STAFF PAPER

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

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Purpose of session

1. The purpose of this session is to hear the views of GPF members on some of the proposed changes to the IASB's *Conceptual Framework*.

2. The changes on which we would like to hear views are those affecting:
   (a) the *definitions* of assets and liabilities,
   (b) concepts for *recognition and derecognition* of assets and liabilities, and
   (c) additional concepts to support the *liability* definition.

Background

3. In May 2015, the IASB published an Exposure Draft of proposed changes to its *Conceptual Framework*. The Exposure Draft is available on the IASB website at http://go.ifrs.org/ED-CF-May2015. The IASB has requested comments by 25 November 2015.

4. The Exposure Draft proposals include:
   (a) limited changes to the chapters on the objective of financial reporting and the qualitative characteristics of useful financial information. These changes would:

(i) give more prominence to the importance of providing information needed to assess management's *stewardship* of the entity's resources;

(ii) reintroduce an explicit reference to the notion of *prudence*; and

(iii) state more explicitly that a faithful representation requires an entity to report the *economic substance* of an economic phenomenon, not merely its legal form.

(b) *on the definitions of the elements of financial statements:* changes to the definitions of an asset and a liability, and additional concepts to support those definitions;

(c) *on recognition:* a new approach for making decisions about whether a particular asset or liability should be included ('recognised') in the statement of financial position;

(d) *on derecognition*: concepts to guide decisions on the circumstances in which a particular asset or liability should be removed ('derecognised') from the statement of financial position;

(e) *on measurement*: a discussion of different measurement bases and factors to consider when selecting a measurement basis; and

(f) *on reporting financial performance*: a description of the statement of profit or loss as the primary source of information about an entity's financial performance, and guidance to help the IASB decide which items of income and expense should be reported outside the statement of profit or loss and included in other comprehensive income.

5. At its meeting in June 2015, the GPF discussed the Exposure Draft proposals on measurement and reporting financial performance. The GPF has not previously discussed the Exposure Draft proposals on the asset and liability definitions, recognition and derecognition—its previous discussions of these topics took place in 2013, when the IASB was at the stage of developing tentative views and publishing them in a Discussion Paper.

Definitions of assets and liabilities

Proposed definitions

6. The definitions proposed in the Exposure Draft are substantially the same as those developed in the 2013 Discussion Paper.

7. The Exposure Draft proposes to replace the notion of 'expected' economic benefits with a notion of 'potential' economic benefits, and to define an economic resource as a 'right':

	Existing definitions	Proposed definitions
Asset (of an entity)	A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.	A present economic resource controlled by the entity as a result of past events.
Liability (of an entity)	A present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.	A present obligation of the entity to transfer an economic resource as a result of past events.
Economic resource	Not defined	A right that has the potential to produce economic benefits.

8. The Exposure Draft notes that the rights that constitute economic resources can take various forms, including:

Rights established by contract, legislation or similar means, such as:

- Rights arising from financial instruments
- Rights over physical objects such as property, plant and equipment
- Rights to benefit from the stand-ready obligations of other parties
- Rights to receive goods and services
- Intellectual property rights

Rights arising from constructive obligations of another party

Other rights not available to other parties (eg know-how)

Purpose of changes

9. The purpose of replacing the notion of 'expected' economic benefits with a notion of 'potential' economic benefits would be to clarify the definitions. Some people interpret the term 'expected' to mean that an item can be an asset or a liability only if the probability of future inflows or outflows exceeds some minimum threshold. However, such an interpretation was not intended, and has not been applied by the IASB in setting recent Standards. For example, IFRS 9 *Financial Instruments* identifies financial guarantee contracts as giving rise to liabilities, whatever the probability of the guarantee being called upon.

10. The IASB acknowledges concerns about recognising resources or obligations for which the probability of inflows or outflows is low. But it believes that such concerns are best addressed by applying recognition criteria (see paragraphs 15-22 below), not by excluding these items from the definitions of assets and liabilities.

11. In defining an economic resource as a 'right', the *Conceptual Framework* would be confirming a shift away from traditional notions of accounting for physical objects and towards accounting for the rights that would compose economic resources. This shift can be helpful when considering transactions in which an entity transfers some rights while retaining others (see the discussion of derecognition in paragraphs 23-27 below).

12. The purpose of moving the reference to 'economic benefits' into a supporting definition of 'economic resource', would be to emphasise more clearly that an asset or a liability is a resource or an obligation, not the ultimate inflow or outflow of economic benefits that the resource or obligation may produce.

Question for GPF members

Question 1 – definitions of assets and liabilities
Do you agree with the proposed definitions of an asset, a liability and an economic resource set out in paragraph 7? If not, why not, and what alternative definitions do you suggest?

Concepts for recognition of assets and liabilities

13. In accounting terminology, 'recognition' of an asset or a liability means the inclusion of that asset or liability at a monetary amount in relevant totals in the statement of financial position.

Existing concepts

14. The existing *Conceptual Framework* lists three criteria that would apply for any asset or liability:

Existing criteria

- The item meets the definition of an asset or a liability.
- It is **probable** that any future economic benefit associated with the asset or liability will flow to or from the entity.
- The asset or liability has a cost or value that can be measured **reliably.**

Proposed concepts

15. The Exposure Draft proposes a different approach:

Exposure Draft – main proposals

- Failure to recognise assets and liabilities makes financial statements less complete and can exclude useful information.
- But recognition of some items does not provide useful information.
- An entity should recognise an asset or liability if doing so provides:
  - relevant information;
  - a faithful representation; and
  - benefits that exceed costs.

16. The Exposure Draft goes on to propose factors whose presence might indicate that recognition would *not* provide relevant information. The factors it identifies are similar to those that underpin the existing recognition criteria:

Exposure Draft – factors affecting relevance
Recognition might not provide relevant information if: • it is uncertain whether an asset or liability exists. • there is only a low probability that an inflow or outflow of economic benefits will result. • all available measures of the liability have a high level of measurement uncertainty.

17. The Exposure Draft stresses that the presence of any of these factors would not necessarily cause information provided by recognition to lack relevance, and it notes that it will often be a combination of factors, instead of any single factor, that would cause information to lack relevance.

Purpose of changes

18. Existing Standards apply a range of different recognition criteria. In particular, they do not all apply a criterion based on the probability of future inflows or outflows. And those that do apply such a criterion use different probability thresholds. The thresholds include 'probable', 'more likely than not', 'virtually certain' and 'reasonably possible'.

19. The new approach would acknowledge that recognition requirements may need to vary between Standards. And, by setting out the factors that the IASB should consider when specifying requirements for a particular Standard, the *Conceptual Framework* would give the IASB tools to enable it to take decisions based on a coherent set of principles.

20. The change in approach is not designed to either increase or decrease the range of assets and liabilities recognised in financial statements.

Differences from Discussion Paper proposals

21. In the 2013 Discussion Paper, the IASB expressed a preliminary view that an entity should recognise all its assets and liabilities unless the IASB decided when developing or revising a particular Standard that recognition would provide information that was not sufficiently useful to justify the cost.

22. The Exposure Draft tries to take an even-handed approach to recognition. It has no presumption that all assets and liabilities should be recognised or, conversely, that assets and liabilities should be recognised only if they meet stringent criteria. Furthermore, the Exposure Draft does not propose that only the IASB can make decisions about recognition—if a particular asset or liability is not within the scope of any Standard, a preparer of financial statements could refer to the proposed concepts when judging whether to recognise that asset or liability.

Question for GPF members

Question 2 – concepts for recognition of assets and liabilities
Do you agree with the proposed concepts for recognition summarised in paragraphs 15-17? If not, why not, and what changes do you suggest?

Concepts for derecognition of assets and liabilities

23. Derecognition is the removal of all or part of a previously recognised asset or liability from an entity's statement of financial position.

Proposed concepts

24. The Exposure Draft proposes to add the following concepts for derecognition to the *Conceptual Framework*:

The aims of derecognition are to faithfully represent both:

- the assets and liabilities **retained** after a transaction or other event that led to the derecognition.

- the **change** in the entity's assets and liabilities as a result of that transaction or other event.

The two aims are normally achieved by:

- Derecognising any assets or liabilities (component) transferred, consumed, collected, fulfilled or expired.
- Recognising any income or expense on that component.
- Continuing to recognise any assets or liabilities retained (retained component).

If it is difficult to achieve both aims…

- Derecognition of transferred component may achieve both aims if supported by separate presentation or explanatory disclosure
  - eg to highlight greater concentration of risk in retained component.

- Otherwise, may need to continue to recognise not only retained component, but also transferred component:
  - no income / expense recognised.
  - liability (asset) recognised at amount of proceeds received (paid) on transfer.
  - separate presentation or explanatory disclosure needed to depict loss of rights/obligations.

Purpose of changes

25. The purpose of the proposed changes is to fill a gap in the *Conceptual Framework*, which at present has no concepts for derecognition. In the absence of an agreed conceptual approach to derecognition, different Standards have adopted different approaches.

Differences from Discussion Paper proposals

26. In the 2013 Discussion Paper, the IASB discussed two approaches to derecognition for situations in which the entity retains a component of the asset or the liability:

    (a) a ‘control’ approach, whereby an entity would derecognise an asset or a liability when it no longer meets the criteria for recognition; and

    (b) a ‘risks-and-rewards’ approach, whereby 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.

27. The IASB concluded in the Discussion Paper that neither approach would necessarily produce the most useful information in all circumstances. The Exposure Draft proposals build on the arguments in the Discussion Paper: the Exposure Draft does not advocate either a control approach or a risks-and-rewards approach, but instead describes the alternatives available and discusses the factors the IASB would need to consider when developing particular Standards.

Question for GPF members

Question 3 – concepts for derecognition of assets and liabilities
Do you agree with the proposed concepts for derecognition summarised in paragraph 24? If not, why not, and what changes do you suggest?

Additional concepts to support the liability definition

Proposed concepts

28. As noted in paragraph 7, the Exposure Draft proposes to define a liability as a present obligation of the entity to transfer an economic resource as a result of past events.

29. It also proposes to add concepts to help interpret the term 'present obligation':

Exposure draft proposal

An entity has a present obligation to transfer an economic resource if both:

a) the entity has no practical ability to avoid the transfer; and

b) the obligation has arisen from past events, ie the entity has received the economic benefits, or conducted the activities, that establish the extent of its obligation.

For example:

- if the transfer is legally enforceable, or
- if action necessary to avoid the transfer would:
  - cause significant business disruption; or
  - have economic consequences significantly more adverse than the transfer itself.

30. The Exposure Draft also discusses some consequences of these concepts:

Constructive obligations

It is not necessary for the obligation to be legally enforceable.

Liabilities may arise from an entity's customary practices, published policies or statements…

…if the entity has no practical ability to act in a manner inconsistent with those practices, policies or statements.

Conditional obligations

It is not necessary for the obligation to be unconditional.

Liabilities may be conditional on a particular future action of the entity…

…if the entity has no practical ability to avoid that action.

Purpose of changes

31. The lack of an agreed conceptual definition of a ‘present obligation’ has given rise to recurring problems for both the IASB and the IFRS Interpretations Committee, especially when they have been considering situations in which a series of events must occur before an entity becomes unconditionally required to transfer an economic resource. Different Standards have adopted different approaches. For example:

(a) applying the employee benefits Standards, an entity recognises a liability for employee benefits when it receives employee services, even if at that time the benefits are still subject to vesting conditions; whereas

(b) applying IFRIC 21 *Levies*, an entity recognises a liability for a levy only when all the conditions required to trigger the levy have been met.

Differences from Discussion Paper proposals

32. In the 2013 Discussion Paper, the IASB had considered three possible definitions of a present obligation:

(a) the definition now proposed, which focuses on the entity’s practical ability to avoid a future transfer;

(b) a narrower definition, which would have restricted liabilities to obligations that are legally enforceable and strictly unconditional; and

(c) a broader definition, which would have included all obligations that had arisen from past events and could result in a future transfer of economic benefits. The probability of a transfer would be reflected in the measurement of the obligation.

33. Most respondents to the Discussion Paper supported the IASB’s tentative rejection of the narrower definition. Many supported a definition that focused on the entity’s practical abilities. However, some raised concerns that such a definition might encompass future operating costs, which an entity often has no practical ability to avoid. For this reason, the Exposure Draft places more emphasis on the ‘past events’ criterion, ie on the need for the entity also to have

received the benefits or conducted the activities that establish the extent of its obligation.

Possible implications of the proposals

34. Aspects of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* are not consistent with the concepts proposed on the meaning of 'present obligation'. In particular, the consensus in IFRIC 21 (an interpretation of IAS 37) requires liabilities for some levies to be recognised later than liabilities would be recognised applying the proposed concepts.

35. The requirements for levies will not automatically change if and when the proposed concepts are included in a revised *Conceptual Framework*. The *Conceptual Framework* is not a Standard and it does not override specific Standards. Furthermore, the IASB will not necessarily change any existing Standards or Interpretations as a result of changes to the *Conceptual Framework*. However, if the IASB were to take on a project to amend aspects of IAS 37, the proposed concepts could lead it to different requirements for levies from those in IFRIC 21 at present.

Question for GPF members

Question 4 – additional concepts to support the liability definition

Do you agree with the concepts proposed to help interpret the term 'present obligation', as summarised in paragraphs 29-30?

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