lack of consistency in the meaning attached at the Standards-level to the term probable used in the *Conceptual Framework*.

BC5.9 Some have argued that a probability recognition criterion could prevent the recognition of some financial instruments, for example, derivatives. Moreover, it could sometimes result in a gain being recognised for a transaction when no economic gain has occurred. For example, suppose that, in exchange for receiving cash, an entity incurs a liability to pay a fixed amount if some unlikely event occurs in the future. If an outflow of economic benefits is not considered probable, the entity will recognise an immediate gain when it receives the cash.

Problems with reliable measurement criterion

BC5.10 Using reliable measurement as a criterion could be confusing because reliability is not identified as a qualitative characteristic (see paragraphs BC2.21–BC2.25).[2] In practice, the criterion seems to have been interpreted as relating to measurement uncertainty. Hence, a broadly similar result can be achieved by acknowledging that, in some cases, the level of measurement uncertainty can affect the relevance of the information provided by recognising a particular asset or liability (see paragraphs BC5.41–BC5.45).

Approach in the Discussion Paper

BC5.11 The Discussion Paper[3] suggested that the discussion of whether to recognise an asset or a liability should refer directly to the qualitative characteristics of useful financial information. Accordingly, an entity would recognise all its assets and liabilities, unless the IASB decides when developing 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 both of the asset (or the liability) and of the changes in the asset (or the liability), even if all necessary descriptions and explanations are disclosed.

BC5.12 The Discussion Paper also suggested that the *Conceptual Framework* should list the following indicators explaining when recognition may produce information that does not possess those qualitative characteristics:

(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;

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[2] Note for ASAF members: In this Exposure Draft the IASB proposes not to reinstate the term reliability as a label for the qualitative characteristic now called faithful representation.

[3] Note for ASAF members: References to the Discussion Paper are to the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* published in July 2013.

(c) if identifying a 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; and

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

Responses to the Discussion Paper

BC5.13 Some respondents believed that the suggestions in the Discussion Paper were intended to increase the range of assets and liabilities recognised and expressed concerns about that outcome. However, in developing the Discussion Paper, and subsequently the Exposure Draft, the IASB's aim has been solely to develop tools that enable it to take decisions based on a more coherent set of principles, which result in useful information. The IASB has not had, and does not have, an objective of either increasing or decreasing the range of assets and liabilities recognised, although the proposed guidance on the definition of a liability might broaden slightly the population of items identified as meeting that definition.

BC5.14 With regard to the overall direction, some respondents favoured recognising all, or almost all, assets and liabilities:

(a) a few respondents suggested that an entity should recognise all its assets and liabilities, with no exceptions. They argued that this would promote completeness, comparability, consistency and conceptual integrity in financial reporting.

(b) a few other respondents suggested that the *Conceptual Framework* should not provide for departures from the general principle that an entity should recognise all assets and liabilities. If limited exceptions are needed, they could be developed in particular Standards by referring to the qualitative characteristics of useful financial information.

(c) some respondents suggested that the *Conceptual Framework* should establish a rebuttable presumption that all assets and liabilities should be recognised. They indicated that recognition would generally result in the most relevant information.

BC5.15 However, most respondents believed that it is neither relevant nor feasible for an entity to recognise all of its assets and liabilities and that the *Conceptual Framework* should acknowledge this:

(a) some respondents felt that recognition should occur only when there is clear evidence that it provides a relevant and faithful representation. The concerns of those respondents centred on particular items, such as some litigation liabilities and some intangible assets, for which they viewed recognition as inappropriate. They also expressed a wish to avoid any requirements that could result in a time-consuming and costly search to identify all possible assets and liabilities.

(b) others argued that the *Conceptual Framework* should provide criteria for when to recognise assets and liabilities, because:

(i) delegating these decisions to specific Standards may lead to inconsistencies between Standards and create rules instead of principles.

(ii) such criteria would assist preparers and others who need guidance to help them decide when to recognise an asset or a liability that no Standard covers. The use of these criteria by parties other than the IASB should cause no concerns, because the *Conceptual Framework* does not override recognition criteria in Standards.

BC5.16 The IASB concluded that the *Conceptual Framework* should take an even-handed approach to recognition, with neither:

(a) a presumption that all assets and liabilities should be recognised; nor

(b) a presumption that assets and liabilities should be recognised only if they meet stringent criteria.

Instead, the *Conceptual Framework* should simply set out criteria based on the qualitative characteristics and describe the factors that drive recognition decisions.

BC5.17 Many respondents to the Discussion Paper agreed that:

(a) the approach to recognition should refer to relevance and faithful representation;

(b) the *Conceptual Framework* should acknowledge that significant uncertainty and significant measurement difficulties may undermine relevance and make it difficult to provide a faithful representation; and

(c) the cost constraint should play a role in recognition decisions.

BC5.18 Respondents who commented on recognition were evenly divided on how best to refer to relevance and faithful representation and how best to acknowledge the effects of significant uncertainty and significant measurement difficulties:

(a) some favoured retaining one or both of probability and reliability of measurement as explicit recognition criteria. They argued that such criteria are suitable filters to be used in practice for identifying cases in which recognition is not likely to provide information that possesses the qualitative characteristics of useful financial information. There were considerably more requests to retain an explicit probability criterion than requests to retain an explicit reliability criterion.

(b) others favoured the approach suggested by the Discussion Paper, namely to refer more directly to the qualitative characteristics and supplement this by guidance.

BC5.19 Proponents of using probability and reliability as practical filters argued that these criteria would be clearer, more robust and less judgemental than the approach suggested in the Discussion Paper. Some feared that the lack of robust criteria would result in broader, and excessive, recognition of assets and liabilities.

BC5.20 The IASB continues to think that referring directly to the qualitative characteristics of useful financial information is appropriate. Basing recognition criteria on the qualitative characteristics should result in useful information. Nevertheless, the IASB thinks that merely referring directly to the qualitative characteristics, without providing supporting guidance, could lead to inconsistent recognition decisions at the Standards level.

BC5.21 Paragraph 5.9 of the Exposure Draft sets out the IASB's proposed recognition criteria, which refer to:

(a) relevance (see paragraphs BC5.22–BC5.45);

(b) faithful representation (see paragraphs BC5.46–BC5.47); and

(c) the cost constraint (see paragraph BC5.48).

Relevance (paragraphs 5.13–5.21)

BC5.22 The guidance supporting the proposed recognition criteria lists the following indicators to help in identifying some of the cases when recognising an asset or a liability may not provide users of financial statements with relevant information:

(a) if it is uncertain whether the asset exists, or is separable from goodwill, or whether a liability exists (see paragraphs BC5.25–BC5.35);

(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 (see paragraphs BC5.36–BC5.40); or

(c) if a measurement of an asset or a liability is available (or can be obtained) but the level of measurement uncertainty is so high that the resulting information has little relevance and no other relevant measure is available or can be obtained (see paragraphs BC5.41–BC5.45).

Those indicators cover some (but not necessarily all) cases in which the recognition criteria in the existing *Conceptual Framework* might have led to a conclusion that a flow is not probable or that reliable measurement is not possible.

BC5.23 The indicators are derived from indicators suggested by the Discussion Paper (see paragraph BC5.12). Some respondents stated that:

(a) it would be useful to explain how the qualitative characteristics might be applied in recognition, but that indicators are not necessary to achieve this.

(b) the indicators, and supporting examples illustrating how the indicators might be applied, do not provide concepts. The *Conceptual Framework* should contain clear concepts.

BC5.24 Other respondents stated that such indicators are essential to make the recognition criteria sufficiently robust. The IASB continues to agree with that

view. However, to avoid providing Standards-level detail, the IASB has deleted the specific examples that the Discussion Paper had provided as illustrations of how the indicators might be applied.

Existence uncertainty (paragraphs 5.15–5.16)

BC5.25 The definitions of assets and liabilities allow for uncertainty about whether the inflows or outflows of economic benefits will ultimately occur (see paragraphs BC4.11–BC4.17)[4]. But there could also be uncertainty over the existence of an asset or a liability.

BC5.26 Feedback on the Discussion Paper's discussion on existence uncertainty focused on:

(a) whether to distinguish existence uncertainty from outcome uncertainty (see paragraphs BC5.27–BC5.31); and

(b) whether the *Conceptual Framework* should address existence uncertainty (see paragraphs BC5.32–BC5.34).

BC5.27 Several respondents commented explicitly that it is useful to differentiate between existence uncertainty and outcome uncertainty. Doing so would clarify how to deal with both types of uncertainty.

BC5.28 Other respondents stated that it can be difficult to distinguish the two types of uncertainty. They often occur together and hence need to be dealt with together.

BC5.29 In the IASB's view, it is helpful to distinguish existence uncertainty from outcome uncertainty. Making this distinction makes it easier to decide what information is most likely to be relevant to users of financial information and how to provide the most faithful and understandable representation of that information. Outcome uncertainty affects many assets and liabilities. Although outcome uncertainty does not always cause measurement uncertainty, it may sometimes contribute to measurement uncertainty. It could therefore affect decisions about recognition and the selection of a measurement basis. Existence uncertainty, on the other hand, may be a separate factor to consider for decisions about recognition.

[4] Note for ASAF members: Paragraphs BC4.11–BC4.17 discuss why the IASB has proposed replacing the notion that an inflow or outflow of resources is expected with the notion that an asset (or a liability) is capable of generating economic benefits (or requiring a transfer of economic resources).

BC5.30 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 the inappropriate recognition of liabilities for actual or potential claims under lawsuits.

(b) constructive obligations, because there is no contract or legislation that establishes the liability.

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

(d) items acquired or incurred in non-monetary exchange transactions.

BC5.31 Although the vast majority of assets and liabilities are not typically subject to existence uncertainty, the IASB agrees that existence uncertainty is not rare so that statement is not included in the Exposure Draft.

BC5.32 Several respondents agreed with the suggestion in the Discussion Paper that the *Conceptual Framework* should not set a probability threshold for cases in which it is uncertain whether an asset or a liability exists. The IASB could decide how to deal with that uncertainty when the IASB develops or revises a Standard on that type of asset or liability.

BC5.33 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. Dealing with existence uncertainty in individual Standards could lead to an unnecessary proliferation of Standards and inconsistencies.

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

BC5.34 The Exposure Draft lists uncertainty over whether an asset or a liability exists as one of the indicators that may lead to a conclusion that recognition of that asset or liability may not produce relevant information. The IASB believes that it would not be useful to provide more detailed guidance on how to address

existence uncertainty, because the relevant factors are likely to depend very much on particular circumstances.

Separability from goodwill

BC5.35 The Discussion Paper stated that, because the recognition of internally generated goodwill would require a valuation of the entity as a whole, its recognition is unnecessary to meet the objective of financial reporting. Although the IASB continues to believe that this statement is valid, the Exposure Draft does not include this case as an indicator that recognition might not result in relevant information. The IASB agrees with those respondents who argued that such an indicator is not useful because it applies only to internally generated goodwill. However, the IASB concluded that difficulty in assessing whether an asset exists separately from the business as a whole (that is whether there is an asset distinct from goodwill) is a factor that could indicate that recognition of the asset would not provide relevant information.

Low probability of a flow of economic benefits

BC5.36 As noted, the existing *Conceptual Framework* includes a probability-based recognition criterion. The Discussion Paper suggested that this should be removed and many respondents agreed. 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 at a Standards level. This guidance could explain when recognition is unlikely to be appropriate and how uncertainty affects relevance and reliability.

(b) many uncertainties relate to measurement and can be dealt with by choosing an appropriate measurement basis.

(c) a probability threshold has a disproportionate effect when an item crosses the threshold. The economic change that causes the item to cross the threshold may be small, but the resulting accounting effect could be large.

(d) any thresholds set by the IASB will prevent management from considering carefully how to present relevant information. Management should apply materiality and a higher threshold for recognising assets than for liabilities.

BC5.37 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 way to filter out assets and liabilities with low probability, which are not relevant to users and are costly for preparers 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 hard to understand. For example, it could result in a multitude of items being recognised at small amounts or lead to frequent reversals in subsequent periods when the inflow or outflow does not occur.

(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 wider, and excessive, use of measurements based on expected value techniques, and of fair value measurements. Disclosures are sometimes more useful than a measure that uses weighted averages or fair value. Such measures provide an illusion of 'precision' that does not exist.

(iv) intensify measurement problems, because measurement may be sensitive to small changes in probability estimates.

(c) retaining a probability threshold within the recognition criteria in the *Conceptual Framework* may lead to more consistent recognition decisions in Standards.

(d) 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 or warranty claim by a customer, the economic resource transferred is the service provided, not the payment or receipt of cash that may or may not occur ultimately.

BC5.38 Some respondents suggested applying a probability filter for some assets or liabilities, but not for all. For example:

(a) a probability filter may be necessary for non-financial assets with uncertain benefits, such as patents and research and development. For these items, 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 providing information in the notes. Moreover, for these items, it may not be possible to make reasonable estimates of the probabilities of each outcome. On the other hand, a probability filter could inappropriately exclude assets such as options or other financial instruments for which a market price is available or for which well-developed measurement models exist.

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

(c) it is not reasonable to remove the probability requirement from the recognition criteria simply to permit the recognition of some financial instruments. In such cases, it is only necessary to stipulate an exception for particular financial instruments in a particular Standard.

BC5.39 The IASB acknowledges that a probability threshold could be a practical way to filter out assets and liabilities whose recognition would not provide relevant information. However, an explicit, specified probability threshold is not sufficiently aligned with the concept (relevance) that it is supposed to achieve. Too many assets and liabilities would not be recognised when recognition would

have provided relevant information. The IASB also noted that the measure of any recognised asset or liability with a low probability of an inflow or outflow would be likely to reflect that low probability—it is unlikely that a required measurement basis would reflect only the maximum inflow or outflow.

BC5.40 Hence, the Exposure Draft does not propose a specific probability threshold. Instead, low probability is noted in the Exposure Draft as an indicator that recognition may sometimes not provide relevant information, for reasons discussed in paragraphs 5.17–5.19 of the Exposure Draft.

Measurement uncertainty and reliability

BC5.41 The recognition criteria in the existing *Conceptual Framework* state that an entity recognises an asset or a liability only if it has a cost or value that can be measured with reliability.

BC5.42 As previously noted, the Discussion Paper suggested that reliability should no longer be a recognition criterion. Many respondents did not comment explicitly on reliability. However, some respondents explicitly opposed the retention of reliable measurement as a recognition criterion. They felt that it may inappropriately preclude the recognition of some assets and liabilities that are subject to considerable measurement uncertainty, such as pension liabilities and insurance liabilities.

BC5.43 In contrast, other respondents suggested retaining reliability of measurement as an explicit recognition criterion. They provided the following arguments, which focused on cases of high measurement uncertainty:

(a) including unreliable estimates would obscure financial performance, confuse users, undermine their trust in financial statements and pollute the whole communication process, even if estimation uncertainty is disclosed in footnotes. Disclosures cannot compensate for large margins of errors in measurement. Moreover, disclosures about estimation uncertainty would contribute to disclosure overload.

(b) some elements of reliability exist in relevance and faithful representation. However, reliability would provide a more understandable and operational basis for determining whether assets and liabilities should be recognised.

(c) reliability is as important as relevance, and there is a trade-off between them. Consequently, if relevance is used as a recognition filter, then so should be reliability. Reliable information may not always be relevant, and relevant information may not always be reliable.

(d) reliability is a key element of faithful representation. No measure will result in a faithful representation if it is not capable of reliable measurement.

(e) recognition of items measured with a high degree of estimation uncertainty adds costs and complexity for preparers and results in information that is difficult to audit.

(f) if reliability is replaced as a recognition criterion by faithful representation (defined as complete, neutral and free from error), anything could be recognised. This is because any estimate, however uncertain, could be faithfully represented if supported by sufficient disclosure about the estimation process.

(g) although the *Conceptual Framework* no longer defines reliability as a qualitative characteristic, there is no reason why the recognition criteria cannot still use that term.

BC5.44 The IASB proposes in the Exposure Draft not to retain reliability as a recognition criterion, because:

(a) the concerns expressed by some respondents about the removal of ‘reliability’ as a recognition criterion appear to relate mainly to concerns about measurement uncertainty. Paragraph QC16 of the existing *Conceptual Framework* already captures the idea that an estimate might not provide relevant information if the level of uncertainty in the estimate is too high. The IASB proposes to make this idea more visible (see paragraphs 2.12–2.13 and BC2.21–BC2.25). The IASB also proposes that measurement uncertainty should be discussed as an indicator that recognition may not provide relevant information.

(b) the former notion of a trade-off between relevance and reliability still exists, but is now captured by a trade-off within relevance itself. As explained in paragraphs 2.13 and BC2.24(c), there is sometimes a trade-

off between measurement uncertainty (which is a factor that affects relevance) and other factors that also affect relevance.

BC5.45 Some respondents to the Discussion Paper suggested that more measurement uncertainty is tolerable when recognising expenses than when recognising income. They described this as an application of asymmetric prudence (applying the terminology in paragraph BC2.6), not cautious prudence. The IASB thinks that the level of measurement uncertainty that makes a measure lose relevance depends on the circumstances and can be determined only when developing specific Standards. Hence, the *Conceptual Framework* neither requires nor prohibits a symmetrical approach that would set the same level of measurement uncertainty as being tolerable for the recognition of both income and expenses.

Faithful representation (paragraphs 5.22–5.23)

BC5.46 The Discussion Paper suggested that faithful representation could be used as a recognition criterion (see paragraph BC5.11). A few respondents commented on this:

(a) the recognition criteria need not refer separately to faithful representation. There are no circumstances when recognising an asset or a liability would provide information that is relevant but yet could not result in a faithful representation of that asset or liability and of changes in that asset or liability, given adequate disclosure.

(b) if measurement uncertainty is part of relevance, not of faithful representation, it is not clear what faithful representation means. The Discussion Paper included no examples of measurements that are not faithful representations of assets or changes in assets.

(c) the Discussion Paper suggested that one case in which information is not relevant (or does not give a faithful representation of what it is trying to depict) is if it 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.

BC5.47 The IASB continues to think that faithful representation is a necessary factor to consider when deciding whether to recognise an element. In particular, problems may arise in giving a faithful representation of a transaction or other event when

some of the assets or liabilities affected by the transaction or other event are not recognised. Partial recognition of the effects of the transaction or other event (ie the effect only on the recognised assets and liabilities) may give a misleading depiction of the effect of the transaction.

Cost constraint (paragraph 5.24)

BC5.48 Paragraph BC2.33 explains why there is an explicit reference to the cost constraint in the chapter on recognition.[5]

Derecognition (paragraphs 5.25–5.36)

BC5.49 The existing *Conceptual Framework* does not define derecognition, nor does it describe when derecognition should occur. Because there is no agreed conceptual approach to derecognition, different Standards have adopted different approaches.

BC5.50 The IASB suggested in the Discussion Paper, and proposes again now in the Exposure Draft, that accounting requirements for derecognition should aim to represent faithfully both:

(a) the assets and the liabilities retained after the transaction or other event that led to the derecognition; and

(b) the changes in the assets and the liabilities as a result of the transaction or other event.

BC5.51 Achieving that twin aim is straightforward if an entity disposes of an entire asset or an entire liability and retains no exposure to that asset or liability, but can be more difficult if an entity disposes of only part of an asset or a liability or retains some exposure.

BC5.52 The following two examples illustrate some difficulties that can arise. In both examples, derecognising the asset would result in accounting that faithfully represents any asset or liability retained. However, it may sometimes misrepresent the extent of the changes in the entity's financial position:

[5] Note for ASAF members: Paragraph BC2.33 notes that the cost constraint plays a particularly important role in decisions about the unit of account, recognition, measurement and presentation and disclosure.

(a) sale of receivables with recourse—suppose that an entity sells some receivables to another party, but guarantees the third party against any credit losses it may incur on the receivables. If the entity derecognises the receivables and recognises its obligation under the guarantee as a liability, that may significantly reduce the total assets and total liabilities recognised in the statement of financial position, even though the credit risk is unchanged.

(b) sale and repurchase agreement—suppose that an entity sells an asset and at the same time contracts to buy it back at a fixed price. Derecognising the asset could suggest that the entity's asset mix has changed significantly, even though the change is only temporary and will be reversed. In addition, if the asset is measured on a historical cost basis, derecognising the asset would lead to the recognition of income and expenses at the time of the original sale, and then a corresponding increase or decrease in the carrying amount of the asset when the repurchase is completed.

BC5.53 In the Discussion Paper, the IASB discussed two approaches to derecognition when the entity retains a component of the asset or the liability:

(a) a control approach—derecognition is simply the mirror image of recognition. Thus, an entity would derecognise an asset or a liability when it no longer meets the criteria for recognition (or no longer exists, or is no longer an asset or a liability of the entity).

(b) a risks-and-rewards approach—an entity would continue to recognise an asset or a liability until the entity is no longer exposed to most of the risks and rewards generated by that asset or liability. This would apply even if the remaining asset (or liability) would not qualify for recognition if acquired (or incurred) separately at the date when the entity disposed of the other components.

BC5.54 The IASB concluded in the Discussion Paper that neither approach would necessarily produce the most useful information in all circumstances. Instead, the IASB suggested that:

(a) an entity would, in most cases, achieve the twin aim described in paragraph BC5.50 by derecognising an asset or a liability when it no longer meets the recognition criteria (or no longer exists, or is no longer an asset or a liability of the entity); but

(b) if the entity retains a component of the asset or the liability, the IASB should determine, when developing particular Standards, how the entity would best portray the changes that resulted from the transaction. The Discussion Paper suggested that possible approaches for this could include:

(i) enhanced disclosure;

(ii) presenting any rights or obligations retained on a line item different from the line item that was used for the original rights or obligations, to highlight the greater concentration of risk; or

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

BC5.55 Views of the respondents to the Discussion Paper were mixed. Some respondents favoured the control approach (possibly including risks and rewards as an indicator of control). Other respondents favoured the risks-and-rewards approach. Yet other respondents stated that the *Conceptual Framework* should discuss both approaches, including the relative merits of the approaches, and indicate when each should be used.

BC5.56 The IASB noted that it is possible to resolve some, but not all, apparent conflicts between the control approach and the risks-and-rewards approach by considering:

(a) whether a transferee acquires an asset as a principal or as an agent; and

(b) the fact that, in some cases, continuing exposure to variations in benefits (sometimes known as exposure to the significant risks and rewards of ownership) is an indicator of continuing control.

BC5.57 In the IASB's view, the control approach focuses more on the aim mentioned in paragraph BC5.50(a) and the risks-and-rewards approach focuses more on the aim mentioned in paragraph BC5.50(b). The difficulties that the IASB has

encountered in practice have arisen when those two aims conflict. The IASB views both aims as valid. Accordingly, the Exposure Draft does not advocate using the control approach or the risk-and-rewards approach in all circumstances. Instead, the Exposure Draft describes the alternatives available and discusses what factors the IASB would need to consider when developing particular Standards.

BC5.58 The Discussion Paper also discussed factors that the IASB should consider in deciding which approach to use when derecognition occurs: partial derecognition (derecognise the transferred component and continue to recognise the retained component) or full derecognition (derecognise the entire asset or liability and recognise the retained component as a new asset or liability). The Exposure Draft does not discuss this aspect of derecognition, because it is closely linked to issues of determining the unit of account and selecting the measurement basis for the retained component.

Modification of contracts (5.33–5.36)

BC5.59 The Discussion Paper did not discuss how modifications of contracts would affect decisions about derecognition. As requested by some respondents to the Discussion Paper, the Exposure Draft proposes some guidance on this topic. The guidance is consistent with the sections in the Exposure Draft on the unit of account and on reporting the substance of contractual rights and obligations.