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STAFF PAPER

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Project	**Conceptual Framework**
Paper topic	Feedback summary—Recognition

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Purpose of paper

1. This paper is one of two papers that summarise feedback on Chapter 5 of the Exposure Draft *Conceptual Framework for Financial Reporting* ('the Exposure Draft').
2. Chapter 5 of the Exposure Draft discusses the recognition process, recognition criteria and derecognition. This paper summarises feedback on the recognition process and recognition criteria. AP10H *Feedback summary—Derecognition* summarises feedback on derecognition.
3. This paper provides a high-level summary of the comments received. Where appropriate, we will provide more details for future meetings.

Summary of key messages

4. Many respondents broadly agreed with the proposed approach to recognition. Those broadly agreeing included many regulators, standard-setters, accountancy bodies and

accounting firms. The views of preparers and users of financial statements were more divided.

5. Most of those who disagreed with the proposed approach would prefer to keep the existing criteria, and in particular the 'probability criterion'. They expressed concerns that the proposed approach:

   (a) is too abstract and subjective; and

   (b) could lead to requirements to recognise assets and liabilities for which there is a low probability of an inflow or outflow of future economic benefits. Some respondents expressed a view that recognition of such assets and liabilities might not provide useful information. A few also expressed concerns that measuring such assets and liabilities can be complex and would place additional burdens on preparers of financial statements.

6. Some respondents suggested that the Board needs to test the impact of the proposals.

Structure of paper

7. The paper is structured as follows:

   (a) Exposure Draft proposals

      (i) recognition process (paragraphs 8-9); and

      (ii) recognition criteria (paragraphs 10-13).

   (b) Summary of feedback

      (i) general comments on recognition proposals (paragraphs 14-18);

      (ii) main concerns (paragraphs 19-28);

      (iii) alternative suggestions (paragraph 29);

      (iv) requests for additional guidance (paragraphs 30-31);

      (v) comments on specific aspects of the recognition proposals (paragraphs 32-40); and

      (vi) other comments (paragraphs 41-42).

Exposure Draft proposals (paragraphs 5.2–5.24 and BC5.5–BC5.48)

Recognition process

8. Paragraph 5.2 of the Exposure Draft proposed to define recognition:

> 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. [...]

9. Paragraphs 5.3-5.8 explain what the recognition process involves and the linkage the recognition process establishes between the elements, the statement of financial position and the statement(s) of financial performance.

Recognition criteria

10. The existing *Conceptual Framework* specifies three recognition criteria that apply for the recognition of all assets and liabilities:

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.**

11. However, existing IFRS Standards do not all apply these recognition criteria. In particular, they do not all apply a criterion based on the probability of future inflows or outflows ('the probability criterion'). In addition, those that do apply such a criterion use different thresholds. The thresholds include 'probable', 'more likely than not', 'virtually certain' and 'reasonably possible'.

12. Accordingly, the Exposure Draft proposed a new approach to recognition. Paragraph 5.9 proposed that assets and liabilities (and any related income, expenses or changes

in equity) should be recognised 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;

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

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

13. The supporting discussion identifies circumstances in which recognition may not provide relevant information. These circumstances include some cases in which:

(a) it is uncertain whether an asset exists, or is separable from goodwill, or whether a liability exists;

(b) there is only a low probability that an inflow or outflow of economic benefits will result; or

(c) 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).

Summary of feedback

General comments on recognition proposals

14. Many respondents commented on the recognition proposals. Of those who responded, many broadly agreed with the overall approach proposed. Those broadly agreeing included many regulators, standard-setters, accountancy bodies and accounting firms. Of those who gave reasons for their support:

(a) some generally agreed with removing the probability criterion and instead including in the *Conceptual Framework* recognition criteria based on the qualitative characteristics;

(b) some specifically agreed that the probability criterion is not appropriate for some types of assets and liabilities such as derivatives;

(c) some specifically agreed that detailed recognition criteria should be considered at an IFRS Standards level; and

(d) a few supported what they described as the ‘even-handed’ approach proposed in the Exposure Draft, ie an approach that neither required recognition of all assets and liabilities, nor set specified criteria.

15. Some of those who broadly agreed nevertheless expressed concerns about some of the specific aspects of the proposals. Their concerns are included in the applicable sections below.

16. The views of the preparers and users of financial statements, academics and individuals were more divided. The main concerns raised by those who expressed overall disagreement are explained in paragraphs 19-28 below.

17. A few respondents (two standard-setting bodies, one academic and one preparers’ representative body) commented on the manner in which the discussion around recognition is articulated in the Exposure Draft. They are of the view that the discussion is vague; descriptions are not well structured and the proposals on recognition lack sufficiently robust concepts to enable constituents to understand the Board’s rationale and intentions. One of them also believes that the chapter is too long and its contents are redundant, considering other chapters (especially Chapter 1 and 2) in the Exposure Draft.

18. One standard-setting body has questioned why the Exposure Draft does not include any discussion on the role that the enhancing qualitative characteristics (ie, comparability, verifiability, timeliness and understandability) play in recognition. That respondent suggested that the Board should consider whether the enhancing qualitative characteristics have any specific implications for recognition. If the Board

concludes that they do not have any specific implications for recognition, it should explain its reasoning in the Basis for Conclusions.

Main concerns

19. The main concerns of those who disagreed with the proposed approach and a few who agreed are that:

(a) the proposals are too abstract and subjective (paragraph 20);

(b) the proposed changes might not lead to useful information in financial statements (paragraphs 21-22);

(c) measurement could become more complex (paragraphs 23-24);

(d) the impact of the proposals needs to be tested (paragraph 25); and

(e) the probability criterion has proved to be useful in practice (paragraphs 26-28).

Proposals are too abstract and subjective

20. Some respondents—including standard-setters, regulators, an accounting firm, and preparers of financial statements—expressed a view that the proposals are too abstract and subjective. They suggest that the way in which the Board or preparers apply the fundamental characteristics could depend on individual perspectives. They think that more concrete and robust concepts would be required to ensure that:

(a) the Board develops high quality IFRS Standards (with consistent requirements that result in useful information);

(b) preparers adopt appropriate accounting policies for transactions that are not within the scope of any IFRS Standard or for which the applicable IFRS Standard permits a choice of accounting policies;

(c) the recognition criteria limit the recognition of assets or liabilities to those presenting a probable flow of economic benefits; and

(d) preparers do not have discretion and are not required to exercise significant judgement when applying the recognition criteria, because such use of discretion and judgement could affect the consistency and comparability of financial statements.

Proposed changes might not lead to useful information

21. Some respondents—including standard-setters, regulators, an accounting firm, and preparers of financial statements—believe the proposed changes (especially the removal of the probability criterion in combination with the removal of the reference to 'expected' from the definitions of an asset and a liability) could mean that future IFRS Standards will not filter out assets and liabilities with a low likelihood of producing inflows or outflows of economic benefits. Consequently, entities might recognise assets and liabilities for which recognition does not provide useful information.

22. Some respondents also noted that preparers are required to refer to the *Conceptual Framework* when applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to develop an accounting policy in the absence of a specific IFRS Standard. They thought that the absence of specific recognition criteria could result in entities recognising a larger number of intangible assets such as customer relationships, which might not provide useful information.

Measurement could become more complex

23. A few standard-setters expressed concerns that if assets and liabilities with a low probability of future inflows or outflows were recognised, they might have to be measured at expected value. Measuring such assets and liabilities at expected value is difficult and would place additional burdens on preparers of financial statements. In addition, recognising assets and liabilities that have a low probability of generating inflows or outflows could result in gains and losses that frequently reverse in subsequent periods when the inflow or outflow does not occur.

24. One standard-setter and a preparers' representative body believe that removal of the probability criterion could particularly affect liabilities. They noted the negative

feedback that the Board received when it proposed to delete the probability criterion in the 2005 Exposure Draft of proposed amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*[1].

The impact of the proposals needs to be tested

25. Some (predominantly European) respondents—including regulators and preparers of financial statements—believe that the Board should assess the implications of the proposed changes to the recognition criteria (especially the removal of the probability criterion). They think that the Board should assess possible implications for both:

(a) the Board in revising existing IFRS Standards or developing new IFRS Standards; and

(b) preparers that apply the *Conceptual Framework* to develop an accounting policy in the absence of a specific IFRS Standard, or when the applicable Standard permits a choice of policies.

The probability criterion has proved to be useful in practice

26. Some respondents are of the view that the probability criterion has proved effective in practice and has offered a practical way of filtering assets and liabilities with only low probabilities of a flow of economic benefits. For such assets, the probability criterion is the best means of applying the two main qualitative characteristics (ie relevance and faithful representation).

27. A few respondents expressed a view that the Board has not adequately justified removing that filter from the *Conceptual Framework*. Some of these respondents acknowledge that there may be some assets and liabilities (such as derivatives) for which the probability criterion is not appropriate. Nevertheless, they note that (as stated in paragraph IN3 of the Exposure Draft) the Board may sometimes specify requirements in individual IFRS Standards that depart from aspects of the *Conceptual Framework*. They think that recognition of assets and liabilities with a

[1] Exposure Draft of Proposed Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 19 *Employee Benefits*.

low probability of future inflows or outflows should be by exception and should be fully explained. Deleting the probability criterion to solve the recognition issues for exceptional cases, such as derivatives, could create other, major problems in future.

28. Respondents also argued that the existing probability criterion is a more practical approach than the proposed approach because:

(a) the proposed guidance addressing items with a low probability of a flow of economic benefits is not clear enough and will lead to many areas for doubt and inconsistency; and

(b) 'low probability' is subjective because it is a relative term, and will be open to interpretation.

Alternative suggestions

29. Some respondents suggested alternatives to the approach proposed in the Exposure Draft:

(a) A few respondents expressed disagreement with the proposal that recognition requirements might need to vary between IFRS Standards. One respondent particularly disagreed with the reasoning in paragraph 5.10, which states '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'. They believe that the *Conceptual Framework* should set out recognition criteria that may be applied consistently in all IFRS Standards.

(b) One standard-setter agreed that the probability criterion is not always necessary. However, it believes that the criterion should be retained for recognition of assets and liabilities that have been created from a right or an obligation arising from events other than transactions.

(c) A few respondents took the view that there should be a presumption (or overarching principle) that every item meeting the definition of an asset or a liability should be recognised. They believe that recognition should be triggered when the definition of an element is met. The Board could include an exception to this principle in individual IFRS Standards if it decided that recognition of a particular item would not meet the objectives of financial reporting.

Requests for additional guidance

30. Some respondents of all types asked for further guidance for assets or liabilities with a low probability of future inflows or outflows of economic benefits. Respondents suggested that the *Conceptual Framework* should:

    (a) state that the potential magnitude of the outcome should be considered when considering the recognition of an asset or liability with a low probability of a future inflow or outflow of economic benefits;

    (b) specify the level of probability that would require the recognition of assets and liabilities (paragraph 5.13(b) of the Exposure Draft does not provide specific guidance); and

    (c) specify whether the same level of probability should be used for both assets and liabilities.

31. Some respondents of all types asked for further guidance on the circumstances in which recognition may not provide relevant information, may not result in faithful representation, or may not have benefits that exceed the cost of recognition. For example, some asked for guidance on:

    (a) when uncertainty leads to non-recognition or how it affects recognition;

    (b) the need to consider factors such as ‘accounting mismatches’. Respondents asked for guidance on when different assets and liabilities should be considered together to avoiding accounting mismatches. One respondent asked for examples of situations in which elements of financial statements that normally would not have been recognised are included in the financial statements to eliminate accounting mismatches (eg fair value hedges of a firm commitment); and

(c) the types of situations in which recognising an asset where there is measurement and existence uncertainty, or a low probability of an inflow or an outflow, would not result in relevant information.

Comments on specific aspects of the recognition proposals

32. Some respondents asked for additional guidance on, or suggested refinements to, specific aspects of the recognition proposals:

(a) relevance (paragraph 33);

(b) existence uncertainty and separability (paragraph 34);

(c) low probability of a flow of economic benefits (paragraph 35);

(d) measurement uncertainty (paragraph 36-37);

(e) faithful representation (paragraph 38-39); and

(f) cost-benefit criteria (paragraph 40).

Relevance

33. Commenting on the discussion of the need for recognition to provide relevant information:

(a) An organisation representing regulators suggested clarifying that relevance should be assessed from the perspective of a user of financial statements, and not from the perspective of the management preparing the financial statements. Such a clarification would help counter the inherent risk of management understating liabilities.

(b) One standard-setter suggested discussing aggregation as part of relevance. It suggested, for example, stating that aggregating high- and low-probability cash flows or relatively certain items with highly uncertain items would probably reduce the relevance of the total.

Existence uncertainty and separability

34. Commenting on the discussion of existence uncertainty and separability:

(a) a few respondents suggested that the discussion of existence uncertainty and separability would be better placed in the chapter discussing the definitions of an asset and a liability.

(b) an accountancy body suggested clarifying that decisions regarding existence uncertainty and separability need to be taken at an IFRS Standards level.

Low probability of a flow of economic benefits

35. Some respondents noted that some parts of the discussion refer to 'low probability', while other parts refer to 'very low probability'. They suggested that the Board should either clarify any intentional difference between these terms, or that it should use one or other term consistently.

Measurement uncertainty

36. An association of actuaries suggested clarifying that a high level of measurement uncertainty does not necessarily imply that the information resulting from recognition lacks relevance. It noted, as an example, situations in which there are a number of items that individually would have a low level of certainty but in aggregate have a higher level of certainty.

37. A few respondents expressed concern that the Exposure Draft placed too much emphasis on the impact of high measurement uncertainty in recognition decisions:

(a) one standard-setter expressed a view that high measurement uncertainty alone should not be sufficient reason to preclude recognition, because this may result in arguments against recognising liabilities such as provisions for rehabilitation or lawsuits; and

(b) two regulators also expressed concern that too much focus on measurement uncertainty might lead to non-recognition of assets and liabilities whose recognition would provide useful information. They argued that even under conditions of high measurement uncertainty, an estimate can provide relevant information to users of financial statements and an asset or liability should be recognised (along with appropriate disclosures). As examples, they suggested that:

(i) it could be imprudent not to recognise liabilities purely on the ground of measurement uncertainty; and

(ii) in a business combination, recognising an intangible asset separately from goodwill can provide more relevant information than subsuming that intangible asset within a large goodwill amount, even if the measurement uncertainty is high.

Faithful representation

38. One accounting firm thinks that all of the factors affecting relevance—ie existence uncertainty and separability, low probability of a flow of economic benefits and measurement uncertainty—also affect faithful representation.

39. A few respondents said that they did not think that the discussion of faithful representation would provide a useful tool for deciding what should and should not be recognised in practice.

Cost-benefit criteria

40. A few preparers of financial statements explicitly agreed with the proposal to identify cost-benefit as one of the three criteria to be considered in recognition decisions. However, some respondents across all categories expressed concerns about this proposal. They argued that:

(a) the ‘cost constraint’ should not be given a similar level of importance or prominence as ‘relevance’ and ‘faithful representation’. It should be identified as a constraint on the two main criteria, not as a separate criterion in its own right;

(b) the cost constraint is a general constraint or an overarching concept in financial reporting. Identifying it as a specific recognition criterion could give the impression that the constraint does not apply unless specifically mentioned;

(c) the proposed concepts for recognition could be applied by preparers of financial statements for some transactions. But only the Board—and not individual preparers of financial statements—should be allowed to reach decisions on cost-benefit considerations. Preparers of financial statements are not in a position to assess the benefits of recognition for users of financial statements;

(d) materiality provides a more conceptually sound basis for the decision of whether or not to recognise an asset or liability; and

(e) it is not clear whether the cost constraint should be assessed only when an item first arises, or whether it should be assessed on an ongoing basis.

Other comments

41. With respect to the impact of the recognition proposals on disclosures, a few respondents suggested that:

(a) additional disclosure requirements referred in the Exposure Draft should be decided at an IFRS Standards level rather than in the *Conceptual Framework*; and

(b) the proposals tend to give the impression that when recognition is not considered to be relevant, disclosure would be sufficient. However, respondents think that this should not be the case, because of the different roles of the face of the financial statements and the notes.

42. Some respondents referred to the discussion of asymmetric recognition thresholds in the Basis for Conclusions. Those comments are summarised together with other comments on asymmetry in AP10B Feedback summary—Chapter 2—*Qualitative characteristics of useful financial information*.