STAFF PAPER

September 2016

World Standard-Setters Conference

Project	**Conceptual Framework**	
Paper topic	Testing the proposed asset and liability definitions	
CONTACT	Joan Brown	jbrown@ifrs.org

This paper has been prepared for discussion at a public meeting and does not represent the views of the International Accounting Standards Board (the Board) or any individual member of the Board. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB® *Update*.

The International Accounting Standards Board is the independent standard-setting body of the IFRS Foundation, a not-for-profit corporation promoting the adoption of International Financial Reporting Standards. For more information visit www.ifrs.org.

Project background

The Board is conducting a project to revise its *Conceptual Framework*.

In May 2015, the Board published an Exposure Draft *Conceptual Framework for Financial Reporting* ('the Exposure Draft') which, among other things, proposed changes to the existing definitions of an asset and a liability, and to the concepts supporting those definitions.

Many respondents to the Exposure Draft expressed broad support for those changes. However, some respondents suggested that the Board should assess the robustness and possible implications of the revised definitions before finalising them.

This session at the World Standard-setters Meeting will form part of that assessment.

Purpose of session

The purpose of this session is to test the proposed definitions of an asset and a liability and the concepts supporting those definitions.

The Board wishes to test the proposed definitions and supporting concepts to help it assess whether those definitions and concepts will enable it to develop IFRS Standards that best meet the needs of existing and potential investors, lenders and other creditors.

To test the definitions, the staff are planning to prepare papers that:

(a) analyse the outcome of applying the proposed definitions and supporting concepts to a range of illustrative examples; and

(b) discuss how the definitions and supporting concepts could help the Board reach decisions in some of its current projects.

The staff would like your input to help them reach a view on the first of these topics, the outcome of applying the proposed definitions and supporting concepts to a range of illustrative examples.

Format of session

You will be divided into five break-out groups. Each group will be allocated five of the examples in this paper, and asked to consider the following questions:

Questions for break-out groups

(1) For each of the examples allocated to your group:

 (a) What is the outcome of applying the proposed definitions and supporting concepts to the fact pattern in the example? Does the entity have an asset/liability (are all the criteria met)? Why or why not?

 (b) How easy or hard was it to get to an answer using the proposed definitions and supporting concepts?

(2) Do you have any concerns about the outcomes or other observations about the examples? *Remember: the fact that an asset exists does not necessarily mean that it will be recognised (see page 3).*

Please read the fact patterns in advance so that you are ready to discuss them as soon as you join your break-out group.

Before you start—a note about recognition of assets and liabilities

Even if an item meets the definition of an asset or a liability, an entity would not necessarily be permitted or required to recognise that asset or liability in its statement of financial position. The applicable IFRS Standard could specify that the asset or liability should be recognised only if particular criteria are met.

Furthermore, there would be no automatic requirement for an entity to disclose information about an unrecognised asset or liability. However, IFRS Standards may specify disclosure requirements for some unrecognised assets and liabilities.

In making decisions about the circumstances in which a particular asset or liability would be recognised, the Board would consider the concepts for recognition in the revised *Conceptual Framework*.

Key aspects of the concepts for recognition proposed for the revised *Conceptual Framework*[1]

The Board would apply these concepts in developing IFRS Standards. Preparers of financial statements would apply these concepts in developing or selecting accounting policies for assets and liabilities when no IFRS Standard specifically applies.

An asset or a liability (and any related income, expenses or changes in equity) should be recognised if recognition provides users of financial statements with useful information, ie relevant information about, and a faithful representation of, the asset or liability and any income, expenses or changes in equity.

Recognition of a particular asset or liability may not necessarily provide *relevant information*:

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

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

Recognition of a particular asset or liability may not necessarily provide a *faithful representation*:

(a) if the level of measurement uncertainty is exceptionally high; or

(b) if related assets and liabilities are not recognised.

It will often be a combination of factors, instead of any single factor, that would mean that recognition does not provide useful information.

As with all other areas of financial reporting, cost constrains recognition decisions. Recognition of an asset or a liability (and any related income, expenses or changes in equity) is appropriate only if the benefits of the information provided to the users of financial statements are sufficient to justify the cost.

[1] Exposure Draft proposals, updated for refinements that the Board has tentatively decided upon in light of feedback on the Exposure Draft.

Before you start—a note about the distinction between liabilities and equity claims

This paper does not address questions that arise in distinguishing between liabilities and equity claims.

The Board is not developing concepts for distinguishing between liabilities and equity claims as part of the Conceptual Framework project.

It is developing such concepts in a separate research project on Financial Instruments with Characteristics of Equity.

In reaching decisions in that project, the Board will not be constrained by the concepts in the revised *Conceptual Framework*. Consequently, when the Board completes that project, it may decide that it needs to make further changes to the *Conceptual Framework* definition of a liability, or to the concepts supporting that definition.

Accordingly, in this exercise to test the proposed definitions and supporting concepts, we have not included any examples that consider whether particular financial instruments would meet the definition of a liability (as opposed to an equity claim).

Contents

Section 1—Proposed asset definition	Page
Proposed definition and key supporting concepts	**6**
Examples	
1.1—Production process	7
1.2—Assembled workforce	8
1.3—Option to purchase a commodity at a fixed price	9
1.4—Jointly-controlled real estate	10
1.5—Deferred tax—unused tax loss	11

Section 2—Proposed liability definition	Page
Proposed definition and key supporting concepts	**12**
Examples	
2.1—Product warranties	13
2.2—Contaminated land constructive obligation	14
2.3—A court case	15
2.4—Long service leave	16
2.5(a), (b), (c)—Levies (three examples)	17–19
2.6(a), (b)—Restructuring costs (two examples)	20–21
2.7—Legal requirement to fit smoke filters	22
2.8—Refurbishment costs	23
2.9(a), (b)—Deferred tax (two examples)	24–25
2.10—Non-compete agreement	26
2.11—Government grant	27

Section 1—Proposed asset definition

This section asks you to apply the proposed definition of an asset and supporting concepts to a range of examples. The examples have been chosen to test various different aspects of the proposed definition and supporting concepts.

The examples in this paper illustrate transactions that are within the scope of existing IFRS Standards.

The conclusions you reach when applying the proposed concepts to some of these transactions might be inconsistent with the requirements of the applicable IFRS Standard.

Any inconsistency would not mean that the existing requirements will change. The *Conceptual Framework* does not override existing IFRS Standards—the applicable Standard will continue to apply unless the Board amends that Standard. Furthermore, the Board will not automatically amend existing IFRS Standards as a result of changes to the *Conceptual Framework*. Any decision to amend an existing Standard would require the Board to go through its normal due process for adding a project to its agenda and developing an Exposure Draft and an amendment to that Standard.

Proposed definition and key supporting concepts

An **asset** is a present economic resource controlled by the entity as a result of past events.

An **economic resource** is a right that has the potential to produce economic benefits.

In principle, each of an entity's rights is a separate asset. However, for accounting purposes, related rights are often treated as a single asset, namely the 'unit of account'.

For an economic resource to have the **potential to produce economic benefits**, it need not be certain or even probable that the economic resource will produce economic benefits. It is only necessary that the economic resource already exists and that there is at least one circumstance in which it would produce economic benefits. (However, if the probability of future economic benefits is low, the Board might decide in some cases that the applicable IFRS Standard should not require recognition of the asset—see page 3.)

An entity **controls** an economic resource if it has present ability to direct the use of the economic resource and obtain the economic benefits that flow from it.

Example 1.1—Production process

Facts An entity has developed an efficient process for producing a new material. The entity has not yet patented the process, but has successfully kept it secret. The process has the potential to produce significant economic benefits for the entity. But the material is not yet in commercial production, so those economic benefits are highly uncertain—the range of possible outcomes is extremely wide and the likelihood of each outcome is exceptionally difficult to estimate. Does the entity have an asset?

Criterion	Met?	Comments
Right		
Controlled by entity		
As a result of past events		
Potential to produce economic benefits		

Asset?		

If an asset exists, would it be recognised?

The proposed concepts for recognition (see page 3) envisage that IFRS Standards may not require the recognition of some assets for which the probability of future economic benefits is low, or whose values are subject to very high measurement uncertainty.

If the Board were to apply these concepts to any asset identified in this example, it could arrive at requirements similar to those already in IAS 38 Intangible Assets. Applying IAS 38, intangible assets are recognised if future economic benefits are probable and if their cost can be measured reliably. IAS 38 states that assets arising from the research phase of a project would not meet these criteria, and that assets arising from a development phase would meet the criteria only in specified circumstances.

The Board has no intention at present to review the recognition requirements in IAS 38.

Example 1.2—Assembled workforce

Facts

An entity has assembled and trained a workforce to operate its business efficiently.

Employees must give three months' notice to terminate their contracts of employment. However, employees are likely to make their services available for longer periods. So the value of the assembled workforce is higher than the value of the entity's contractual right to exchange three further months' service from each employee for three further months' salary.

Does the assembled workforce give rise to an asset *beyond* any asset arising from the entity's contractual right to exchange three months' service from each employee for three months' salary?

Criterion	Met?	Comments
Right		
Controlled by entity		
As a result of past events		
Potential to produce economic benefits		

⇩

Asset?		

Example 1.3—Option to purchase a commodity at a fixed price

Facts

An entity has entered into a contract that gives it an option to purchase a commodity for a fixed price of CU10,000[2]. The entity can exercise the option at any time in the next year. The current price of the commodity is CU9,000. The entity paid CU100 for the option. The option cannot be traded.

Does the entity have an asset, and if so, what is that asset?

Criterion	Met?	Comments
Right		
Controlled by entity		
As a result of past events		
Potential to produce economic benefits		

⇩

Asset?		

2 In these examples, monetary amounts are denominated in 'currency units' (CU).

Example 1.4—Jointly-controlled real estate

Facts

Entities A, B and C jointly purchased, and now own, commercial real estate on terms that provide them with 25 per cent, 40 per cent and 35 per cent respectively of the economic benefits flowing from that real estate.

Any decision to change the way in which the real estate is used, or any decision to sell the real estate, requires the unanimous consent of all three entities.

An entity may sell its share in the real estate. However, it must first offer the share to the other two entities.

Does entity A have an asset and, if so, what is that asset?

Criterion	Met?	Comments
Right		
Controlled by entity		
As a result of past events		
Potential to produce economic benefits		

⇩

Asset?		

Example 1.5—Deferred tax—unused tax loss

Facts

An entity has incurred a tax loss for the period. The tax loss cannot be carried back to recover current tax of a previous period, so it remains unused at the end of the period. Tax law permits entities with unused tax losses to carry those losses forward for up to 10 years and offset them against future taxable profits. Does the entity have an asset?

Criterion	Met?	Comments
Right		
Controlled by entity		
As a result of past events		
Potential to produce economic benefits		

Asset?		

If an asset exists, would it be recognised?

The proposed concepts for recognition (see page 3) envisage that IFRS Standards may not require the recognition of some assets for which the probability of future economic benefits is low, or whose values are subject to high measurement uncertainty.

If the Board were to apply these concepts to any asset identified in this example, it could arrive at requirements similar to those already in IAS 12 Income Taxes. Applying IAS 12, the asset arising from unused tax losses is recognised to the extent that it is probable that future taxable profit will be available against which the unused tax loss can be utilised. IAS 12 provides guidance on the factors that would be considered in judging whether this criterion is met.

The Board has no intention at present to review the recognition requirements in IAS 12.

Section 2—Proposed liability definition

This section asks you to apply the proposed definition of a liability and supporting concepts to a range of examples.

In their responses to the Exposure Draft, some respondents referred to particular transactions for which they thought the implications of the proposed definition were unclear. The examples include those transactions.

Respondents often highlighted transactions within the scope of IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IFRIC 21 Levies. So the examples in this section include a variety of transactions within the scope of IAS 37 and IFRIC 21.

The conclusions you reach when applying the proposed concepts to some of these transactions might be inconsistent with the requirements of the applicable IFRS Standard.

Any inconsistency would not mean that the existing requirements will change. The *Conceptual Framework* does not override existing IFRS Standards—the applicable Standard will continue to apply unless the Board amends that Standard. Furthermore, the Board will not automatically amend existing IFRS Standards as a result of changes to the *Conceptual Framework*. Any decision to amend an existing Standard would require the Board to go through its normal due process for adding a project to its agenda and developing an Exposure Draft and an amendment to that Standard.

Proposed definition and key supporting concepts

A **liability** is a present obligation of the entity to transfer an economic resource as a result of past events.

An entity's obligation to transfer an economic resource must have the potential to require the entity to **transfer an economic resource to another party**. It need not be certain, or even probable, that the entity will be required to transfer an economic resource, but the obligation must already exist and there must be at least one circumstance in which it will require the entity to transfer an economic resource. (However, if the probability of a transfer being required is low, the Board might decide in some cases that the applicable IFRS Standard should not require recognition of the liability—see page 3.)

An entity has an **obligation** if it has no practical ability to avoid the transfer. An entity has no practical ability to avoid a transfer if, for example, the transfer is legally enforceable, or if any action necessary to avoid the transfer would cause significant business disruption or would have economic consequences significantly more adverse than the transfer itself.

An obligation is **a result of past events** (and hence a **present** obligation) if the entity has received the economic benefits or conducted the activities that establish the extent of its obligation.

An **executory contract** establishes a right and an obligation to exchange resources. The combined right and obligation give rise to a single asset or liability. The entity has a liability (an obligation to *transfer* an economic resource) only if the terms of the exchange are unfavourable.

Example 2.1—Product warranties

Facts

A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale.

The manufacturer has sold a batch of products. No defects have yet been reported to it.

Does the entity have a liability?

Would the answer be different if the entity had sold only one product?

The facts are the same as those of Example 1 in Section C of the guidance accompanying IAS 37.

Criterion	Met?	Comments
Obligation to transfer an economic resource to another party		
As a result of past events		
No practical ability to avoid		

Liability?		

If a liability exists, would it be recognised?

If a liability exists, whether it would be recognised might depend on the probability of future claims.

The proposed concepts for recognition (see page 3) envisage that IFRS Standards may not require the recognition of some liabilities with a low probability of outflows of economic benefits.

If the Board were to apply these concepts to this example, it could arrive at requirements similar to those already in IAS 37. Applying IAS 37, liabilities are recognised if, among other things, it is probable that an outflow of resources will be required to settle the obligation.

*In its 'research pipeline', the Board has a project to consider whether it should review some aspects of IAS 37. However, on the basis of the evidence gathered to date, the staff do **not** expect to recommend that the Board reviews the existing recognition criteria.*

Example 2.2—Contaminated land constructive obligation

Facts

An entity in the oil industry causes contamination and operates in a country where there is no environmental legislation. However, the entity has a widely published environmental policy in which it undertakes to clean up all contamination that it causes. The entity has a record of honouring this published policy.

Does the entity have a liability?

The facts are the same as those of Example 2B in Section C of the guidance accompanying IAS 37.

Criterion	Met?	Comments
Obligation is to transfer an economic resource to another party		
As a result of past events		
No practical ability to avoid		

⇩

Liability?		

Example 2.3—A court case

Facts

After a wedding, ten people died, possibly as a result of food poisoning from products sold by the entity. Legal proceedings are started seeking damages from the entity. The entity disputes that its products were the cause of the deaths. Does it have a liability?

The facts are the same as those of Example 10 in Section C of the guidance accompanying IAS 37.

Criterion	Met?	Comments
Obligation is to transfer an economic resource to another party		
As a result of past events		
No practical ability to avoid		

⇩

Liability?		

Example 2.4—Long service leave

Facts

Employees have a statutory entitlement to two months' paid long service leave if they work for the same employer for 10 years.

If an employer terminates an employee's services after five years (for any reason other than serious misconduct), the employee is entitled to a pro-rata payment.

An entity has employed:

- one group of employees for nine years, and
- a second group of employees for two years.

Does it have a liability?

Criterion	Met?	Comments
Obligation is to transfer an economic resource to another party		
As a result of past events		
No practical ability to avoid		

⇩

Liability?		

Example 2.5(a)—Levy triggered when entity generates revenue in two periods

Facts

A government charges levies on entities as soon as they generate revenue in 20X1. The amount of the levy that each entity pays is calculated by reference to the revenue the entity generated in 20X0.

An entity's reporting period ends on 31 December 20X0. The entity generated revenue in 20X0, and in 20X1 it starts to generate revenue on 3 January 20X1.

Does the entity have a liability at 31 December 20X0 for the levy charged on 3 January 20X1?

The facts are consistent with those in Illustrative Example 2 accompanying IFRIC 21.

Criterion	Met?	Comments
Obligation is to transfer an economic resource to another party		
As a result of past events		
No practical ability to avoid		

Liability?		

Example 2.5(b)—Levy triggered if entity operates at end of reporting period

Facts

A government charges levies on entities that are operating as banks at the end of their reporting period. The amount of the levy is 0.1% of liabilities reported in the entity's statement of financial position at the end of the reporting period. If the reporting period is longer or shorter than 12 months, the levy is increased or reduced proportionately. For example, for a 9-month reporting period, the levy is 9/12^{ths} of the initial amount calculated.

An entity with a 12-month reporting period ending on 31 December 20X1 is preparing interim financial statements at 30 June 20X1. Does it have a liability at 30 June 20X1 for the levy chargeable at the end of the reporting period?

The facts are consistent with those in Illustrative Example 3 accompanying IFRIC 21.

Criterion	Met?	Comments
Obligation is to transfer an economic resource to another party		
As a result of past events		
No practical ability to avoid		

⇩

Liability?		

Example 2.5(c)—Threshold levy

Facts

A government charges levies on entities that generate revenue in excess of CU50 million in a calendar year. The levy rate is two per cent of the revenue in excess of CU50 million.

An entity generates revenue from profitable activities evenly through the year. Its 20X1 revenue reaches CU50 million on 17 July 20X1.

The entity's reporting period ends on 30 June 20X1. Does it have a liability at that date for the 20X1 levy?

The facts are consistent with those in Illustrative Example 4 accompanying IFRIC 21.

Criterion	Met?	Comments
Obligation is to transfer an economic resource to another party		
A result of past events		
No practical ability to avoid		

Liability?		

Example 2.6(a)—Restructuring costs—employee termination benefits

Facts

An entity is required by law to make payments to employees if it terminates their employment contracts. The amount paid to each employee depends on the duration of that employee's past service. In the normal course of business, the entity rarely, if ever, needs to make termination payments. However, as a result of a recent acquisition, the entity now has excess production capacity. It has prepared a plan for closing one factory and terminating the contracts of all employees at that factory. It has announced that plan to the employees.

Does the entity have a liability for employee termination benefits?

Criterion	Met?	Comments
Obligation is to transfer an economic resource to another party		
As a result of past events		
No practical ability to avoid		

⇩

Liability?		

Example 2.6(b)—Restructuring costs—associated legal fees

Facts

The entity described in Example 2.6(a) will need expert advice to help it calculate the exact amounts of termination benefits owed to each employee. The entity has entered into a contract with a firm of specialist employment lawyers to provide that advice. The lawyers have not yet started providing their services.

Does an entity have a liability for the expected legal fees?

Criterion	Met?	Comments
Obligation is to transfer an economic resource to another party		
As a result of past events		
No practical ability to avoid		

⇩

Liability?		

Example 2.7—Legal requirement to fit smoke filters

Facts

Under new legislation, an entity is required to fit smoke filters to its factories by 30 June 20X1. At the end of the entity's reporting period (30 December 20X0), the entity has not fitted the smoke filters.

Does it have a liability at 30 December 20X0 for the cost of fitting smoke filters?

The facts are the same as those of part (a) of Example 6 in Section C of the guidance accompanying IAS 37.

Criterion	Met?	Comments
Obligation is to transfer an economic resource to another party		
As a result of past events		
No practical ability to avoid		

⇩

Liability?		

Example 2.8—Refurbishment costs

Facts

An airline is required by law to overhaul its aircraft once every three years.

It is two years since the airline last overhauled its aircraft. Does the entity have a liability?

The facts are the same as those of Example 11B in Section C of the guidance accompanying IAS 37.

Criterion	Met?	Comments
Obligation is to transfer an economic resource to another party		
As a result of past events		
No practical ability to avoid		

⇩

Liability?		

Example 2.9(a)—Deferred tax—income recognised before it is taxable

Facts

At the end of the current reporting period, the entity has earned income that it has not yet received. It has recognised the income in its statement(s) of financial performance and its right to receive cash in its statement of financial position. The income is taxable when it is received.

Does the entity have a liability for the tax on the income that it has recognised but not yet received?

Criterion	Met?	Comments
Obligation is to transfer an economic resource to another party		
As a result of past events		
No practical ability to avoid		

⇩

Liability?		

Example 2.9(b)—Deferred tax—expense deductible before it is recognised

Facts

An entity purchases equipment for CU10,000 at the start of a year. The entity depreciates the equipment on a straight-line basis over five years. Consequently, at the end of the year of purchase, the carrying amount of the equipment is CU8,000.

The full cost of the equipment is deductible for tax purposes in the year of purchase. Profits (before depreciation) earned using the equipment are taxable. If the entity were to sell the equipment, the proceeds of disposal would also be taxable.

Does the entity have a deferred tax liability at the end of the year in which it purchased the equipment?

Criterion	Met?	Comments
Obligation is to transfer an economic resource to another party		
As a result of past events		
No practical ability to avoid		

⇩

Liability?		

Example 2.10—Non-compete agreement

Facts

An entity that operates restaurants in cities throughout a region sells one of its restaurants. It receives a fee in exchange for agreeing not to open another restaurant in that city for five years.

Does the entity have a liability?

Criterion	Met?	Comments
Obligation is to transfer an economic resource to another party		
As a result of past events		
No practical ability to avoid		

⇩

Liability?		

Example 2.11—Government grant

Facts

A government provides grants to entities that invest in a region that has high rates of unemployment.

An entity has just received a grant towards the cost of building a manufacturing plant in that region. As a condition of the grant, the entity must employ at least 10,000 people in the plant for at least 10 years. If the entity fails to meet this condition it must repay some of the grant. The amount repayable will depend on how many people are employed and for how long. The grant agreement is legally enforceable.

Does the entity have a liability?

Criterion	Met?	Comments
Obligation is to transfer an economic resource to another party		
As a result of past events		
No practical ability to avoid		

⇩

Liability?		