STAFF PAPER

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Accounting Standards Advisory Forum

Project	**Conceptual Framework**		
Paper topic	Recognition—low probability of a flow of economic benefits		

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Purpose of the paper

1. The Exposure Draft *Conceptual Framework for Financial Reporting* ('the Exposure Draft') proposed concepts for recognition of assets, liabilities, income and expenses.

2. The IASB staff are developing suggestions for possible refinements to those concepts. In particular, we are considering possible ways of improving the concepts relating to the recognition of assets and liabilities with a low probability of inflows or outflows of economic benefits.

3. This paper requests views from ASAF members on the staff suggestions. We will use ASAF members' comments to help develop the suggestions further for future discussion with the Board.

Background

Exposure Draft proposals

4. 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.**

5. However, some existing IFRS Standards do not 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'.

6. Accordingly, the Exposure Draft proposed a new approach to recognition. Paragraph 5.9 explained that failure to recognise items that meet the definition of an element makes the statement of financial position and the statement(s) of financial performance less complete and can exclude useful information from financial statements. But it went on to acknowledge that in some circumstances, the recognition of some items that meet the definition of an element can provide information that is not useful. The Exposure Draft 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.

7. The supporting discussion identified circumstances in which recognition may not provide relevant information. These circumstances included 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).

8. The Exposure Draft also proposed that it will often be a combination of the factors described in paragraph 7 above, instead of any single factor, that causes information to lack relevance.

Summary of feedback

9. Many of the respondents who commented on the recognition proposals broadly agreed with the overall approach proposed in the Exposure Draft. 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 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.

10. However, some respondents disagreed with the proposed approach. The main concerns of those respondents—which were shared by some respondents who broadly agreed with the proposed approach—were that:

(a) the proposals were too abstract and subjective. They did not provide enough direction, and, as a result, the way in which the Board or preparers apply them could depend too much on individual perspectives. More concrete and robust proposals would be required to ensure that the Board develops Standards with consistent requirements that result in useful information.

(b) 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 lead to requirements for entities to recognise more assets and liabilities with a low probability of inflows or outflows. Preparers of financial statements would have to perform unlimited searches for rights and obligations. And they may be required to recognise assets and liabilities for which recognition would not provide useful information. (Recognising such assets and liabilities would frequently result in recognition of gains or losses in one period that reverse in subsequent periods.)

(c) 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 assets and liabilities at expected value is difficult and puts additional burdens on preparers of financial statements.

(d) the probability criterion has proved to be effective in practice. It is a more practical way of applying the qualitative characteristics than that proposed in the Exposure Draft:

   (i) 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

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

11. Respondents with concerns about the proposed approach suggested various alternatives:

(a) some respondents suggested retaining the probability criterion.

(b) the Accounting Standards Board of Japan (ASBJ) suggested that:

(i) for recognition of an asset or a liability created from a right or an obligation that arises from transactions, the probability criterion is unnecessary; whereas

(ii) for recognition of an asset or a liability or a group of assets and/or liabilities created from a right or an obligation (or rights and/or obligations) that arises from 'other events', the probability criterion is necessary.

(c) Some respondents asked for further guidance for assets or liabilities with a low probability of inflows or outflows of inflows or outflows. Suggestions included:

(i) stating that the potential magnitude of the outcome should be considered;

(ii) specifying the level of probability at which assets and liabilities should be recognised;

(iii) clarifying whether the same level of probability should be applied for both assets and liabilities;

(iv) identifying the types of situation in which recognising an asset or liability with a low probability of inflows or outflows of economic benefits would not result in relevant information.

(d) 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.

Recent Board decisions

12. At its May 2016 meeting, the Board tentatively decided to describe measurement uncertainty as a factor affecting faithful representation, not relevance.

13. This tentative decision has implications for the proposed recognition concepts. In particular, high measurement uncertainty would no longer be characterised as a factor that could affect decisions on whether recognition provides relevant information about an entity's assets, liabilities, income and expenses. Instead, it would be characterised as a factor that could affect decisions on whether recognition would provide a faithful representation of the entity's assets, liabilities, income and expenses.

Next steps

14. At a future meeting, the Board will discuss the responses to the recognition concepts proposed in the Exposure Draft. At that meeting, it will consider the views of those who disagree with the overall approach to recognition proposed in the Exposure Draft, and in particular the views of those who think that that the *Conceptual Framework* should retain a probability criterion that would apply to all assets and liabilities.

15. However, given the broad support for the overall approach proposed in the Exposure Draft, the IASB staff will also offer the Board an option of refining the proposed approach, rather than fundamentally changing it.

Possible refinements

16. The staff are considering possible refinements to the concepts for recognising assets and liabilities with a low probability of future inflows or outflows. Those refinements would not fundamentally change the approach proposed in the Exposure Draft:

(a) they would not change the statements in paragraph 5.9 of the Exposure Draft that:

(i) failure to recognise items that meet the definition of an element makes the statement of financial position and the statement(s) of financial performance less complete and can exclude useful information from financial statements; but

(ii) in some circumstances, the recognition of some items that meet the definition of an element can provide information that is not useful;

(b) they would not change the proposal in paragraph 5.9 that an entity should recognise an asset or a liability if recognition provides users of financial statements with useful information and recognition results in benefits exceeding the cost of providing that information; and

(c) they would not change the proposal in paragraph 5.13(b) of the Exposure Draft that recognition of an existing asset or a liability may not provide relevant information if there is only a low probability that an inflow or outflow of economic benefits will result from the asset or liability.

17. The refinements would affect the concepts supporting paragraph 5.13(b), ie those proposed in paragraphs 5.17–5.19 of the Exposure Draft. The objective of the refinements would be to ensure that:

(a) in reaching decisions on whether particular assets or liabilities should be recognised, the Board takes into account any applicable reasons why recognition of assets and liabilities with a low probability of inflow or outflow might not provide useful information; and

(b) the concepts for recognition of such assets or liabilities are balanced: the drafting does not suggest that either recognition or non-recognition is the ‘preferred’ outcome.

18. The staff thinks that the first objective could be met by identifying in the *Conceptual Framework* some of the reasons why recognition of assets and liabilities with a low probability of future inflows and outflows might not provide useful information. We have identified three possible reasons:

(a) the most relevant information about assets and liabilities with a low probability of future inflows or outflows will often be information about the amount, timing and likelihood of the possible outflows. This information is typically communicated by explanatory disclosures. Recognition decisions need to consider whether recognising an asset or a liability would provide additional relevant information beyond that provided by disclosure.

(b) whether recognition provides additional relevant information may depend on the nature of the asset or the liability. As the ASBJ have suggested, a relevant factor may be the way in which the asset or liability has arisen, ie whether it has arisen from a transaction or some other event. For further details of the ASBJ's suggestions, see ASBJ Short Paper No. 2 Recognition Criteria in the *Conceptual Framework*,[1] which was Agenda Paper 3 for the December 2015 ASAF meeting,

(c) a low probability of future inflows or outflows could contribute to measurement uncertainty and hence might need to be taken into consideration in assessing both relevance and faithful representation. A low probability of future inflows or outflows could contribute to measurement uncertainty because, for example:

  (i) the frequency of a low probability outcome may be difficult to estimate because historical data may not provide a long enough observation period in which to estimate probability. For example, a 50 year observation period would not provide much evidence about the frequency of an event that occurs only once every 200 years; and

  (ii) if the probability of future inflows or outflows is low, but their possible magnitude is high, the measure of an asset or a liability may be highly sensitive to small changes in estimates of the probability.

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[1] http://www.ifrs.org/Meetings/MeetingDocs/ASAF/2015/December/1512-ASAF-03-ASBJ-Short-Paper-No-2-Recognition-Criteria-in-the-CF.pdf

19. The staff has also identified refinements that might help avoid any suggestion that recognition is the 'preferred' outcome for assets or liabilities with a low probability of inflows or outflows. These refinements could include:

(a) redrafting paragraphs 5.18 and 5.19 so that there is as much discussion of situations in which recognition may provide information that *is not* relevant as of situations in which recognition may provide information that *is* relevant. This could be achieved by including examples for each situation. In the Exposure Draft, there was an example (in paragraph 5.18) to explain when recognition of an asset or liability with low probability of inflow or outflows may provide information that is not relevant. However, there was no example (in paragraph 5.19) to explain when recognition may provide information that is not relevant.

(b) discussing the possibility of non-recognition of assets and liabilities for which the probability of future inflows or outflows is 'low', not only assets or liabilities for which that probability is 'very low'.

Drafting illustration

20. The appendix to this paper illustrates how we think the refinements discussed in paragraphs18–19 could be drafted if they were to be approved by the Board (and assuming that the Board does not decide to make more fundamental changes to the proposed concepts for recognition).

21. The illustration includes all of the refinements that would be reflected in the paragraphs discussing relevance. The illustration does not include one refinement that would instead be reflected in the paragraphs discussing faithful representation, ie the suggestion in paragraph 18(c) that a low probability of future inflows or outflows could also contribute to measurement uncertainty. The wording of this refinement would have to be considered alongside other changes required to implement the Board's decision to characterise measurement uncertainty as a factor affecting faithful representation (instead of relevance).

Questions to ASAF members
1. Do you agree with the refinements suggested in paragraphs18–19?
2. Do you have any other comments or suggestions on the concepts for recognising assets or liabilities with a low probability of future inflows or outflows?

Appendix—Drafting illustration—possible refinements to recognition concepts

The original text is from the Exposure Draft. Suggested insertions are underlined, and suggested deletions are struck through.

Relevance

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

(a) …;

(b) if an asset or a liability exists, but there is only a low probability that an inflow or outflow of economic benefits will result (see paragraphs 5.17–5.19); or

(c) ….

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

Existence uncertainty and separability

5.15 ….

5.16 …...

Low probability of a flow of economic benefits

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

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

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

5.18 If the probability of an inflow or outflow of economic benefits is low, the most relevant information may be that provided by disclosure of information about the asset or the liability in the notes to the financial statements. That information may include information about the possible amounts of any inflows or outflows of economic benefits, their possible timing and the factors affecting their likelihood.

5.19 Whether recognition of the asset or liability provides additional relevant information beyond that provided by disclosure could depend on factors such as how the asset or liability arose. For example:

(a) if an asset is acquired, or a liability is incurred, in an exchange transaction for an observable price, its cost reflects the low probability that economic benefits will flow and that cost may be relevant information. Furthermore, not recognising the asset or liability would result in the recognition of income or an expense at the time of the exchange, which might not be a faithful representation of the transaction (see paragraph 5.23(a)).

(b) if an asset or a liability arose from an event other than an exchange transaction, that asset or the liability might not have a cost. In such circumstances, recognition of the asset or the liability typically results in recognition of income or an expense. Users of financial statements might not regard the recognition of the asset and income, or the liability and expense, as relevant information if there is only a low probability that the asset or liability will result in an inflow or outflow of economic benefits.