AASB Staff Issues Paper on IASB Conceptual Framework Developments (Draft IASB Discussion Paper)

Recognition and Derecognition of the Elements of Financial Statements

Introduction

1 This AASB Staff Issues Paper, together with AASB Agenda Paper 14.2, provides the focus for the Board's non-deliberative high-level 'educational' session at the forthcoming AASB meeting on the latest publicly available Draft IASB Discussion Paper (DP) on Conceptual Framework, as reflected in IFRS Staff Papers issued in April 2013.

2 Extracts from the Draft IASB DP covering the recognition and derecognition of the elements of financial statements are provided in AASB Agenda Paper 14.6. That paper is a copy of an IFRS Staff Paper.

3 This paper includes the AASB staff's questions that AASB members will be asked to discuss regarding the above-mentioned extracts from the Draft IASB DP. Board members' tentative leanings on these questions would be welcome.

Background on the selected questions asked in this paper

4 The questions asked of AASB members in this paper focus on the key issues, as AASB staff see them, affecting the IASB's draft discussion of the criteria for recognition and derecognition of the elements of financial statements. Board members' views on them will inform staff in identifying key concerns to raise in an initial draft of the AASB's submission on the IASB DP and in discussions with AOSSG and ASAF members.

5 Some of the questions in this paper [Questions 1, 2(a) and 4] are closely related to questions asked of IASB members in the attached IFRS Staff Paper (AASB Agenda Paper 14.6). Other questions in this paper raise issues not raised in the IFRS Staff Paper [Questions 2(b) and 3]. Some questions asked of IASB members in the attached IFRS Staff Paper (namely, those in paragraph 47(c) and 48 of AASB Agenda Paper 14.6) are not raised in this paper because AASB staff think they do not relate to key issues or are very general in nature. Any IASB questions on the criteria for recognition and derecognition of the elements of financial statements that are not included in this paper will be addressed in AASB Staff Papers for future Board meetings.

6 At the Board meeting session, AASB staff will give a PowerPoint-based verbal presentation on the part of the draft IASB DP covered by AASB Agenda Paper 14.6. (Copies of the PowerPoint slides will be tabled at the Board meeting.)

7 This paper includes views of AASB staff on the issues discussed. Consistent with the introductory nature of this Board meeting's discussion, those AASB staff views are tentative in nature.

Recognition Criteria

Probability

8 AASB staff have some concerns about the IASB's preliminary view that "The reference to probability should be deleted from the recognition criteria." [AASB Agenda Paper 14.4, paragraph 38(c)] AASB staff tentatively think further consideration should be given to adopting some form of probability-related recognition criterion (whether a 'probable' criterion or another criterion: see paragraph 9 below) in the IASB Conceptual Framework in relation to outcome uncertainty. This is because:

(a) it would detract from the recognised items in financial statements if those recognised items included items that are material (due to having the potential for very large amounts of inflows or outflows of economic resources) but have only a remote chance of the outcome occurring. For example, a frivolous claim against an entity for alleged damages with a remote chance of success might be material, but we think it would not warrant recognition; and

(b) recognising all rights and obligations regardless of probability of outcome might require entities to search 'endlessly' for potential rights and obligations, including those that are remote but still potentially material in amount.

9 A 'probability-related recognition criterion' could be, for example, the 'probable' criterion for recognition in paragraph 4.38(a) of the IASB Conceptual Framework[1] or a 'more than remote' criterion. Either of these criteria could address the concerns in (a) and (b) of paragraph 8 above. Both of them would have the disadvantage (compared with the IASB's preliminary view not to include any form of probability-based recognition criterion for the elements of financial statements) that "some such items [i.e. items judged at a particular time to have a low probability of resulting in an inflow or outflow of economic benefits] may swing above and below the threshold as the probabilities change" [AASB Agenda Paper 14.4, paragraph 38(c)]. In addition, both of these examples of applying a 'probability-related recognition criterion' would have the disadvantage that economically similar rights or obligations might be treated differently for recognition purposes because they fall on different sides of the threshold adopted. However, AASB staff think these disadvantages are likely to be outweighed by the advantages of addressing the concerns in (a) and (b) of paragraph 8 above. This is particularly the case because AASB staff think an element's failing to meet the 'probable' criterion for recognition would only occur rarely, and failing to meet a 'more than remote' criterion would occur even more rarely; therefore, concerns about falling on either side of a threshold are exaggerated by implying a level of precision in probability assessments that would not be expected to be common in practice.

10 AASB staff observe that adopting a 'more than remote' criterion would lead to the recognition of more elements of financial statements than applying a 'probable' criterion, which would seem likely to arguably result in the provision of more relevant information on the face of the pertinent financial statement. On the other hand, AASB

[1] Paragraph 83(a) of the AASB *Framework for the Preparation and Presentation of Financial Statements*.

staff note that some might argue that adopting a ‘probable’ criterion is more neutral than a ‘more than remote’ criterion, and note that a ‘probable’ criterion is more familiar to readers of the existing IASB Conceptual Framework and users of general purpose financial reports. AASB staff do not express a tentative preference at this stage for either a ‘probable’ criterion or a ‘more than remote’ criterion.

11 AASB staff acknowledge that their suggestions imply different treatment, in concept, of existence uncertainty and outcome uncertainty [i.e. applying best judgement (but not a formal probability-related criterion) to identify whether an asset or a liability exists[2], and applying a probability-related criterion regarding whether the outcome of an asset or a liability will be an inflow or outflow of economic benefits]. We note that some commentators have expressed concern that, in some cases, it can be difficult in practice to distinguish existence uncertainty and outcome uncertainty. However, we counter that:

(a) practical difficulties with applying concepts are a Standard-level issue that does not undermine the merits of those concepts. For the Conceptual Framework, the test should be whether the treatment is conceptually sound when the distinction between existence uncertainty and outcome uncertainty is clear;

(b) existence uncertainty should (as the IASB indicates in paragraph 25(a) of AASB Agenda Paper 14.4) occur only rarely, e.g. in the case of litigation. Therefore, applying different conceptual responses to existence uncertainty and outcome uncertainty should not be regarded as a significant inconsistency; and

(c) because of its general rarity, existence uncertainty generally relates to individual rights or obligations, for which there is generally not a large population of items on which to develop probabilities (e.g. there would seldom be significant experience with the items on which to base statistical techniques for estimating associated probabilities). Therefore, in practice, a ‘best judgement’ approach and ‘probable’ (i.e. more likely than not) approach would be expected to lead to the same or similar conclusions in practice [however, as noted in paragraph 10 above, AASB staff do not express a tentative preference at this stage for a ‘probable’ criterion over a ‘more than remote’ criterion].

12 AASB staff think it is potentially confusing to exclude probability as a recognition criterion but to mention [in paragraph 24(a) of IFRS Staff Paper 10D(a) for the IASB’s April 2013 meeting (AASB Agenda Paper 14.6)] a low probability of an inflow or outflow of economic resources as a reason why recognition of an asset or a liability might not provide relevant information (and thus that the liability or asset might not qualify for recognition). (See also the discussion of relevance and the cost constraint in paragraphs 13 – 20 below.)

Question for Board members

Q1 What are your tentative leanings on the IASB’s preliminary view that the reference to probability should be deleted from the recognition criteria?

[2] See AASB Agenda Paper 14.2, paragraph 51.

Relevance and the Cost Constraint

13 Paragraph 9 of AASB Agenda Paper 14.6 says "… In most cases, recognising rights and obligations provides users with relevant information, but in some cases it may provide information that is not relevant, or that is not sufficiently relevant to justify the cost". In this regard, the IASB Conceptual Framework says the following about relevance:

> "Relevant financial information is capable of making a difference in the decisions made by users. …" (paragraph QC6); and
>
> Financial information is capable of making a difference in the decisions if it has predictive value, confirmatory value or both." (paragraph QC7)

14 Given this conceptual guidance on the broad meaning of relevance, AASB staff disagree that recognising a resource or obligation might provide information that is not relevant (e.g. information about a particular resource, such as smoke filters on a factory, might not seem to some to provide useful insights into the entity's future cash inflows, but nevertheless might at least have confirmatory value as input to assessing the current period's rate of return on economic resources deployed). In forming this opinion, AASB staff viewed usefulness of information not only on a stand-alone basis, but also the effects of that information on assessments of the statement of financial position (and supporting notes) viewed in its entirety (i.e. AASB staff view completeness of the statement of financial position and supporting notes as an aspect of the decision usefulness of each item of information disclosed therein). In addition, regarding this issue, see paragraphs 15 – 16 below.

15 AASB staff note that, for particular entities, information about a resource or obligation might be irrelevant because it is immaterial. Paragraph QC11 of the IASB Conceptual Framework says:

> "Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. In other words, *materiality is an entity-specific aspect of relevance …*" (emphasis added).

16 AASB staff think that, in addressing the usefulness of particular information, the IASB Conceptual Framework's recognition criteria for the elements of financial statements need not, and should not, deal with materiality, due to its entity-specific nature. Therefore, AASB staff think any statement in the IASB Conceptual Framework that information about some economic resources or obligations lacks relevance logically should mean lacking relevance for all entities.

17 AASB staff observe that AASB Agenda Paper 14.6 says recognising some rights and obligations might not provide sufficiently relevant information to justify the cost (see paragraph 13 above). AASB staff agree, but think the discussion of the cost constraint in the IASB Conceptual Framework chapter on the Qualitative Characteristics covers this issue, and does not need to be commingled with a discussion specifically of recognition of the elements of financial statements. AASB staff think that, if the cost

constraint were to be explicitly specified in relation to relevance, it should be explicitly specified in relation to each of the other qualitative characteristics as they are applied to recognition of the elements of financial statements.

18 For the reasons in paragraphs 13 – 17 above, AASB staff disagree with the IASB's preliminary view in paragraph 10 of AASB Agenda Paper 14.6 that "… the IASB should not require recognition of an asset or liability if, in the IASB's view, recognition would result in information that is not relevant, or not sufficiently relevant to justify the cost of preparing it." AASB staff also note that, if the IASB were to confirm this preliminary view, a potential question arises whether, in concept, recognition of the asset or liability in question should be prohibited.

Internally generated goodwill

19 In relation to the discussion of the relevance and cost of recognising internally generated goodwill as an asset, in paragraphs 9(d) and 9(e) of AASB Agenda Paper 14.6:

(a) AASB staff disagree with the comment in paragraph 9(d)(i) that recognising internally generated goodwill provides little or no benefit because financial reports are not designed to show the value of a reporting entity. Although internally generated goodwill is estimated by reference to the value of an entity, it does not represent the value of an entity. A logical consequence of applying the argument repeated in the first sentence of this sub-paragraph is that purchased goodwill should not be recognised as an asset, either. The only difference between purchased and internally generated goodwill is that purchased goodwill is acquired in a transaction. A transaction (or cost) is not an essential characteristic of an asset. We think it is clear that recognising internally generated goodwill as an asset would provide relevant information to users for assessing the economic benefits an entity is likely to generate;

(b) we think that the cost of providing information, referred to in paragraphs 9(d)(ii) and 9(e), would be less of an issue for recognition than the ability to estimate a measure that faithfully represents the amount of internally generated goodwill. For various entities, the cost of measuring internally generated goodwill would not exceed the cost of measuring some other assets, including internally developed tangible assets. We acknowledge that estimating a representationally faithful measure of the amount of internally generated goodwill may often be problematic, and think an entity should not recognise an asset or a liability if no measure of the asset or liability would result in a faithful representation of that element even after including explanatory information about the estimation uncertainty[3]—however, we think issues regarding faithful representation should not be conflated with relevance and cost/benefit issues; and

[3] AASB staff understand that the IASB has possibly changed its mind regarding whether non-recognition of an asset or a liability would be appropriate if no measure of the asset or liability would result in a faithful representation of that element even after including explanatory information about the estimation uncertainty. Therefore, discussion of whether a 'faithful representation' recognition criterion should be included in the IASB Conceptual Framework has been deferred by AASB staff until after the IASB's Discussion Paper is issued.

(c) we think that, in any event, it is outside the scope of a Conceptual Framework to opine on whether a particular type of asset (such as internally generated goodwill) passes the cost-benefit test. Instead, we think that issue is a Standards-level issue.

20 In this regard, the statement in paragraph 24(e) of AASB Agenda Paper 14.6 that recognising internally generated goodwill as an asset is unnecessary to meet the objective of financial statements looks like an assertion.

Question for Board members

Q2 What are your tentative leanings on the IASB's preliminary views that the IASB Conceptual Framework should indicate that:

(a) in some cases, recognising rights and obligations may provide information that is not relevant, or that is not sufficiently relevant to justify the cost; and

(b) recognising internally generated goodwill provides little or no benefit to users?

Enhancing Qualitative Characteristics

21 AASB staff agree with the IASB's preliminary view (in paragraph 21 of AASB Agenda Paper 14.6) not to include recognition criteria relating to the enhancing qualitative characteristics (QCs) of comparability, verifiability, timeliness and understandability. As these enhancing QCs are not fundamental QCs, it would seem inappropriate for an element that meets the fundamental QCs of relevance and faithful representation to be omitted on the grounds of failing to meet an enhancing QC (in fact, it is likely that omitting an element that meets the fundamental QCs would detract in other ways from meeting the enhancing QCs—e.g. omitting an element because it cannot be verified might result in a reduction in comparability of the information reported). Another reason for supporting the above-mentioned preliminary view of the IASB is that the existing IASB Conceptual Framework does not include recognition criteria based on the enhancing QCs, and AASB staff are unaware that any problems have arisen from that approach.

Question for Board members

Q3 What are your tentative leanings on the IASB's preliminary view not to include recognition criteria relating to the enhancing qualitative characteristics?

Derecognition

22 AASB staff strongly support the IASB's preliminary view (in paragraph 45 of AASB Agenda Paper 14.6) that, in most cases, an entity should derecognise an asset or liability when it no longer meets the recognition criteria. This concept would be neutral between initial recognition and subsequent recognition (e.g. in assessing whether an element meets the criteria for recognition, it would be irrelevant whether the element had previously been recognised).

23 However, AASB staff disagree with the IASB's preliminary view that, if an entity retains a component of the asset or liability being derecognised, the IASB should determine in Standards projects whether to apply the general preliminary view above. Some of the possible approaches identified in AASB Agenda Paper 14.6 for consideration in Standards projects include:

(a) continuing to recognise the original asset or liability, and treating the proceeds received or paid for the transfer as a loan received or granted (paragraph 45(c) of AASB Agenda Paper 14.6);

(b) a full derecognition approach, under which the entire asset or liability is derecognised and a new asset or liability recognised (paragraph 46(a) of AASB Agenda Paper 14.6); and

(c) a partial derecognition approach, under which the components retained continue to be recognised (paragraph 46(b) of AASB Agenda Paper 14.6).

24 AASB staff think that, to facilitate a coherent and principles-based approach to derecognition when a component of an asset or a liability is retained in a transfer, the IASB should identify derecognition concepts for these transfers in its Conceptual Framework. This would not preclude departing from those concepts in Standards projects (e.g. due to decisions by the IASB regarding the unit of account). AASB staff think principles should not be left to Standards-level projects, because of the risk of *ad hoc* and/or inconsistent decisions in different Standards-level projects, and because the IASB's Conceptual Framework should impose a discipline on the IASB in developing its proposals in Standards-level projects.

25 AASB staff have mixed views regarding whether to support the full derecognition approach or the partial derecognition approach referred to in paragraph 23(b) and (c) above. However, Conceptual Framework project staff tentatively lean toward supporting the partial derecognition approach because it seems most representationally faithful of the economics of the transfer to:

(a) depict the disposal of a component of the asset or liability; and

(b) depict that the remainder of the asset or liability was retained (rather than disposed of or reacquired).

26 Depending on the circumstances, under a partial derecognition approach, the description and classification of the retained component might differ from the asset recognised under a full derecognition approach. In some cases, the measurement of the retained component would differ from the measurement of the corresponding asset recognised under a full derecognition approach because, under a full derecognition approach, the retained component of a resource is treated as being disposed of and reacquired, whereas, under a partial derecognition approach, the retained component is treated as not having been disposed of.[4]

[4] In this regard, the extent of a resource recognised upon derecognising an asset sold (in an arrangement in which the vendor has rights to part of the resource sold) would seem to be consistent under both a partial derecognition approach and a full derecognition approach. For example, as illustrated in Example C under paragraph 43 of AASB Agenda Paper 14.6, in the case of a sale and leaseback with a lease term shorter

27 AASB project staff acknowledge that our tentative leaning above seems to differ from the view expressed by the AASB in its submission (dated 10 December 2010) on IASB ED/2010/9 *Leases*. In its submission, the AASB argued for a full derecognition approach to lessor accounting. The AASB's reasons for arguing for a full derecognition approach instead of a partial derecognition approach, which are noted in the footnote below[5], are not discussed in this paper because of the high level, 'introductory' nature of this Board meeting session. They could be explored in more detail in future Board papers.

28 In relation to Example A ('Sale of receivables with partial recourse') and Example B ('Sale of a bond with repurchase agreement') discussed in paragraphs 36 – 41 of AASB Agenda Paper 14.6, that IFRS Staff Paper identifies concerns that derecognition of assets or liabilities using a control/present obligation approach, rather than a risks and rewards approach, can lead to recognition of gains or losses from transactions that change neither the amount or riskiness of the entity's expected future cash flows. Under a risks and rewards approach, when the entity retains sufficient risks and rewards in relation to the sold item, the sold item is not derecognised (i.e. sale of the item is not recognised) and no gain or loss is recognised. AASB staff think that it can be a faithful representation to recognise changes in assets and liabilities without changes in the entity's risks. Criticism of a control approach because changes in assets and liabilities might be recognised without changes in the entity's risks implies a view that risks should be *pro rata* to contractual rights and obligations—however, AASB staff do not think such a *pro rata* relationship should necessarily exist.

29 AASB staff agree with the comment in paragraph 41 of AASB Agenda Paper 14.6 that a solution to concerns that derecognition of assets or liabilities using a control/present obligation approach can lead to recognition of gains or losses from transactions that

---

than the remaining useful life of the asset sold, the asset recognised (however described and measured) would be a right of use for the term of that lease. A difference in measurement of the right of use may occur under a partial derecognition approach and a full derecognition approach because those approaches differ regarding whether they treat that right of use as being conveyed by the leaseback. Under a full derecognition approach, the right of use is treated as being conveyed by the leaseback, and measured at the current present value of the lease rentals as at the date of the leaseback transaction. In contrast, under a partial derecognition approach, the right of use would be treated as existing before the sale and measured accordingly, either on an historical cost basis or at a revalued amount. Depending on the circumstances, those measurements of the right of use might, but would not necessarily, be different.

[5] The AASB's submission said the Board supports the full derecognition approach for lessor accounting because:

- "the 'full derecognition approach better reflects the economics of a lease transaction;
- it is more consistent with the proposed approach to lease accounting (easier/more intuitive for sublessors and consolidations);
- the Basis for Conclusions states that avoiding day one profit/loss is one of the reasons for proposing a partial rather than full derecognition approach. However, the partial derecognition approach may result in day one profit/loss anyway, so this is not a valid argument for the partial derecognition approach instead of using the full derecognition approach;
- partial derecognition does not give intuitive outcomes when the fair value of the residual asset is greater than its carrying amount, as a profit may be recognised at the end of the lease contract if the residual asset is subsequently revalued;
- the lessor is required to obtain the fair value of the underlying asset to be able to apply the partial derecognition approach, yet it is the fair value of the residual asset that lessors current focus on in managing their business, so 'full' derecognition is likely to be less costly for lessors to apply;".

change neither the amount or riskiness of the entity's expected future cash flows would be to measure all assets and liabilities at fair value or fair value less costs to sell[6]. In this regard, AASB staff note that the gains or losses that might arise from transactions involving derecognition would not necessarily reflect the consequences of the transaction, but, rather, earlier unrecognised changes in the values of the assets or liabilities transferred. AASB staff disagree with the following comment in paragraph 41 of AASB Agenda Paper 14.6 that: "However, … measuring all assets and liabilities on that basis would not provide users with the most relevant information." AASB staff think it is inconsistent to say a conceptual solution to derecognition concerns should not be set out in the Conceptual Framework because of implications for measurement of elements. To AASB staff, the IASB's concern about measurement seems to reflect implementation concerns and therefore should preferably be dealt with at a Standards level (rather than complicating or diluting the concepts for derecognition).

Question for Board members

Q4 What are your tentative leanings on the IASB's preliminary views that:

(a) in most cases, an entity should derecognise an asset or liability when it no longer meets the recognition criteria; and

(b) if an entity retains a component of the asset or liability, the IASB should determine in Standards projects whether to apply the general proposal above? If the IASB Conceptual Framework were to include concepts for this issue, would you tentatively support a partial derecognition approach?

[6] The suitability of adopting such measurement bases for all assets and liabilities (including non-financial) requires further consideration beyond the scope of this paper.