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**REG IASB**

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| **Project** | **Conceptual Framework** | | |
| Paper topic | Draft discussion paper: Elements – Definition of elements | | |
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# Elements of financial statements

This paper is a very early draft of part of the Conceptual Framework discussion paper. It has been prepared by the staff for discussion by the IASB. Issues discussed and conclusions reached will be subject to change.

**What does this section cover?**

This section discusses:

- What is an asset or liability?
- What are income and expense?
- What should the conceptual framework say about unit of account?

**Why is this section important? What problems will this section help address?**

This section addresses the following problems with the existing definitions of assets and liabilities:

- They contain references to expected inflows or outflows of economic benefits. Those references are confusing because some have read them as:
  - importing a notion of probability into the definitions
  - implying that the asset or liability is the ultimate inflow or outflow of economic benefits, rather than the underlying resource or obligation.
- It has been unclear how to apply the existing definitions in some cases.
- Recognition and measurement issues often depend on the unit of account. The existing framework does not discuss how the IASB should determine the unit of account.

**What do the staff recommend?**

- An asset is a present economic resource.
- A liability is a present obligation to transfer an economic resource.
- An economic resource is a scarce item that is capable of producing economic benefits for the party that controls the item.
- Income and expense would still be defined as changes in assets and liabilities.
- Determining the unit of account will normally be a standards level decision.
- The selected unit of account must provide relevant information and faithfully represent what it purports to represent.
- The unit of account for recognition and measurement will normally be the same, but might sometimes need to differ.

1. This section deals with the following topics:

   (a) Summary of objectives and qualitative characteristics (paragraph 2)

   (b) Focus on financial statements (paragraphs 3-6)

   (c) Definitions of assets and liabilities (paragraphs 7-32)

   (d) Definitions of income and expense (paragraphs 33-38)

   (e) Other definitions (paragraphs 39)

   (f) Unit of account (paragraphs 40-45)

## Summary of objectives and qualitative characteristics

2. The following is a brief summary of the objectives of general purpose financial reporting, and of the qualitative characteristics of useful financial information, as discussed in chapters 1 and 3 of the conceptual framework:

   (a) The objective of general purpose financial reporting[1] is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.[2]

   (b) To assess an entity's prospects for future net cash inflows, existing and potential investors, lenders and other creditors need information about the entity's resources, claims against the entity, and how efficiently and effectively the entity's management and governing board[3] have discharged their responsibilities to use the entity's resources.[4]

   (c) Financial reports provide information about the reporting entity's financial position (its economic resources and claims against the entity) and the effects of transactions and other events and conditions that change those resources and claims. Both types of information provide useful input for decisions about providing resources to an entity.[5]

   (d) If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable.[6]

[1] Footnote text Throughout this discussion paper and the *Conceptual Framework*, the terms *financial reports* and *financial reporting* refer to *general purpose financial reports* and *general purpose financial reporting* unless specifically indicated otherwise.

[2] Paragraph OB2 of the Conceptual Framework. All references are to the Conceptual Framework, unless otherwise stated.

[3] Throughout the Conceptual Framework, the term management refers to management and the governing board of an entity unless specifically indicated otherwise.

[4] OB4

[5] OB12, QC2

[6] QC4

(e) Reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information.[7]

## Focus on financial statements

3. The *Conceptual Framework* deals with financial reports. This discussion paper deals with financial statements, which are one form of financial reports. The IASB does not plan to address other forms of financial report in this project. Financial statements give information about:

   (a) an entity's financial position (its resources and the claims on the entity), reported in a statement of financial position.

   (b) changes in an entity's resources, and in the claims on the entity. An entity reports separately on the following components of those changes:

      (i) the entity's financial performance, reported in a statement of comprehensive income;

      (ii) changes in the entity's equity, reported in a statement of changes in equity;

      (iii) the entity's cash flows, reported in a statement of cash flows;

      (iv) changes in other assets and liabilities, reported in the notes to the financial statements.

4. Financial statements portray the financial effects of transactions and other events by grouping them into broad classes, the *elements* of financial statements. Elements are the building blocks from which financial statements are constructed.

5. Classifying, characterising and presenting information clearly and concisely makes it *understandable*.[8] To provide an understandable presentation, the statements of financial position, of performance, of changes in equity and of cash flows namely its resources and the claims on the entity include only items that are elements defined for the statement in question, and totals and sub-totals derived from those elements.

[7] QC35

[8] QC30

6. The elements are:

   (a) In the statement of financial position: assets, liabilities and equity;

   (b) In the statement of comprehensive income: income and expense;

   (c) In the statement of changes in equity: income, expense, contributions of equity, distributions of equity, transfers between classes of equity, as well as the opening and closing amounts of equity (or of components of equity);

   (d) In the statement of cash flows: cash inflows and cash outflows, as well as the opening and closing cash balances.

## Definitions of assets and liabilities

7. The elements of the statement of financial position are assets, liabilities and equity.

8. These elements provide users with information about an entity's resources and claims against the entity.[9] This is part of the information that users need to assess the entity's prospects for future net cash inflows, and to assess how efficiently and effectively the entity's management have discharged their responsibilities to use the entity's resources.[10]

9. The existing definitions of assets and liabilities are:

   (a) an asset: 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[11]

   (b) a liability: 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.[12]

[9] QC2

[10] OB4

[11] 4.4(a)

[12] 4.4(b)

10. These definitions have proved over many years to be a useful tool for solving many issues in standard setting. They focus on economic phenomena that exist in the real world, are relevant to users and are understandable. Nevertheless, improvements are possible. This discussion paper identifies three types of improvement:

   (a) An essential improvement, discussed in paragraphs 12-14, to confirm more explicitly that:

      (i) an asset is a resource (rather than the inflow of economic benefits that the resource may generate).

      (ii) a liability is an obligation (rather than the outflow of economic benefits that the obligation may generate).

      (iii) although an asset (or liability) must be capable of generating inflows (or outflows) of economic benefits, there is no minimum probability threshold that those inflows (or outflows) must reach before a resource (or obligation) qualifies as an asset (or liability).

   (b) Further improvements that are not essential, but would streamline the definitions without changing their meaning. These improvements would:

      (i) move the reference to control from the definition of an asset into the recognition criteria. Control does not determine whether an asset exists, it determines which entity controls that asset. Agenda paper 3E discusses control.

      (ii) delete the reference to past events. The requirement for an asset to be a present resource, and for a liability to be a present obligation, already includes the notion of a past event.

      (iii) move the reference to future economic benefits into a new definition of economic resource. This would make the definition of an asset more concise. It would also permit a more focussed definition of a liability as an obligation to transfer economic resources. These changes also reinforce the message that the asset (or liability) is the resource (or obligation), not the flows of economic benefits that may result.

(c) Additions to the guidance supporting the definition, to clarify various issues that have caused difficulties in standards level projects. These are discussed in paragraphs 17-32 for assets and in agenda paper 3C for liabilities.

11. This paper proposes the following definitions to implement the changes discussed in paragraph 10(a) and (b):

(a) an asset: a present economic resource

(b) a liability: a present obligation to transfer an economic resource.

(c) economic resource: a scarce item that is capable of producing economic benefits for the party that controls the item.

### *An asset is a resource and a liability is an obligation*

12. Because the existing definitions refer to expected flows of economic benefits, some readers have sometimes confused the resource (asset) or obligation (liability) with the resulting inflow (or outflow) of economic benefits. Two factors cause this risk of confusion:

(a) Some readers interpret the term ‘expected’ as conveying a probability threshold. Paragraph 14 discusses whether it is appropriate to include a threshold.

(b) The explicit reference to the flows of economic benefits blurs the distinction between the resource or obligation and the resulting flows of economic benefits. The proposed definition seeks to remove that source of confusion by moving the reference to economic benefits into the new definition of an economic resource.

13. The guidance supporting the definition of an asset would note that the asset is the resource, it is not the ultimate future inflow. For example:

(a) For a call option on an underlying asset, the resource is the right to buy the underlying asset, not the underlying asset. (Similarly, the holder has no obligation to pay the strike price.)

(b) For a free-standing put option on an asset, the resource is the right to sell the underlying asset, not the sale proceeds. (If the put option is not free-standing but embedded in the asset itself, the option might be viewed as being part of the asset rather than a separate asset. Whether that view is taken depends on the unit of account. The final section of this paper discusses unit of account.)

(c) Under a forward purchase contract, the resource is the right to purchase the underlying asset at a future date. The purchaser also has an obligation to pay the consideration, unless the purchaser has already fulfilled that obligation. The nature of the purchaser's rights and obligation may depend on the circumstances.

  (i) In some cases, the purchaser might have a single net right or net obligation to exchange the underlying asset and the purchase price simultaneously. Often, that net right or net obligation would be measured at zero.

  (ii) In other cases, the purchaser might have a separate gross right to receive the asset and a separate gross obligation to pay the purchase price. In practice, such rights and obligations are sometimes offset.

  (iii) In current practice, a forward contract is sometimes treated as equivalent to the underlying (eg trade date accounting for some financial instruments).

(d) For pharmaceutical research in progress, the asset is the know-how, not the benefit that will arise if the research is successful (Although the measure of such assets might in some cases be very small, or immaterial, if the likelihood of future cash inflows is remote or the future cash inflow is small, that does not mean that an asset does not exist.)

(e) For a lottery ticket, the resource is the right to participate in the lottery, not the cash prize.

### *Role of uncertainty*

14. The existing definitions include the notion that future economic benefits (or a future outflow of resources) must be ‘expected’. Some have viewed that notion as requiring that the probability of an inflow of economic benefits must meet some minimum threshold. However, any such probability threshold would exclude many items that are clearly assets, such as many purchased options. The important thing is that there are at least some outcomes in which the resource will generate economic benefits. Thus, the proposed definition of an economic resource clarifies that an economic resource is *capable* of producing economic benefits. Agenda paper 3E concludes that the degree of likelihood should not affect recognition, but may affect measurement.

### *Past event*

15. The existing definitions refer to a past event and to a present economic resource and present obligation. Identifying a past event is not sufficient to determine whether an economic resource or obligation still exists. Moreover retaining that reference creates the risk that an asset or liability would not be identified if it were difficult to determine precisely which past event gave rise to the economic resource or obligation. The key question is whether the economic resource or obligation exists at the reporting date. Thus, the reference to a past event is redundant, and may cause unnecessary difficulties.

16. Therefore, the proposed definitions do not retain the reference to a past event. The supporting guidance could note that identifying an economic resource or obligation may sometimes be easier if the entity can identify a past event that brought that resource or obligation into existence. However, identifying such a past event would not be a necessary step. [Agenda paper 3C discusses how to identify a present obligation. One approach discussed there would give a more prominent role to the past event in some cases. If the IASB adopts that approach, the discussion in this paragraph will need to change to reflect that.]

### *Clarifying the guidance on the definitions*

17. To address various issues that have arisen during standards level project, this paper proposes to add to the conceptual framework further guidance to support the definitions of an asset and a liability in the following areas:

    (a) Economic resources (paragraphs 18-28)

    (b) Obligations to transfer economic resources (agenda paper 3C)

    (c) Contractual rights and contractual obligations (paragraphs 29-31(b))

    (d) Executory contracts (paragraph 32)

*Economic resources*

18. The proposed definition of an economic resource includes the notions that the resource:

    (a) is scarce. The notion of scarcity is intended to convey the idea that the item will generate economic benefits only for the party that controls it. Public goods, such as air, provide benefits to all, and are not economic resources.

    (b) is capable of producing economic benefits.

19. Paragraphs 20-32 address various issues that have arisen over the years during standards level projects in relation to the definition of asset. This paper proposes that the IASB should add to the conceptual framework further guidance on these issues.

20. Economic resources may take various forms:

    (a) Enforceable rights established by contract, law or similar means:

        (i) Enforceable rights arising from a financial instrument, such as an investment in a debt security or an equity investment

        (ii) Enforceable rights over physical objects, such as property, plant and equipment or inventories. Such rights might include ownership of a physical object, the right to use a physical object, or the right to the residual value of a leased object

(iii) Enforceable rights to receive another resource if the holder of the right chooses to exercise that right (an option to acquire the underlying resource) or is required to exercise that right (a forward contract to buy the underlying resource). Examples include options to receive other assets, net rights under forward contracts to buy or sell other assets, rights to receive services for which the entity has already paid, rights to benefit from stand ready obligations (agenda paper 3C discusses stand ready obligations).

(iv) Enforceable intellectual property rights (eg registered patents)

(b) Other economic resources if they both (i) are capable of generating economic benefits to the party that controls the economic resource and (ii) do not generate economic benefits for other parties. Agenda paper 3E discusses how an entity establishes control of such resources. Examples of such resources include:

(i) know-how

(ii) customer lists

(iii) customer and supplier relationships

(iv) an existing work force

(v) goodwill. The IASB concluded in paragraphs BC313-323 of the *Basis for Conclusions on* IFRS 3 *Business Combinations* that goodwill does meet the definition of an asset. However, agenda paper 3E notes that recognising internally generated goodwill is not necessary to meet the objectives of financial statements and would not pass a cost-benefit test.

(c) Some assets, particularly many services, that are consumed immediately on receipt.[13]

21. The guidance would clarify that economic benefits derived from an asset are the potential cash flows that can be obtained directly or indirectly in many ways, such as by:

[13] Revenue recognition ED paragraph 31

(a) using the asset to produce goods or provide services;

(b) using the asset to enhance the value of other assets;

(c) using the asset to fulfil liabilities or reduce expenses;

(d) selling or exchanging the asset;

(e) receiving services from the asset.

(f) pledging the asset to secure a loan; or

(g) holding the asset.[14]

22. The supporting guidance would clarify that, for a physical object, such as an item of property, plant and equipment, the economic resource is not the underlying object but a right (or set of rights) to obtain the economic benefits generated by the physical object. Accordingly, in principle, although there is a difference in degree between full unencumbered legal ownership of, for example, a machine and a right to use such a machine for a fixed period under a lease, there is no difference in nature.

(a) In the case of the right to use under a lease, the holder's right is to obtain some of the benefits generated by the machine – those benefits generated during the period for which the lessee has the right of use.

(b) In the case of full unencumbered legal ownership the holder's right is to obtain all of the benefits generated by the machine throughout its useful life.

23. In many cases, economic resources will comprise various different rights. For example, if an entity has legal ownership of a physical asset, the economic resource will comprise rights such as:

(a) The right to use the asset

(b) The right to sell the asset

(c) The right to pledge the asset.

(d) Legal title to the asset.

[14] Most of this list is from the revenue recognition ED paragraph 31. 'receiving services from the asset' was added.

24. Sometimes one party holds all these rights. Sometimes, as in a lease, different parties hold these rights, in which case each party recognises the rights that it controls.

25. In principle, each of these rights is capable of being a separate asset. However, in many cases an entity treats all of those rights as a single asset. Nevertheless, an entity would treat some of those rights as one or more separate assets if such separation would produce users with information that is relevant, and provides a faithful representation of the resources, at a cost that does not exceed the benefits of doing so. (see further discussion on unit of account in the final section of this paper)

26. A right is enforceable if the holder of the right can ensure that it will retain any economic benefits generated by the right. Enforceability does not mean that the entity can ensure that those economic benefits will arise. For example, shares normally give the holder an enforceable right to receive any dividends that the issuer chooses to issue, even if the holder cannot compel the issuer to declare a dividend.

27. In assessing whether an item meets the definition of an asset or liability, attention would need to be given to its underlying substance and economic reality and not merely its legal form. In some cases, the legal form is an important part of the substance. In other cases, the legal form is only a minor part of the substance.

28. The following are examples of items that do not meet the definition of an asset:

    (a) Equity instruments issued by the entity and repurchased by it (eg treasury shares). Those instruments are not capable of providing economic benefits to the entity. (However, if another party held those equity instruments, they would be an asset for that party because they are capable of providing economic benefits, such as dividends.)

    (b) A call option on the entity's own equity instruments. This is not an asset for the issuer because the underlying equity instruments that would be received on exercise are not an asset for the entity. (However, if another party held that call option, the call option would be an asset for that party, because the equity instruments would be an asset for that party.)

(c) Fish in water to which access is not restricted. Although a potential source of economic benefits, this is not an economic resource because those benefits are available to any party. (The fish would be an asset of an entity that has an exclusive right to catch them. Similarly, if fishing quotas are introduced, the quota of each party would become an asset of that party, though the fish themselves would still not become an economic resource.)

(d) Knowledge that is in the public domain and freely available to anyone without significant effort or cost.

*Contractual rights and contractual obligations*

29. An important class of resources and obligations is the resources and obligations that arise under contracts. Entering into a contract gives rise to rights and obligations, if (and only if) those rights and obligations are enforceable.

30. If neither party is bound by one particular term in a contract, that term has no commercial substance and so is not a source of rights and obligations. Therefore, that term does not qualify for recognition as part of an asset (assets) or liability (liabilities) arising from that contract.

31. The unit of account will determine whether a contract is viewed as giving rise to a single net right or net obligation, or to one or more separate rights and obligations and liabilities. For example:

(a) If a single legal document contains two or more sets of rights and obligations that would all have been identical if they had been created through more than one legal document, the entity may need to account for them in the same way as if they were separate contracts, in order to give a faithful representation of the rights and obligations and of changes in those rights and obligations.

(b) If a single set of rights and obligations is contained in more than one legal document, an entity may need to account for them as a single contract, in order to give a faithful representation of the rights and obligations and of changes in those rights and obligations. One case where this may be particularly important is if rights or obligations in one contract entirely negate obligations or rights in another contract.

*Executory contracts*

32. In principle, a net asset or net liability arises under a contracts for which neither party has yet performed (an *executory contract*) if the contract is enforceable. However, if the contract was priced on arm's length terms, the initial measurement of that contract would typically be zero because the rights of one party have the same value as its obligation to the other party. Accordingly, typically neither party has a (net) asset or (net) liability at inception. After inception, one or both parties may need to recognise a (net) asset or (net) liability, depending on the measurement basis applied.

| **Questions for the IASB** |
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| 1. Do you agree with the following definitions: |
| (a) an asset: a present economic resource? |
| (b) a liability: a present obligation to transfer an economic resource? |
| (c) economic resource: a scarce item that is capable of producing economic benefits for the party that controls the item? |
| 2. Do you have any other comments on the proposed guidance? |

[Agenda paper 3C contains a discussion of guidance on liabilities, Agenda paper 3D includes a definition of equity and a discussion of the liability /equity distinction]

## Definitions of income and expense

33. The elements of the statement of comprehensive income are income and expense.

34. These elements provide users with information about some of the changes in an entity's resources and in claims against the entity.[15] This is part of the information

[15] QC2

that users need to assess the entity's prospects for future net cash inflows, and to assess how efficiently and effectively the entity's management have discharged their responsibilities to use the entity's resources.[16]

35. This paper does not propose significant changes to the existing definitions of income and expense, which are based on changes in the carrying amount of assets or liabilities:

(a) Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

(b) Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants. [17]

36. When an entity issues equity instruments in exchange for an asset, the entity acquires that asset (and recognises it if the recognition criteria are met). Similarly, when an entity issues equity instruments in exchange for receiving services, the services received are an asset: when the entity consumes that asset, it recognises an expense. In many cases, an entity consumes that asset immediately; if so, the entity recognises the expense at the same time as it recognises the related increase in equity.[18] Agenda paper 3G discuss how, on initial recognition, an entity should measure the asset or service received and the related contribution to equity.

37. The existing Framework distinguishes two categories of income (revenue and gains) and two categories of expense (expenses that arise in the course of the entity's ordinary activities, and losses). The Framework does not treat those four categories as separate elements. This paper does not discuss whether it is useful for the Framework to identify such categories.

[16] OB4

[17] 4.25

[18] Basis for Conclusions on IFRS 2, paragraphs BC45-BC53

38. Section [5] of this draft discussion paper [will] discuss [whether and] how to distinguish profit and loss from other comprehensive income (OCI). Such a distinction could be implemented by either:

    (a) identifying one set of elements for inclusion in profit or loss and a separate set of elements for inclusion on OCI, or

    (b) identifying a single set of elements for inclusion in both profit or loss and OCI, and establishing presentation concepts that identify which types of income and expense would be presented in profit or loss and which would be presented in OCI.

## Other definitions

39. Other elements (not defined in existing framework), no detailed explanation required:

    (a) Cash receipts

    (b) Cash payments

    (c) Contributions to equity

    (d) Distributions of equity

    (e) Transfers between classes of equity

| Question for the IASB | |
|---|---|
| 3. | Do you have any comments on the definitions of income and expense, and the other items listed in paragraph 39? |

## Unit of account

40. In order to recognise and measure assets and liabilities in the financial statements in a way that provides useful information to existing and potential investors, lenders and other creditors it is usually necessary to aggregate individual rights and obligations. The level of aggregation required is usually referred to as the unit of account.

41. For example, ownership of a physical asset such as a machine comprises several rights (the right to use the asset, the right to sell the asset, the right to pledge the asset and legal title to the asset). Although, in principle each of these rights is capable of being a separate asset, combining these rights into a single unit of account and recognising a single asset (the machine) will in many cases provide the most relevant and understandable information to the users of the financial statements. In other cases (for example when the machine has been leased), recognising (or derecognising) some of the rights separately may provide a more faithful representation of the financial position of the entity.

42. The unit of account used can also affect the measurement of recognised assets and liabilities. For example,

    (a) A different measure of an equity investment may be obtained if:

        (i) the value of an individual share is measured and multiplied by the number of shares; or

        (ii) the value of the total equity investment is measured.

    (b) In determining whether an asset is impaired, a different conclusion may be reached if the asset is reviewed for impairment in isolation or as part of a group of assets. This is because, within a group, gains on some assets may be offset against losses on other assets, whereas if they were reviewed in isolation the gains would be ignored.

43. Determining which unit of account will provide the most useful information to existing and potential investors, lenders and other creditors will normally be a standards level decision. In making that decision, the IASB will consider the qualitative characteristics of useful information. The selected unit of account must:

    (a) provide relevant information. Information about individual rights or obligations may not be relevant if those rights or obligations cannot be, or are unlikely to be, separated.

    (b) faithfully represent what it purports to represent. Grouping unrelated assets or liabilities together, in order to measure them, may not faithfully represent the financial position or performance of an entity

In addition, the costs associated with the selected unit of account must exceed the benefits. In general, the costs associated with recognising and measuring items will increase with the level of disaggregation.

44. In some cases the IASB may not need to specify a particular unit of account (for example, if the unit of account is unlikely to affect the recognition or measurement of assets or liabilities). However, in other cases, the IASB may decide that it needs to specify a unit of account to ensure comparability either between entities or over time. The selected unit of account must also provide information that is understandable.

45. The unit of account for recognition and measurement will normally be the same. However, there may be situations where the IASB decide that a different unit of account should be used for recognition and measurement.

| **Question for the IASB** |
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| 4. Do you support the proposed discussion of the unit of account issue? |