

# **A Review of the IASB's Conceptual Framework for Financial Reporting**

Comments to the AASB by 8 November 2013



**Australian Government**

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**Australian Accounting  
Standards Board**

## Commenting on this AASB Invitation to Comment

Constituents are strongly encouraged to respond to the AASB and the IASB. The AASB is seeking comment by 8 November 2013. This will enable the AASB to consider Australian constituents' comments in the process of formulating its own comments to the IASB, which are due by 14 January 2014. Comments should be addressed to:

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Collins Street West Victoria 8007  
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Respondents to the IASB are asked to send their comments electronically to the IFRS Foundation website ([www.ifrs.org](http://www.ifrs.org)), using the 'Comment on a proposal' page.

All submissions on possible, proposed or existing financial reporting requirements, or on the standard-setting process, will be placed on the public record unless the Chairman of the AASB agrees to submissions being treated as confidential. The latter will occur only if the public interest warrants such treatment.

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## BACKGROUND

### Introduction

The Australian Accounting Standards Board (AASB) is inviting comments on International Accounting Standards Board (IASB) Discussion Paper entitled *A Review of the Conceptual Framework for Financial Reporting*. The IASB Discussion Paper seeks initial views on important issues the IASB will consider as it develops an Exposure Draft of possible changes to its Conceptual Framework, and is the IASB's first due process step in developing a revised Conceptual Framework.

The IASB's Conceptual Framework sets out the concepts that underlie the preparation and presentation of financial reports. It identifies principles for the IASB to use when it develops and revises International Financial Reporting Standards (IFRSs). The IASB's Conceptual Framework project has the potential to have a major impact on the future direction of IFRSs. Because the AASB's policy is to incorporate IFRSs into Australian Accounting Standards, the outcome of the IASB's project could also have a major impact on the future direction of Australian Accounting Standards.

Additional background information on the IASB Discussion Paper is set out below. Furthermore, at the end of the Request for Comments section of this Invitation to Comment, background information is set out on:

- (a) the relationship of the IASB Discussion Paper to the AASB Conceptual Framework; and
- (b) the corresponding Conceptual Framework project of the International Public Sector Accounting Standards Board (IPSASB).

### IASB Conceptual Framework

The IASB has recommenced its project to develop an improved Conceptual Framework that, once finalised, would replace the IASB's existing Conceptual Framework. The IASB has stated that its objective is to produce principle-based financial reporting standards, and that a Conceptual Framework that is sound, comprehensive and internally consistent will help achieve this. The existing IASB Conceptual Framework does not cover some important areas adequately – for example, principles for derecognition and measurement of assets and liabilities, and principles for presentation and disclosure – and some guidance needs updating. Rather than undertake a fundamental re-think of the existing concepts, the project's stated aim is to build on the existing IASB Conceptual Framework by completing, refining and updating it.

The IASB's Conceptual Framework project has already resulted in finalised and proposed chapters of a revised Conceptual Framework. In September 2010, the IASB issued the first two chapters of its revised Conceptual Framework, entitled *The Objective of General Purpose Financial Reporting* and *Qualitative Characteristics of Useful Financial Information*. The IASB also issued an Exposure Draft of a proposed chapter, entitled *Conceptual Framework for Financial Reporting: The Reporting Entity* in March 2010. That Exposure Draft was incorporated in AASB Exposure Draft ED 193 of the same title in March 2010.

The IASB paused its Conceptual Framework project from 2010 until 2012 while it progressed some time-critical projects. The attached IASB Discussion Paper covers Conceptual Framework topics not covered by the above-mentioned finalised and proposed chapters. These topics are:

- (a) definitions of assets and liabilities;
- (b) recognition and derecognition;

- (c) the distinction between equity and liabilities;
- (d) measurement;
- (e) presentation and disclosure; and
- (f) other comprehensive income.

## **AASB REQUEST FOR COMMENTS**

In light of the AASB's policy of incorporating IFRSs into Australian Accounting Standards in a transaction neutral manner, the AASB is inviting comments on:

- (a) any of the preliminary views in the attached IASB Discussion Paper, including the twenty-six specific questions listed in the Invitation to Comment section (Appendix H) of the attached IASB Discussion Paper; and
- (b) the 'AASB Specific Matters for Comment' listed below.

Submissions play an important role in the decisions that the AASB will make in regard to the Conceptual Framework. The AASB would prefer that respondents supplement their opinions with detailed comments, whether supportive or critical, on the major issues. The AASB regards both critical and supportive comments as essential to a balanced review and will consider all submissions, whether they address all specific matters, additional issues or only one issue.

### **Due Date for Comments to the AASB**

Comments should be submitted to the AASB by 8 November 2013. This will enable the AASB to consider those comments in the process of formulating its own comments to the IASB. It will also assist the AASB Chairman in identifying issues to discuss in international forums that provide input to the IASB's deliberations, including the Asian-Oceanian Standard-Setters Group and the Accounting Standards Advisory Forum. Constituents are also strongly encouraged to send their response to the IASB.

In addition to this Request for Comments, the AASB plans to hold forums in Canberra, Melbourne and Sydney, targeted for October 2013, to provide an opportunity for constituents and Board members to discuss the IASB's preliminary views included in the Discussion Paper. The locations and specific dates will be detailed on the AASB's website at <http://www.aasb.gov.au/News/Upcoming-events.aspx>.

### **AASB Specific Matters for Comment**

The AASB would particularly value comments on the following:

1. whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the preliminary views, particularly any issues relating to:
  - (a) not-for-profit entities; and
  - (b) public sector entities, including the implications of the preliminary views for GAAP/GFS harmonisation;
2. whether, overall, the preliminary views would result in financial statements that would be useful to users;
3. whether the preliminary views are in the best interests of the Australian economy; and
4. unless already provided in response to specific matters for comment 1 – 3 above, the costs and benefits of the preliminary views relative to the current treatments, whether quantitative (financial or non-financial) or qualitative.

## Relationship to the AASB Conceptual Framework

The AASB Conceptual Framework applies to all Australian entities that prepare general purpose financial statements. In relation to for-profit entities, the AASB's policy is to incorporate without amendment the IASB Conceptual Framework into the AASB's Conceptual Framework, consistent with the AASB's policy to incorporate IFRSs without amendment into Australian Accounting Standards.

Consistent with its approach to conceptual guidance for not-for-profit entities in the existing AASB Conceptual Framework (the AASB *Framework for the Preparation and Presentation of Financial Statements*), the AASB intends, in due course, developing material for not-for-profit entities for incorporation into a revised AASB Conceptual Framework that is:

- (a) based on the revised IASB Conceptual Framework; and
- (b) expressed in a sector-neutral manner, thus providing a Conceptual Framework that effectively covers the for-profit and not-for-profit sectors (while continuing the AASB's approach of incorporating IASB wording without amendment for application to for-profit entities).

In developing the above-mentioned not-for-profit entity material, the AASB will continue to monitor the progress of the IPSASB's Conceptual Framework project (see section below) and consider the suitability of the IPSASB's decisions for Australian not-for-profit entities. Developing that Australian not-for-profit entity material will take some time. In the meantime, the AASB has decided to:

- (a) issue a revised AASB Conceptual Framework applicable to for-profit entities that incorporates the revised IASB Conceptual Framework issued to date (which includes new chapters on the 'Objective of General Purpose Financial Reporting' and the 'Qualitative Characteristics of Useful Financial Information'); and
- (b) retain without substantive amendment the existing text of the AASB Conceptual Framework (including its 'Aus' paragraphs) for application by not-for-profit entities. This retained text would be included within a revised AASB Conceptual Framework covering for-profit and not-for-profit entities, which would be subject to subsequent revision in response to the IASB's completion of its Conceptual Framework and the development by the AASB of not-for-profit entity material.

The AASB aims to 'catch up' with the revisions already made to the IASB Conceptual Framework by issuing an amended AASB Conceptual Framework during the second half of 2013.

The IASB Discussion Paper does not consider the applicability to not-for-profit entities of the IASB's preliminary views. Consequently, the AASB does not envisage a change to its present approach of developing not-for-profit entity material.

The AASB will continue to monitor the development of the IASB Conceptual Framework project from the perspective of private and public sector not-for-profit entities, as well as from the perspective of for-profit entities in the private and public sectors. The AASB intends encouraging the IASB to phrase its Conceptual Framework in as sector-neutral language as is possible, thus reducing the amount of additional material that will be necessary for the AASB to develop for not-for-profit entities.

## IPSASB Conceptual Framework

The IPSASB is in the process of developing a public sector Conceptual Framework applicable to the preparation and presentation of general purpose financial reports of public sector entities. The IPSASB Conceptual Framework is being developed primarily for public sector

entities other than Government Business Enterprises (GBEs); the IPSASB has indicated it expects GBEs to fall within the scope of IFRSs and the IASB's Conceptual Framework. The IPSASB has stated that its Conceptual Framework project is neither an interpretation of the IASB's current and evolving Conceptual Framework nor an IPSASB/IASB convergence project, although the IPSASB intends having regard to developments in the IASB's Conceptual Framework project as the IPSASB's project is progressed.

The IPSASB Conceptual Framework project is being progressed in phases. In January 2013, the IPSASB issued the first four chapters of *The Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities*. The IPSASB is undertaking due process steps in relation to the remaining chapters of its Conceptual Framework, with a view to issuing them simultaneously as a completed package. More information about the IPSASB's Conceptual Framework project can be accessed at: <http://www.ifac.org/public-sector/projects/public-sector-conceptual-framework>

The scope of the attached IASB Discussion Paper is similar to the scope of the topics to be addressed in the remaining chapters of the IPSASB Conceptual Framework.

The AASB considers that it is important to engage in both the IASB and IPSASB Conceptual Framework projects.

July 2013

Discussion Paper DP/2013/1

# A Review of the Conceptual Framework for Financial Reporting

Comments to be received by 14 January 2014

IASB<sup>®</sup>

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# **A Review of the Conceptual Framework for Financial Reporting**

*Comments to be received by 14 January 2014*

Discussion Paper DP/2013/1 *A Review of the Conceptual Framework for Financial Reporting* is published by the International Accounting Standards Board (IASB) for comment only. Comments on the Discussion Paper need to be received by **14 January 2014** and should be submitted in writing to the address below or electronically via our website [www.ifrs.org](http://www.ifrs.org) using the 'Comment on a proposal' page.

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## CONTENTS

*from paragraph*

<b>SUMMARY AND INVITATION TO COMMENT</b>	
<b>SECTION 1—INTRODUCTION</b>	
History of the project	1.1
Development of this Discussion Paper	1.11
Scope of this Discussion Paper	1.17
Effect on existing practice and use of examples	1.22
Purpose of the <i>Conceptual Framework</i>	1.25
Status of the <i>Conceptual Framework</i>	1.30
Summary of objective and qualitative characteristics	1.34
<b>SECTION 2—ELEMENTS OF FINANCIAL STATEMENTS</b>	
What are the elements of financial statements?	2.2
Definitions of assets and liabilities	2.6
Definitions of income and expense	2.37
Other definitions	2.52
<b>SECTION 3—ADDITIONAL GUIDANCE TO SUPPORT THE ASSET AND LIABILITY DEFINITIONS</b>	
Introduction	3.1
Economic resource	3.4
Control of an economic resource	3.16
To transfer an economic resource	3.35
Constructive obligations	3.39
‘Present’ obligation	3.63
Reporting the substance of contractual rights and contractual obligations	3.98
Executory contracts and other forward contracts	3.109
<b>SECTION 4—RECOGNITION AND DERECOGNITION</b>	
Recognition	4.1
Derecognition	4.28
<b>SECTION 5—DEFINITION OF EQUITY AND DISTINCTION BETWEEN LIABILITIES AND EQUITY INSTRUMENTS</b>	
Introduction	5.1
Definition of equity	5.2
Distinguishing liabilities from equity instruments	5.22
<b>SECTION 6—MEASUREMENT</b>	
How the objective of financial reporting and qualitative characteristics of useful financial information influence measurement	6.6
Measurement categories	6.37
Identifying an appropriate measurement	6.55
Cash-flow-based measurements other than estimates of current prices	6.110

<b>SECTION 7—PRESENTATION AND DISCLOSURE</b>	
Introduction	7.1
Other work on presentation and disclosure	7.6
What is meant by the terms ‘presentation’ and ‘disclosure’?	7.9
Presentation in the primary financial statements	7.14
Disclosure in the notes to the financial statements	7.32
Materiality	7.43
Form of disclosure and presentation requirements	7.47
<b>SECTION 8—PRESENTATION IN THE STATEMENT OF COMPREHENSIVE INCOME—PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME</b>	
Introduction	8.1
Purpose of the statement(s) of profit or loss and OCI	8.5
Statement(s) of profit or loss and OCI—current IFRS	8.8
Profit or loss and recycling in the <i>Conceptual Framework</i>	8.19
Approaches to profit or loss and recycling	8.27
Approach 1: prohibit recycling	8.29
Approaches that retain the concept of profit or loss and recycling	8.34
Approach 2A: narrow approach to OCI	8.40
Approach 2A: applying the principles	8.54
Approach 2B: broad approach to OCI	8.79
Impact of Approaches 2A and 2B on items currently reported in profit or loss	8.95
Comparison of approaches	8.97
<b>SECTION 9—OTHER ISSUES</b>	
Chapter 1 and Chapter 3 of the existing <i>Conceptual Framework</i>	9.2
The use of the business model concept in financial reporting	9.23
Unit of account	9.35
Going concern	9.42
Capital maintenance	9.45
<b>APPENDIX A—TEXT OF CHAPTERS 1 AND 3 OF THE EXISTING CONCEPTUAL FRAMEWORK</b>	
<b>APPENDIX B—REPORTING ENTITY</b>	
<b>APPENDIX C—DISTINCTION BETWEEN LIABILITIES AND EQUITY INSTRUMENTS</b>	
<b>APPENDIX D—EFFECT OF STRICT OBLIGATION APPROACH ON DIFFERENT CLASSES OF INSTRUMENT</b>	
<b>APPENDIX E—RIGHTS AND OBLIGATIONS ARISING UNDER OPTIONS AND FORWARDS ON AN ENTITY’S OWN SHARES</b>	
<b>APPENDIX F—WRITTEN PUT OPTIONS ON OWN EQUITY AND ON NON-CONTROLLING INTERESTS</b>	
<b>APPENDIX G—OVERVIEW OF TOPICS FOR THE REVISED CONCEPTUAL FRAMEWORK</b>	
<b>APPENDIX H—SUMMARY OF QUESTIONS FOR RESPONDENTS</b>	

## Summary and invitation to comment

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### Why is the IASB issuing this Discussion Paper?

The *Conceptual Framework for Financial Reporting* (the 'Conceptual Framework') sets out the concepts that underlie the preparation and presentation of financial statements. The IASB's preliminary view is that the primary purpose of the *Conceptual Framework* is to assist the IASB by identifying concepts that it will use consistently when developing and revising IFRSs.

Although the existing *Conceptual Framework* has helped the IASB when developing and revising IFRSs, the IASB has identified a number of problems with the existing *Conceptual Framework*:

- (a) important areas are not covered. For example, the existing *Conceptual Framework* provides very little guidance on measurement, presentation, disclosure or how to identify a reporting entity.
- (b) the guidance in some areas is unclear. For example, the existing definitions of assets and liabilities could be improved.
- (c) some aspects of the existing *Conceptual Framework* are out of date and fail to reflect the current thinking of the IASB. For example, the existing *Conceptual Framework* states that an asset or a liability should be recognised only if it is probable that there will be a flow of economic resources. However, the IASB has concluded in some situations that recognising an asset or a liability would provide useful information even when a flow of economic resources is not probable.

In 2011, the IASB carried out a public consultation on its agenda. Most respondents to that consultation identified the *Conceptual Framework* as a priority project for the IASB. Consequently, the IASB decided to restart its *Conceptual Framework* project, which had been suspended in 2010.

This Discussion Paper is the first step towards issuing a revised *Conceptual Framework*. It is designed to obtain initial views and comments on a number of matters, and focuses on areas that have caused the IASB problems in practice. Consequently, this Discussion Paper does not cover all the issues that the IASB would expect to cover in an Exposure Draft of the *Conceptual Framework*. The Discussion Paper sets out the IASB's preliminary views on some of the topics discussed. However, the IASB has not reached preliminary views on all of the issues discussed in this Discussion Paper.

### Who will be affected by the proposals in this Discussion Paper?

The primary purpose of the *Conceptual Framework* is to assist the IASB by identifying concepts that can be used consistently when developing and revising IFRSs (see Section 1). The *Conceptual Framework* may also assist parties other than the IASB to:

- (a) understand and interpret existing IFRSs; and
- (b) develop accounting policies when no Standard or Interpretation specifically applies to a particular transaction or event.

The *Conceptual Framework* is not a Standard or Interpretation and does not override the requirements of any Standard or Interpretation. However, the *Conceptual Framework* will have a significant influence in the development of new and revised Standards.

Once the IASB finalises the revised *Conceptual Framework*, it will start using it immediately. However, a revised *Conceptual Framework* will not necessarily lead to changes to existing IFRSs. Any proposal to change an existing Standard or Interpretation would need to go through the IASB's normal due process (including a formal decision to add the project to the IASB's agenda).

### **What does this Discussion Paper include?**

This Discussion Paper suggests that the IASB should make the following significant changes to the existing *Conceptual Framework*:

- (a) a revised statement of the primary purpose of the *Conceptual Framework*;
- (b) revised definitions of assets and liabilities;
- (c) additional guidance on applying the definitions of assets and liabilities;
- (d) revised guidance on when assets and liabilities should be recognised;
- (e) new guidance on when assets and liabilities should be derecognised;
- (f) a new way to present information about equity claims against the reporting entity;
- (g) a new section on the concepts that should guide the IASB when it selects measurements in a new or revised Standard or Interpretation;
- (h) a new section on presentation and disclosure; and
- (i) principles for distinguishing profit or loss from other comprehensive income (OCI).

The following paragraphs summarise each section of this Discussion Paper. A high-level overview of the topics to be covered in the *Conceptual Framework* is provided in Appendix G.

### **Section 1—Introduction**

Section 1:

- (a) describes the history of the *Conceptual Framework* project;
- (b) describes the development and scope of this Discussion Paper;
- (c) explains how the proposals in this Discussion Paper will affect existing practice and the use of examples in this Discussion Paper;
- (d) outlines the purpose and status of the *Conceptual Framework*; and
- (e) summarises the objective of financial reporting and the qualitative characteristics of useful financial information as described in Chapters 1 and 3 of the existing *Conceptual Framework* and explains how they have affected the development of this Discussion Paper.

The IASB's preliminary views on the purpose and status of the *Conceptual Framework* are as follows:

- (a) the primary purpose of the revised *Conceptual Framework* is to assist the IASB by identifying concepts that the IASB will use consistently when developing and revising IFRSs.
- (b) the *Conceptual Framework* may also assist parties other than the IASB to:
  - (i) understand and interpret existing IFRSs; and

- (ii) develop accounting policies when no Standard or Interpretation specifically applies to a particular transaction or event.
- (c) the *Conceptual Framework* is not a Standard or Interpretation and does not override any specific Standard or Interpretation.
- (d) in rare cases, in order to meet the overall objective of financial reporting, the IASB may decide to issue a new or revised Standard that conflicts with an aspect of the *Conceptual Framework*. In such cases, the IASB would describe the departure from that aspect of the *Conceptual Framework*, and the reasons for it, in the Basis for Conclusions on that Standard.

## Section 2—Elements of financial statements

The definitions of assets and liabilities are discussed in Section 2.

### Definitions of assets and liabilities

The existing definitions of assets and liabilities have proved over many years to be useful tools for solving many issues in standard-setting. They focus on economic phenomena that exist in the real world (resources and obligations), that are relevant to users of financial statements and that are understandable.

Nevertheless, the IASB believes that the definitions could be clarified. They contain references to expected inflows or outflows of economic benefits. Some have interpreted these references as implying that the asset or the liability is the ultimate inflow or outflow of economic benefits, rather than the underlying resource or obligation. To avoid misunderstandings, the IASB's preliminary view is that it should amend the definitions to confirm more explicitly that:

- (a) an asset (or a liability) is the underlying resource (or obligation), rather than the ultimate inflow (or outflow) of economic benefits; and
- (b) an asset (or a liability) must be capable of generating inflows (or outflows) of economic benefits. Those inflows (or outflows) need not be certain.

The IASB proposes the following definitions:

- (a) an asset is a present economic resource controlled by the entity as a result of past events.
- (b) a liability is a present obligation of the entity to transfer an economic resource as a result of past events.
- (c) an economic resource is a right, or other source of value, that is capable of producing economic benefits.

### Uncertainty

This section also discusses whether uncertainty should play any role in the definitions of, and the recognition criteria for, assets and liabilities. The IASB's preliminary views are:

- (a) the definitions of assets and liabilities should not retain the notion that an inflow or outflow is 'expected'. An asset must be capable of producing economic benefits. A liability must be capable of resulting in a transfer of economic resources.

- (b) the *Conceptual Framework* should not set a probability threshold for the rare cases in which it is uncertain whether an asset or a liability exists. If there could be significant uncertainty about whether a particular type of asset or liability exists, the IASB would decide how to deal with that uncertainty when it develops or revises a Standard on that type of asset or liability.
- (c) the recognition criteria should not retain the existing reference to probability.

### Other elements

This section also briefly discusses how to define the main building blocks (elements) for the statement(s) of profit or loss and other comprehensive income (income and expense), the statement of cash flows (cash receipts and cash payments) and the statement of changes in equity (contributions to equity, distributions of equity, and transfers between classes of equity).

### Section 3—Additional guidance to support the asset and liability definitions

Section 3 considers areas in which the IASB could add further guidance to the *Conceptual Framework* to support the revised definitions of an asset and a liability.

There are three reasons for adding more guidance on those definitions:

- (a) Section 2 proposes changes to aspects of the definitions of an asset and a liability. Further guidance would help to explain the terms that are used within those proposed definitions.
- (b) some aspects of the existing definition of a liability are unclear: there is little guidance in the *Conceptual Framework* and the principles underlying different Standards can appear inconsistent. As a result, the IASB, the IFRS Interpretations Committee and others have had difficulty reaching conclusions on whether and when some transactions give rise to liabilities. Additional guidance could establish principles on which to develop future requirements.
- (c) other aspects of the existing definitions for an asset and a liability have become clearer in recent years as the IASB has developed requirements and guidance within individual Standards. For example, several Standards now give guidance on identifying the substance of contractual rights and obligations. The IASB thinks that it would be helpful to update the *Conceptual Framework* to include the general principles underlying that guidance.

Section 3 suggests the following:

- (a) to support the definition of an **asset**, guidance should be provided on:
  - (i) the meaning of ‘economic resource’; and
  - (ii) the meaning of ‘control’.
- (b) to support the definition of a **liability**, guidance should be provided on:
  - (i) the meaning of ‘transfer an economic resource’;
  - (ii) constructive obligations; and
  - (iii) the meaning of ‘present’ obligation.
- (c) to support **both definitions**, guidance should be provided on:



- (i) reporting the substance of contractual rights and contractual obligations; and
- (ii) executory contracts.

The most detailed discussion in Section 3 relates to constructive obligations and to the meaning of 'present' obligations. For constructive obligations, the IASB's preliminary view is that the existing definition of a liability—which encompasses both legal and constructive obligations—should be retained and more guidance should be added to help to distinguish constructive obligations from economic compulsion.

The discussion on the meaning of present obligation notes that a present obligation arises from past events. An obligation can be viewed as having arisen from past events if the amount of the liability will be determined by reference to benefits received, or activities conducted, by the entity before the end of the reporting period. However, it is unclear whether such past events are sufficient to create a present obligation if any requirement to transfer an economic resource remains conditional on the entity's future actions. The discussion identifies three different views that the IASB could use as a starting point in developing guidance for the *Conceptual Framework*:

- (a) View 1: a present obligation must have arisen from past events and be strictly unconditional. An entity does not have a present obligation if it could, at least in theory, avoid the transfer through its future actions.
- (b) View 2: a present obligation must have arisen from past events and be practically unconditional. An obligation is practically unconditional if the entity does not have the practical ability to avoid the transfer through its future actions.
- (c) View 3: a present obligation must have arisen from past events, but may be conditional on the entity's future actions.

The IASB has tentatively rejected View 1. However, it has not reached a preliminary view in favour of View 2 or View 3.

## Section 4—Recognition and derecognition

Section 4 discusses:

- (a) recognition: when should an entity's statement of financial position report an economic resource as an asset or an obligation as a liability?
- (b) derecognition: when should an entity remove an asset or a liability from its statement of financial position?

The IASB's preliminary view on recognition is that an entity should recognise all its assets and liabilities, unless the IASB decides when developing or revising a particular Standard that an entity need not, or should not, recognise an asset or a liability because:

- (a) recognising the asset (or the liability) would provide users of financial statements with information that is not relevant or is not sufficiently relevant to justify the cost; or
- (b) no measure of the asset (or the liability) would result in a faithful representation of both the asset (or the liability) and the changes in the asset (or the liability), even if all necessary descriptions and explanations are disclosed.

The existing *Conceptual Framework* does not address derecognition. The IASB's preliminary view is that an entity should derecognise an asset or a liability when it no longer meets the recognition criteria. However, for cases in which an entity retains a component of an asset or a liability, the IASB should determine, when developing or revising particular Standards how the entity would best portray the changes that resulted from the transaction. Possible approaches include:

- (a) enhanced disclosure;
- (b) presenting any rights or obligations retained on a line item that is different from the line item used for the original rights or obligations, to highlight the greater concentration of risk; or
- (c) continuing to recognise the original asset or liability and treating the proceeds received or paid for the transfer as a loan received or granted.

## **Section 5—Definition of equity and distinction between liability and equity elements**

Section 5 discusses the definition of equity, the measurement and presentation of different classes of equity and how to distinguish liabilities from equity instruments. It addresses the following problems:

- (a) financial statements do not clearly show how equity instruments with prior claims against the entity affect possible future cash flows to investors.
- (b) existing IFRSs do not apply the definition of a liability consistently when distinguishing financial liabilities from equity instruments. This results in exceptions to the definition of a liability. Those exceptions are complex, difficult to understand and difficult to apply, causing inconsistency and many requests for Interpretations. That inconsistency makes financial statements difficult to understand and creates opportunities for structuring.

The IASB's preliminary views are that:

- (a) the *Conceptual Framework* should retain the existing definition of equity as the residual interest in the assets of the entity after deducting all its liabilities.
- (b) the *Conceptual Framework* should state that the IASB should use the definition of a liability to distinguish liabilities from equity instruments. Two consequences of this are:
  - (i) obligations to issue equity instruments are not liabilities; and
  - (ii) obligations that will arise only when the reporting entity is liquidated are not liabilities.
- (c) an entity should:
  - (i) update the measure of each class of equity claim at the end of each reporting period. The IASB would determine when developing or revising particular Standards whether that measure would be a direct measure or an allocation of total equity.
  - (ii) recognise updates to those measurements in the statement of changes in equity, as a transfer of wealth between classes of equity claim.

- (d) if an entity has issued no equity instruments, it may be appropriate to treat the most subordinated class of instruments as if it were an equity claim, with suitable disclosure. Identifying whether to use such an approach, and if so, when, would be a decision that the IASB would need to make when it develops or revises particular Standards.

## Section 6—Measurement

The existing *Conceptual Framework* provides little guidance on measurement and when particular measurements should be used. Section 6 describes the guidance that the IASB could include in a revised *Conceptual Framework* to assist the IASB in developing measurement requirements in new or revised Standards. In particular, this section:

- (a) describes how the objective of financial reporting and qualitative characteristics of useful financial information influence measurement requirements.
- (b) describes and discusses the following three categories of measurement:
  - (i) cost-based measurements;
  - (ii) current market prices, including fair value; and
  - (iii) other cash-flow based measurements.
- (c) discusses how to identify an appropriate measurement.

The IASB's preliminary views on measurement are that:

- (a) the objective of measurement is to contribute to the faithful representation of relevant information about:
  - (i) the resources of the entity, claims against the entity and changes in resources and claims; and
  - (ii) how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.
- (b) a single measurement basis for all assets and liabilities may not provide the most relevant information for users of financial statements.
- (c) when selecting which measurement to use for a particular item, the IASB should consider what information that measurement will produce in both the statement of financial position and the statement(s) of profit or loss and OCI.
- (d) the relevance of a particular measurement will depend on how investors, creditors and other lenders are likely to assess how an asset or a liability of that type will contribute to future cash flows. Consequently, the selection of a measurement:
  - (i) for a particular asset should depend on how that asset contributes to future cash flows; and
  - (ii) for a particular liability should depend on how the entity will settle or fulfil that liability.
- (e) the number of different measurements used should be the smallest number necessary to provide relevant information. Unnecessary measurement changes should be avoided and necessary measurement changes should be explained.
- (f) the benefits of a particular measurement to users of financial statements need to be sufficient to justify the cost.

## Section 7—Presentation and disclosure

The existing *Conceptual Framework* does not provide guidance on presentation and disclosure. Section 7 describes the guidance that could be included in a revised *Conceptual Framework* to assist the IASB in developing presentation and disclosure requirements in new or revised Standards to address this issue. In particular, this section describes and discusses:

- (a) presentation in the primary financial statements, including:
  - (i) the objective of primary financial statements;
  - (ii) the concepts of aggregation, classification and offsetting; and
  - (iii) the relationship between primary financial statements.
- (b) disclosures in the notes to the financial statements, including:
  - (i) the objective of the notes to the financial statements; and
  - (ii) the scope of the notes to the financial statements.
- (c) materiality.
- (d) what the IASB might consider when developing the form of disclosure and presentation requirements including:
  - (i) disclosure objectives;
  - (ii) communication principles; and
  - (iii) the implications of delivering financial statements in an electronic format.

The IASB's preliminary views on presentation and disclosure are that:

- (a) the objective of primary financial statements is to provide summarised information about recognised assets, liabilities, equity, income, expenses, changes in equity, and cash flows that has been classified and aggregated in a manner that is useful to users of financial statements in making decisions about providing resources to the entity.
- (b) the objective of the notes to the financial statements is to supplement the primary financial statements by providing additional useful information about:
  - (i) the assets, liabilities, equity, income, expenses, changes in equity, and cash flows of the entity; and
  - (ii) how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.
- (c) to meet the objective of disclosure, the IASB would normally consider requiring disclosure about the following:
  - (i) the reporting entity as a whole;
  - (ii) amounts recognised in the entity's primary financial statements, including changes in those amounts (for example, disaggregation of line items, roll-forwards, reconciliation);
  - (iii) the nature and extent of the entity's unrecognised assets and liabilities;
  - (iv) the nature and extent of risks arising from the entity's assets and liabilities (whether recognised or unrecognised); and

- (v) the methods, assumptions and judgements, and changes in those methods, assumptions and judgements, that affect amounts presented or otherwise disclosed.
- (d) the concept of materiality is clearly described in the existing *Conceptual Framework*. Consequently, the IASB does not propose to amend, or add to, the guidance in the *Conceptual Framework* on materiality. However, the IASB is considering developing additional guidance or education material on materiality outside of the *Conceptual Framework* project.
- (e) forward-looking information would be included in the notes to the financial statements if it provides relevant information about existing assets and liabilities, or about assets and liabilities that existed during the reporting period.

### **Section 8—Presentation in the statement of comprehensive income**

The existing *Conceptual Framework* does not specifically discuss presentation of financial performance in the statement(s) of profit or loss and other comprehensive income (OCI). However, respondents to the IASB's *Agenda Consultation 2011* identified the reporting of financial performance (including the use of OCI and recycling) as a key topic that the IASB should address.

Section 8 discusses:

- (a) the purpose of the statement(s) of profit or loss and OCI; and
- (b) whether the *Conceptual Framework* should require a profit or loss total or subtotal and whether it should require or permit recycling.

The IASB's preliminary views are that:

- (a) the *Conceptual Framework* should require a profit or loss total or subtotal that also results, or could result, in some items of income or expense being recycled; and
- (b) the use of OCI should be limited to items of income or expense resulting from changes in current measures of assets and liabilities (remeasurements). However, not all such remeasurements would be eligible for recognition in OCI. Section 8 discusses two approaches that could be used to define which remeasurements might be included in OCI.

### **Section 9—Other issues**

Section 9 discusses:

- (a) the IASB's approach to Chapter 1 *The Objective of General Purpose Financial Reporting* and Chapter 3 *The Qualitative Characteristics of Useful Financial Information* of the existing *Conceptual Framework*. The IASB does not intend to fundamentally reconsider the content of these chapters. However, the IASB will make changes to those chapters if work on the rest of the *Conceptual Framework* highlights areas within those chapters that need clarifying or amending. Section 9 also discusses the concerns that some have raised with how these chapters deal with the issues of stewardship, reliability and prudence.

- (b) the use of the business model concept in financial reporting—this Discussion Paper does not define the business model concept. However, the IASB’s preliminary view is that financial statements can be made more relevant if it considers how an entity conducts its business activities when it develops new or revised Standards.
- (c) unit of account—the IASB’s preliminary view is that the unit of account will normally be decided when it develops or revises particular Standards and that, in selecting a unit of account, it should consider the qualitative characteristics of useful information.
- (d) going concern—the IASB has identified three situations in which the going concern assumption is relevant (when measuring assets and liabilities, when identifying liabilities and when making disclosures about the entity).
- (e) capital maintenance—the IASB may reconsider capital maintenance concepts if it undertakes a project on accounting for high inflation. The IASB plans to keep the existing descriptions and discussion of capital maintenance concepts in the revised *Conceptual Framework* largely unchanged until it undertakes such a project.

### **What are the next steps in this project?**

The views expressed in this Discussion Paper are preliminary and subject to change. The IASB will consider the comments received on this Discussion Paper when developing proposals for an Exposure Draft of a revised *Conceptual Framework*. The IASB aims to finalise a revised *Conceptual Framework* in 2015.

### **Invitation to comment**

The IASB invites comments on all matters in this Discussion Paper and, in particular, on the questions set out at the end of each section. There is also a copy of all the questions in Appendix H.

Comments are most helpful if they:

- (a) respond to the questions as stated;
- (b) indicate the specific paragraph or paragraphs to which the comments relate;
- (c) contain a clear rationale; and
- (d) describe any alternatives that the IASB should consider, if applicable.

Respondents need not comment on all of the questions and are encouraged to comment on any additional matters.

The IASB will consider all comments received in writing by **14 January 2014**.

## Section 1—Introduction

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### History of the project

- 1.1 In 2004, the IASB and the US national standard-setter, the Financial Accounting Standards Board (FASB), initiated a joint project to revise their conceptual frameworks.
- 1.2 In 2010, the IASB and the FASB issued two chapters of a revised conceptual framework:
- (a) Chapter 1—*The Objective of General Purpose Financial Reporting*; and
  - (b) Chapter 3—*Qualitative Characteristics of Useful Financial Information*.<sup>1</sup>
- These chapters became effective as soon as they were published and now form part of the IASB's existing *Conceptual Framework*.
- 1.3 In addition to finalising these chapters, the IASB and the FASB also:
- (a) published a Discussion Paper and an Exposure Draft on the concept of a reporting entity;
  - (b) discussed the definitions of the elements of financial statements; and
  - (c) discussed, and held public round-table meetings about, measurement concepts.
- 1.4 In 2010, the IASB and the FASB suspended work on the joint conceptual framework in order to concentrate on other projects on their agendas.
- 1.5 In 2012, the IASB carried out a public consultation on its agenda. Many respondents to that consultation identified the *Conceptual Framework* as a priority project for the IASB. Consequently, the IASB restarted its *Conceptual Framework* project. This project is no longer being conducted jointly with the FASB.
- 1.6 Feedback received from the *Agenda Consultation 2011* reinforced the importance of giving priority to this project. Consequently, the IASB believes that it should revise the *Conceptual Framework* without delay and aims to complete the revisions to the *Conceptual Framework* by the end of 2015. Setting a tight but achievable deadline means that the IASB must focus on those changes that will provide clear and significant improvements to the existing *Conceptual Framework*.
- 1.7 In developing the revised *Conceptual Framework*, the IASB will focus on:
- (a) elements of the financial statements (including the boundary between liabilities and equity);
  - (b) recognition and derecognition;
  - (c) measurement;
  - (d) presentation and disclosure (including the question of what should be presented in other comprehensive income (OCI)); and
  - (e) the reporting entity.

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<sup>1</sup> Chapter 2 is intended to cover the concept of the reporting entity but has not yet been finalised.

- 1.8 The IASB has decided to build on the existing *Conceptual Framework*—updating, improving and filling in gaps rather than fundamentally reconsidering all aspects of the *Conceptual Framework*.
- 1.9 Consequently, the IASB has decided not to fundamentally reconsider the chapters of the *Conceptual Framework* published in 2010 that deal with the objective of financial reporting and the qualitative characteristics of useful financial information (Chapters 1 and 3). Section 9 explains why the IASB does not propose to fundamentally reconsider Chapters 1 and 3 and seeks views on this proposal. The text of Chapters 1 and 3 is reproduced in Appendix A. The IASB may need to make changes to Chapters 1 and 3 if work on the rest of the *Conceptual Framework* highlights areas in these chapters that need clarifying or amending.
- 1.10 Before 2010, the IASB and the FASB had adopted a phased approach to the *Conceptual Framework* project. They planned to complete the project in eight separate phases. On restarting the project in 2012, the IASB decided not to continue with the phased approach and instead to develop a complete set of proposals for a revised *Conceptual Framework*. The IASB believes that this approach will enable it, and interested parties, to see more clearly the links between different aspects of the *Conceptual Framework*.

### **Development of this Discussion Paper**

- 1.11 In developing this Discussion Paper the IASB has drawn on the extensive public discussions that have already taken place on the *Conceptual Framework*—in particular, the work on elements, measurement and the reporting entity. The IASB has also drawn on the public discussions of conceptual issues in several projects including:
- (a) Financial Statement Presentation (presentation and disclosure);
  - (b) Non-financial Liabilities (measurement and elements);
  - (c) Emission Trading Schemes (elements and unit of account);
  - (d) Leases (elements and unit of account);
  - (e) Revenue Recognition (control);
  - (f) Liabilities/Equity (elements); and
  - (g) Financial Instruments (measurement).
- 1.12 During the development of this Discussion Paper, the IASB referred to the requirements of existing Standards and existing practice when it believed that these helped to illustrate a particular concept. However, the IASB's aim is to select concepts that will result in financial statements that meet the objective of financial reporting, not to justify existing requirements and practice.
- 1.13 Since restarting the *Conceptual Framework* project, the IASB has sought only limited external input. The IASB is using this Discussion Paper to begin seeking external input in a manner that will give interested parties a clear sense of how each part of the project fits into the whole.



- 1.14 During the development of this Discussion Paper, the IASB has received helpful input from:
- (a) its own survey and discussion forum on disclosure held in January 2013; and
  - (b) research undertaken by the Accounting Standards Board of Japan on the use of OCI in financial statements.
- 1.15 The IASB has also considered work undertaken by other organisations including:
- (a) the work of the International Public Sector Accounting Standards Board (IPSASB) to develop a conceptual framework for public entities. The IPSASB sets International Public Sector Accounting Standards and Recommended Practice Guidelines for use by public sector entities, including national, regional, and local governments, and related governmental agencies. IFRSs (and, hence, the IASB's *Conceptual Framework*) are designed to apply to general purpose financial statements and other financial reporting by profit-orientated entities. Consequently, differences between the conceptual frameworks being developed by the IPSASB and the IASB might arise.
  - (b) the work of the International Integrated Reporting Council to develop an integrated reporting framework. That framework is designed to help communicate information about how an organisation's strategy, governance performance and prospects lead to the creation of value over the short, medium and long term. Consequently, the integrated reporting framework covers all aspects of corporate reporting, not just financial reporting.

### **Consultative group**

- 1.16 The IASB normally establishes a consultative group for major projects. The purpose of a consultative group is to provide additional practical experience and expertise. The IASB plans to use the Accounting Standards Advisory Forum (ASAF) as its *Conceptual Framework* consultative group. The ASAF is an advisory group to the IASB, consisting of national accounting standard-setters and regional bodies with an interest in financial reporting. For more information about the ASAF, please refer to <http://go.ifrs.org/ASAF>.

### **Scope of this Discussion Paper**

- 1.17 This Discussion Paper is designed to help the IASB to develop an Exposure Draft of a revised *Conceptual Framework*. In developing this Discussion Paper, the IASB has focused on areas that have caused the IASB problems in practice. Consequently, this Discussion Paper does not cover all the issues that the IASB would expect to cover in an Exposure Draft.
- 1.18 The IASB has not reached preliminary views on all of the issues discussed in this Discussion Paper. Furthermore, the IASB may change its preliminary views because of comments received on this Discussion Paper.
- 1.19 The *Conceptual Framework* deals with financial reports. This Discussion Paper focuses on financial statements, which are one form of financial report. In order

to complete a revised *Conceptual Framework* on a timely basis, the IASB does not plan to address in this project other forms of financial reports, such as management commentary, interim financial reports, press releases and supplementary material provided to analysts. Any decision by the IASB to consider other forms of financial reports would need to go through the normal process for adding a new project to the IASB's agenda.

- 1.20 The IASB has not included a discussion on the reporting entity in this Discussion Paper because the IASB has already issued a Discussion Paper and an Exposure Draft on this topic. To provide context for the areas discussed in this Discussion Paper, Appendix B summarises the proposals in that Exposure Draft and the comments received on it. The IASB intends that the Exposure Draft of the *Conceptual Framework* will include material on the reporting entity, based on the 2010 Exposure Draft and updated in the light of comments received on that Exposure Draft.
- 1.21 In some areas this Discussion Paper includes more discussion than the IASB would include in a revised *Conceptual Framework*. The IASB believes that this additional analysis is needed at this stage of the project to enable interested parties to understand, and provide comments on, the issues raised.

### **Effect on existing practice and use of examples**

- 1.22 The IASB will not necessarily change existing Standards for any of the areas discussed in this *Conceptual Framework*. Any decision to amend an existing Standard would require the IASB to go through its normal due process for adding a project to its agenda and for developing an Exposure Draft and an amendment to that Standard.
- 1.23 The *International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs)* includes a section on the concepts and basic principles underlying the financial statements of small and medium-sized entities that is based on the existing *Conceptual Framework*. The IASB will consider whether it should amend this section of the *IFRS for SMEs* once it has finalised its work on the revised *Conceptual Framework*.
- 1.24 This Discussion Paper also includes examples to illustrate the scope of the problems addressed and the possible consequences of different solutions. The IASB does not plan to reproduce the examples in the *Conceptual Framework*. In addition, the examples do not necessarily illustrate proposed changes to existing IFRSs.

### **Purpose of the *Conceptual Framework***

- 1.25 The *Conceptual Framework* sets out the concepts that underlie the preparation and presentation of financial statements. Its purpose, as described in the existing *Conceptual Framework*, is:
- (a) to assist the IASB in the development of future IFRSs and in its review of existing IFRSs;

- (b) to assist the IASB in promoting harmonisation of regulations, accounting standards and procedures relating to the presentation of financial statements by providing a basis for reducing the number of alternative accounting treatments permitted by IFRSs;
  - (c) to assist national standard-setting bodies in developing national standards;
  - (d) to assist preparers of financial statements in applying IFRSs and in dealing with topics that have yet to form the subject of an IFRS;
  - (e) to assist auditors in forming an opinion on whether financial statements comply with IFRSs;
  - (f) to assist users of financial statements in interpreting the information contained in financial statements prepared in compliance with IFRSs; and
  - (g) to provide those who are interested in the work of the IASB with information about its approach to the formulation of IFRSs.
- 1.26 The IASB believes that a long list of possible uses of the *Conceptual Framework* is unhelpful when developing a revised *Conceptual Framework*. Instead this Discussion Paper proposes that the primary purpose of the revised *Conceptual Framework* is to assist the IASB by identifying concepts that it will use consistently when developing and revising IFRSs. The IASB believes that focusing on the needs of the IASB when setting Standards will help to provide better targeted concepts for the revised *Conceptual Framework*.
- 1.27 In addition, the *Conceptual Framework* plays an important role in helping parties other than the IASB (for example, preparers, auditors, regulators and users of financial statements):
- (a) to understand and interpret existing IFRSs. The rubric in front of each individual Standard states that the Standard should be read in the context of (among other things) the *Conceptual Framework*.
  - (b) to develop accounting policies when no IFRS specifically applies to a particular transaction or event. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* states that preparers should consider the *Conceptual Framework* when developing accounting policies for such transactions or events.
- 1.28 Consequently, the IASB proposes that the revised *Conceptual Framework* should state that it may also assist parties other than the IASB:
- (a) to understand and interpret existing Standards; and
  - (b) to develop accounting policies when no Standard or Interpretation specifically applies to a particular transaction or event.
- 1.29 Some aspects of the *Conceptual Framework* are intended only for the IASB's use as it develops new or revised IFRSs. For example, it is intended that the IASB will use the proposed guidance on when an item of income or expense could be presented in OCI when developing new or revised IFRSs. It is not intended that preparers of IFRS financial statements would use this guidance when developing

accounting policies for items to which no Standard or Interpretation specifically applies. Where the IASB does not intend other parties to use a particular aspect of the *Conceptual Framework* it will make that clear.

### **Status of the *Conceptual Framework***

- 1.30 The existing *Conceptual Framework* is not a Standard or Interpretation and does not override any specific Standard or Interpretation. This Discussion Paper does not propose to change this position.
- 1.31 In a limited number of cases, there may be a conflict between the *Conceptual Framework* and a Standard. Where there is a conflict, the requirements of the Standard prevail over the *Conceptual Framework*. However, because the *Conceptual Framework* will guide the IASB when it develops and revises Standards, the number of these conflicts should diminish through time.
- 1.32 Although the *Conceptual Framework* should guide the IASB when it develops new Standards, there may be rare cases when applying some aspect of the *Conceptual Framework* does not produce financial information about the reporting entity that is useful to the users of the financial statements. In such cases, the IASB may decide that it needs to issue a new or revised Standard that conflicts with that aspect of the *Conceptual Framework* in order to meet the overall objective of financial reporting. This Discussion Paper proposes that, in such a case, the IASB should describe the departure from the *Conceptual Framework*, and the reasons for it, in the Basis for Conclusions on that Standard.
- 1.33 The IASB will review the *Conceptual Framework* from time to time in the light of the IASB's experience of working with it.

### **Summary of objective and qualitative characteristics**

- 1.34 In developing this Discussion Paper, the IASB has considered:
- (a) how the proposals in this Discussion Paper contribute to the objective of general purpose financial reporting (as described in Chapter 1 of the existing *Conceptual Framework*); and
  - (b) the qualitative characteristics of useful financial information (as described in Chapter 3 of the existing *Conceptual Framework*).
- 1.35 The following is a brief summary of the objective of general purpose financial reporting and of the qualitative characteristics of useful financial information (see Appendix A for the full text of Chapters 1 and 3 of the existing *Conceptual Framework*):
- (a) the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to users of financial statements (existing and potential investors, lenders and other creditors) in making decisions about providing resources to the entity.<sup>2</sup>
  - (b) what those users find useful is information about
    - (i) the entity's resources;

<sup>2</sup> See paragraph OB2 of the existing *Conceptual Framework*.

- (ii) claims against the entity;
  - (iii) changes in resources and claims; and
  - (iv) how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.<sup>3,4</sup>
- (c) financial statements and other financial reports provide information about the reporting entity's financial position (its economic resources and claims against the entity). They also provide information about the effects of transactions and other events and conditions that change those resources and claims. Both types of information provide the users of financial statements with useful input for decisions about providing resources to an entity.<sup>5</sup>
- (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.<sup>6</sup>
- (e) reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information.<sup>7</sup>

## Question for respondents

### Question 1

Paragraphs 1.25–1.33 set out the proposed purpose and status of the *Conceptual Framework*. The IASB's preliminary views are that:

- (a) the primary purpose of the revised *Conceptual Framework* is to assist the IASB by identifying concepts that it will use consistently when developing and revising IFRSs; and
- (b) in rare cases, in order to meet the overall objective of financial reporting, the IASB may decide to issue a new or revised Standard that conflicts with an aspect of the *Conceptual Framework*. If this happens the IASB would describe the departure from the *Conceptual Framework*, and the reasons for that departure, in the Basis for Conclusions on that Standard.

Do you agree with these preliminary views? Why or why not?

<sup>3</sup> Throughout the existing *Conceptual Framework*, the term 'management' refers to management and the governing board of an entity unless specifically indicated otherwise.

<sup>4</sup> See paragraph OB4 of the existing *Conceptual Framework*.

<sup>5</sup> See paragraphs OB12 and QC2 of the existing *Conceptual Framework*.

<sup>6</sup> See paragraph QC4 of the existing *Conceptual Framework*.

<sup>7</sup> See paragraph QC35 of the existing *Conceptual Framework*.

## Section 2—Elements of financial statements

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- 2.1 This section deals with the following topics:
- (a) elements of financial statements (see paragraphs 2.2–2.5);
  - (b) definitions of assets and liabilities (see paragraphs 2.6–2.36);
  - (c) definitions of income and expense (see paragraphs 2.37–2.50); and
  - (d) other definitions (see paragraph 2.52).

### What are the elements of financial statements?

- 2.2 Financial statements give information about:
- (a) an entity's financial position (the entity's resources and the claims against the entity), reported in a statement of financial position.
  - (b) changes in an entity's resources and in the claims against the entity. An entity reports separately on the following components of those changes:
    - (i) income and expense, reported in statement(s) of profit or loss and other comprehensive income (OCI);
    - (ii) changes in the entity's equity, reported in a statement of changes in equity;
    - (iii) cash flows, reported in a statement of cash flows; and
    - (iv) other changes in resources and obligations, reported if necessary in the notes to the financial statements. An example of such a change would be the acquisition of property, plant and equipment for non-cash consideration.
- 2.3 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.
- 2.4 Classifying, characterising and presenting information clearly and concisely makes that information understandable.<sup>8</sup> To achieve this, each primary statement includes only items that are elements defined for that statement, and totals and subtotals derived from those elements.<sup>9</sup>
- 2.5 The elements are:
- (a) in the statement of financial position: assets, liabilities and equity (see paragraphs 2.6–2.36 for the discussion on assets and liabilities and Section 5 for the discussion on equity);
  - (b) in the statement(s) of profit or loss and OCI: income and expense (see paragraphs 2.37–2.50);

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<sup>8</sup> See paragraph QC30 of the existing *Conceptual Framework*.

<sup>9</sup> Section 7 discusses the primary financial statements.

- (c) in the statement of changes in equity: contributions of equity, distributions of equity and transfers between classes of equity (see paragraph 2.52 and Section 5); and
- (d) in the statement of cash flows: cash inflows and cash outflows (see paragraph 2.52).

### **Definitions of assets and liabilities**

- 2.6 The elements of the statement of financial position are assets, liabilities and equity. These elements provide users of financial statements with information about an entity's resources, obligations and other claims against the entity. Users need that information to assess the entity's prospects for future net cash inflows.
- 2.7 Information about an entity's resources, obligations and other claims against the entity, and about changes in those items, also helps users of financial statements to assess how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.<sup>10</sup> That assessment provides further input into assessments by users of the entity's prospects for future net cash inflows. Such information is also useful for decisions by existing investors, lenders and other creditors who have the right to vote on, or otherwise influence, management's actions.
- 2.8 The statement of financial position includes recognised assets and liabilities. To recognise an asset or a liability, an entity must answer 'yes' to both of the following questions:
- (a) does something exist that meets the definition of an asset or a liability of the entity (see paragraphs 2.9–2.36)?
  - (b) does that asset or liability meet the recognition criteria discussed in Section 4?
- 2.9 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;<sup>11</sup> and
  - (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.<sup>12</sup>
- 2.10 These definitions have been useful for solving many issues in standard-setting. They focus on economic phenomena that exist in the real world (resources and obligations), that are relevant to users of financial statements and that are understandable. Nevertheless, the IASB believes that the definitions can be improved in two ways:
- (a) confirming more explicitly that:

<sup>10</sup> See paragraph OB4 of the existing *Conceptual Framework*.

<sup>11</sup> See paragraph 4.4(a) of the existing *Conceptual Framework*.

<sup>12</sup> See paragraph 4.4(b) of the existing *Conceptual Framework*.

- (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) an asset must be capable of generating inflows of economic benefits. Those inflows need not be certain. The probability of those inflows need not reach any minimum threshold before the underlying resource meets the definition of an asset.
  - (iv) a liability must be capable of generating outflows of economic benefits. Those outflows need not be certain. Their probability need not reach any minimum threshold before the underlying obligation meets the definition of a liability.
- (b) adding to the guidance supporting the definitions of assets and liabilities, to clarify various matters that have caused difficulties when revising or providing Interpretations for particular Standards. Section 3 discusses suggestions for additional guidance.

2.11 This Discussion Paper proposes the following definitions to implement the changes identified in the previous paragraph:

	<b>Existing definitions</b>	<b>Proposed definition</b>
Asset (of an entity)	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.	a present economic resource controlled by the entity as a result of past events.
Liability (of an entity)	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.	a present obligation of the entity to transfer an economic resource as a result of past events.
Economic resource	[no existing definition]	a right, or other source of value, that is capable of producing economic benefits.

2.12 The following discussion addresses two aspects of the proposed improvements to the definitions of an asset and a liability:

- (a) an asset is a resource and a liability is an obligation (see paragraphs 2.13–2.16); and
- (b) the role of uncertainty (see paragraphs 2.17–2.36).



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

- 2.13 Because the existing definitions refer to expected flows of economic benefits, some readers have sometimes confused the resource (asset) or the obligation (liability) with the resulting inflow or outflow of economic benefits. Two factors give rise to this potential confusion:
- (a) some readers interpret the term 'expected' as conveying a probability threshold. Whether the definition should include such a threshold is discussed in paragraphs 2.17–2.36.
  - (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. As a further advantage, that proposed change would make the definitions more concise and focused, and show more clearly the parallel between the definitions of an asset and a liability.
- 2.14 The guidance supporting the definition of an asset would make clear 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 contractual right to buy the underlying asset, not the underlying asset itself. (Similarly, the holder has no obligation to pay the strike price.)
  - (b) for a free-standing put option on an asset, the resource of the option holder is the contractual right to compel the option writer to buy the underlying asset, not the sale proceeds that the option holder will receive if it exercises its option. (If the put option is not free standing but is instead embedded in the asset itself, the option might be viewed as being part of the asset rather than as a separate asset. Whether that view is taken depends on the unit of account; see Section 9.)
  - (c) under a forward purchase contract, the purchaser's resource is the right to compel the counterparty to sell the underlying asset at a future date. The purchaser also has an obligation to pay the consideration. Section 3 includes a discussion about whether executory contracts, including forward contracts, give rise to a single (net) asset or liability, or to a separate asset and liability.
  - (d) for pharmaceutical research that is in progress, the resource is the know-how, not the economic benefits 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.

- 2.15 In existing practice, some of the economic resources identified in paragraph 2.14 are not typically recognised as assets. The recognition criteria in the relevant Standard would determine whether an entity recognises those assets (see Section 4).
- 2.16 The existing definitions refer to past events that brought a resource under the entity's control, or that imposed the obligation on the entity. The proposed definitions:
- (a) retain the term 'present' in the proposed definition of a liability. This emphasises that, to determine whether a liability exists, the key question is whether the entity has an obligation at the reporting date.
  - (b) add the term 'present' to the proposed definition of an asset. This notion is already implicit in the existing definition. Making it explicit emphasises the parallel with the definition of a liability.
  - (c) retain, in both definitions, the phrase 'as a result of past events'. This emphasises the accounting for the past transaction or other event that brought the resource under the entity's control or imposed the obligation on the entity. It is not necessary to identify that event in order to identify whether the entity has an asset or a liability. Nevertheless, by identifying that event, an entity can determine how best to portray that event in its financial statements, for example, how best to classify and present income, expenses or cash flows arising from that event.

### **Role of uncertainty**

- 2.17 In the existing *Conceptual Framework*, uncertainty may appear to play a role both in the definitions of assets and liabilities and in the recognition criteria:
- (a) the existing definitions include the notion that future economic benefits (or a future outflow of resources) must be 'expected'; and
  - (b) the existing recognition criteria specify that an asset or a liability is recognised if it is probable that any future economic benefit associated with the item will flow to or from the entity.
- 2.18 These features of the existing definitions and recognition criteria have given rise to several questions:
- (a) are the terms 'expected' in the definitions and 'probable' in the recognition criteria both intended to address uncertainty? If so, what is the relationship between the two terms?
  - (b) is either of these terms intended to convey a requirement that the probability of an inflow or outflow of economic benefits must meet some minimum threshold?
  - (c) if the term 'expected' is not intended to convey a minimum threshold, is it used in the mathematical sense of an 'expected value', which refers to a probability-weighted average of the possible outcomes (the mean of a statistical distribution)?

- (d) is the use of the term ‘probable’ in the recognition criteria intended to refer to uncertainty about whether future inflows or outflows will occur? Or is it intended to refer to uncertainty about which entity will receive or transfer those flows?

2.19 In considering those questions, it is worth distinguishing two forms of uncertainty:

- (a) uncertainty about whether an asset or a liability exists (‘existence uncertainty’; see paragraphs 2.20–2.31); and
- (b) uncertainty about whether an asset or a liability will result in any inflow or outflow (‘outcome uncertainty’; see paragraphs 2.32–2.34).

*Existence uncertainty*

2.20 In some rare cases, it is unclear whether an entity has an asset or a liability. Existence uncertainty is present if it is uncertain whether an asset or a liability exists. The most obvious example of existence uncertainty is litigation; for example, it might be uncertain whether an entity committed an act that, if committed, obliges the entity to pay damages or a fine.

2.21 The *Conceptual Framework* could stay silent on existence uncertainty, or it could address existence uncertainty in either the definitions of the elements or the recognition criteria. Because existence uncertainty relates to the existence of an asset or a liability, this Discussion Paper considers it in relation to the definitions.

2.22 Setting an explicit probability threshold in the *Conceptual Framework* could lead to more consistency in decisions when developing or revising Standards. On the other hand, the following are arguments against including an explicit probability threshold in the *Conceptual Framework*:

- (a) existence uncertainty is rare—there is no need to establish a principle for these few cases;
- (b) allowing for judgement is appropriate in principle-based standards; and
- (c) if existence uncertainty is significant in a particular project, the IASB could decide in that project which threshold, if any, would result in the most relevant information for users of financial statements in that particular case. The *Conceptual Framework* could explain this point.

2.23 If the *Conceptual Framework* does set a probability threshold for existence uncertainty, the following questions arise:

- (a) which threshold should it set (see paragraphs 2.24–2.26); and
- (b) should the same threshold apply in all circumstances (see paragraphs 2.27–2.30)?

2.24 Examples of possible probability thresholds include:

- (a) virtually certain: an entity should conclude that an asset or a liability exists if it is virtually certain that the asset or the liability exists (and that it is an asset or a liability of the entity). As a precedent, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* currently uses this as a

recognition criterion for contingent assets, though it does not distinguish existence uncertainty from outcome uncertainty. Once it becomes virtually certain that an inflow of economic benefits will arise, IAS 37 treats this item as an asset to be recognised, not as a contingent asset.<sup>13</sup>

- (b) probable: an entity should conclude that an asset or a liability exists if it is probable that an asset or a liability exists (and that it is an asset or a liability of the entity). As a precedent, IAS 37 adopts this threshold for provisions. (IAS 37 also states that an outflow of resources or other event is probable if it is more likely than not to occur. Other Standards do not define the term ‘probable’.) As noted in (a), IAS 37 does not distinguish existence uncertainty from outcome uncertainty.
- 2.25 Some support using virtual certainty as the threshold in cases of existence uncertainty. They note that the definitions of assets and liabilities are the foundations of financial reporting. In their view, when there is not a high probability that an economic resource or obligation actually exists, reporting an asset or a liability would not result in relevant and understandable information and would undermine the confidence of users in the integrity of financial statements.
- 2.26 Others support using probable (or more likely than not) as the threshold in cases of existence uncertainty. They note that existence uncertainty and outcome uncertainty are often related, and that few would advocate using ‘virtually certain’ as a threshold for outcome uncertainty. When it is not virtually certain whether an asset or a liability exists, there may often also be uncertainty about the outcome that the asset or the liability will produce if it does exist. Consequently, supporters of this approach believe that inconsistencies may arise if an entity delays recognising an asset or a liability until its existence is regarded as virtually certain, but does recognise an asset or a liability whose existence is regarded as certain but whose outcome is uncertain. They believe that financial reporting will be more consistent—and more relevant—if the same probability threshold is set for both existence uncertainty and outcome uncertainty.
- 2.27 Some suggest that the *Conceptual Framework* should set different probability thresholds for existence uncertainty in different circumstances. For example, some believe that an entity should conclude that an asset exists if it is virtually certain that the asset exists (and that it is an asset of the entity); it should conclude that a liability exists if it is probable that the liability exists (and that it is a liability of the entity). This is one feature of IAS 37, which sets different recognition criteria for contingent assets (virtually certain) than for liabilities (probable, defined as more likely than not).
- 2.28 Those who support different thresholds for different circumstances put forward the following arguments:

<sup>13</sup> IAS 37 defines a ‘contingent asset’ as a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the reporting entity. This Discussion Paper does not propose that the *Conceptual Framework* should identify a separate category of ‘contingent assets’ or ‘possible assets’.

- (a) some believe that at least some users of financial statements are more concerned about downside risks than upside potential. Setting a higher threshold for assets (or gains) than for liabilities (or losses) would provide an earlier warning of items that matter more to users of financial statements.
  - (b) exercising a degree of caution in conditions of uncertainty would counter any natural conscious or subconscious bias of management towards optimism.
- 2.29 Others believe that any probability threshold should apply equally in all circumstances. In their view, this is necessary to achieve neutrality.
- 2.30 Some suggest that the IASB should be more willing to conclude that an asset or a liability exists if the entity acquired the asset or incurred the liability in an exchange transaction for observable consideration. In their view, the transaction provides evidence that the asset or the liability existed at the time of the transaction.
- 2.31 Paragraph 2.35 summarises the IASB's preliminary views on existence uncertainty, after a discussion of outcome uncertainty.

*Outcome uncertainty*

- 2.32 Outcome uncertainty refers to cases where the asset or the liability exists, but the outcome is uncertain. Outcome uncertainty arises much more commonly than existence uncertainty. Examples of outcome uncertainty include the following:
- (a) a lottery ticket, where the total number of tickets is known, and hence the probability of winning is also known: the holder has an asset (the ticket) but does not know whether the ticket will win. (Note also that the issuer is certain that it will make a payment to holders of winning tickets, though it does not know which tickets will win. If a probability threshold is applied, either in the definition or in the recognition criteria, the issuer would reach a different judgement for each individual ticket than it would for the whole pool of tickets.)<sup>14</sup>
  - (b) a traded option held: cash flows will occur if the holder exercises the option (ie if the option is in the money at expiry), or if the holder sells the option. The holder has an asset (the option) but does not know whether it will exercise the option. The holder may be able to sell a traded option readily before expiry of the option.
  - (c) an untraded call option on unlisted equities, for which the terms of the option prohibit the transfer of the option to another party: the holder has an asset (the option) but does not know whether it will exercise the option. If it does not exercise the option, it will receive no cash.

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<sup>14</sup> The lottery example is included as a simple illustration of the concepts involved. Most real-life examples are much more complex.

- (d) an investment in a partnership that does not permit the holder to transfer the investment to another party. In this case, the investor will receive cash only if the partnership makes a distribution, or if the partnership is liquidated, or if the other partners buy out the investor. The holder has an asset (the investment) but does not know whether it will receive cash.
- (e) know-how generated by a research and development (R&D) project: this will generate cash if the project is successful, or if the know-how is sold. The holder has an asset (the know-how) but does not know whether it will receive cash. This case differs from the case of the lottery ticket because the probability of success may be unknown and unknowable (and cannot subsequently be back-tested) and there is a very wide range of possible outcomes.
- (f) unquoted shares in an entity whose only activity is carrying out R&D: few would dispute that shares in an entity generally meet the definition of an asset. On the other hand, if there are concerns about whether the know-how generated by an R&D project is an asset, presumably the same concerns would arise for shares in an entity whose only asset is such know-how.
- (g) litigation: the entity will have to pay out cash if it loses the litigation. It may be uncertain whether the entity has an obligation at all until the court determines whether this is the case (existence uncertainty). In addition, even if the entity has already concluded that it will lose the litigation, it may still be uncertain how much the entity will have to pay (outcome uncertainty).
- (h) accounts receivable: the entity has an asset (the accounts receivable) but does not know whether it will receive cash.
- (i) inventory: the entity has an asset (the inventory) but does not know whether it can sell the inventory and receive cash.

2.33 Some suggest that the IASB should retain some probability threshold, either in the definition of the elements or in the recognition criteria, for cases of outcome uncertainty. They think that users of financial statements will not factor some low probability outcomes into their estimates of the amount, timing and uncertainty of future cash flows. Hence, when there is only a small probability of any future cash flows—for example, when an entity has given a guarantee that is very unlikely to be called upon—the costs of recognising and measuring the asset or the liability may exceed the benefits to users of financial statements. Furthermore, in some cases there is a wide range of outcomes, including zero, and the probabilities of the different outcomes are unknown and arguably unknowable (for example, a highly speculative R&D project or some litigation). In some such cases, measures derived from estimates of those probabilities may, arguably, be neither relevant to users of financial statements nor verifiable. Some believe that retaining a probability threshold (in either the definitions or the recognition criteria) would be a practical and inexpensive way to filter these items out. If these items are not recognised, it may be possible to disclose other information that is relevant to users of financial statements.

2.34 Some would be more willing to recognise an item with an uncertain outcome if the measure of the item can be supported by current market prices. Similarly, some would be more willing to recognise an item with an uncertain outcome if the entity acquired it in an exchange transaction for observable consideration. Failing to recognise that asset or liability would lead to a gain or loss that, in their view, would not faithfully represent the change in the entity's financial position.

*Preliminary views on uncertainty*

2.35 The IASB's preliminary views on uncertainty are that:

- (a) the definitions of assets and liabilities should not retain the notion that an inflow or outflow is 'expected'. Retaining such a notion might exclude many items that are clearly assets or liabilities, such as many purchased options or written options. The important thing is that there are at least some outcomes in which an economic resource will generate economic benefits, or in which an obligation will result in a transfer of economic resources. Thus:
  - (i) the proposed definition of an economic resource clarifies that it need not be certain that an economic resource will generate economic benefits, but the economic resource must be capable of producing economic benefits. The definitions would not specify a minimum probability threshold.
  - (ii) similarly, it need not be certain that a present obligation will result in a transfer of an economic resource, but the present obligation must be capable of resulting in a transfer of economic resources. For example, if an obligation will require a transfer of economic resources only if an uncertain future event occurs (for example, a stand-ready obligation), that obligation is a liability, as discussed in Section 3.
- (b) in rare cases it is uncertain whether an asset or a liability exists. The *Conceptual Framework* should not set a probability threshold to determine whether an asset or a liability exists in those rare cases. If there is significant uncertainty about whether an asset or a liability exists, the IASB would decide when developing or revising an IFRS how to deal with that uncertainty. The IASB would also consider how an entity would provide the most faithful representation of the circumstances, and how an entity would make the information provided more comparable, verifiable, timely and understandable.
- (c) the reference to probability should be deleted from the recognition criteria. Including a probability threshold would lead to a failure to recognise some items (for example, options) that are undoubtedly assets or liabilities but are judged, at a particular time, to have a low probability of resulting in an inflow or outflow of economic benefits. Furthermore, some such items may swing above and below the threshold as the probabilities change. In the IASB's preliminary view, uncertainty about the ultimate inflow or outflow should not, by itself, determine whether an entity recognises an asset or a liability, though it may affect

its measurement. Nevertheless, uncertainty may make some rights or obligations so difficult to measure that recognising them might result in information that is not relevant. Section 4 discusses, among other things, whether to include recognition criteria relating to relevance.

- 2.36 Some measurement approaches may create an implicit recognition threshold. For example, if an item is measured at the most likely outcome and the most likely outcome is zero, it will be measured at zero (in effect, the same as not being recognised). Consequently, the outcome of recognition decisions will reflect not just the recognition criteria, but also the measurement that will be used for items that are recognised. Section 6 discusses approaches to cash flows that are uncertain.

### Definitions of income and expense

- 2.37 The existing *Conceptual Framework* states that the elements directly related to the measurement of profit are income and expense, which are defined as follows:
- (a) income: 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: 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.<sup>15</sup>
- 2.38 These elements provide users of financial statements with information about some of the changes in an entity's resources and obligations. This helps users to understand the return the entity has produced on its economic resources.<sup>16</sup> This information in turn helps users to assess the entity's prospects for future net cash inflows. It does this not only directly but also, by helping users to assess how efficiently and effectively the entity's management have discharged their responsibilities to use the entity's resources, indirectly. Thus, information about income and expenses is useful to users of financial statements for decisions about providing resources to the entity.<sup>17</sup>
- 2.39 Profit or loss, total OCI and total comprehensive income are not elements of financial statements. They are subtotals or totals derived by summing items of income or expense. Section 8 discusses the role of these totals and subtotals.
- 2.40 In relation to the definition of an expense, the IASB believes it would be helpful for the *Conceptual Framework* to clarify one point that some have questioned: whether an expense arises when an entity issues an equity instrument in exchange for services. This question is important for determining how to treat share-based payments (for example, share options granted to employees). When an entity acquires an asset in exchange for issuing equity instruments, the entity recognises that asset (if the recognition criteria are met). Similarly, when an

<sup>15</sup> See paragraph 4.25 of the existing *Conceptual Framework*.

<sup>16</sup> See paragraph OB16 of the existing *Conceptual Framework*.

<sup>17</sup> See paragraphs OB2–OB4 of the existing *Conceptual Framework*.



entity receives services in exchange for issuing equity instruments, 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. The IASB reached this conclusion when it developed IFRS 2 *Share-based Payment* and believes that it is still appropriate, and that the revised *Conceptual Framework* should confirm it.<sup>18</sup>

- 2.41 The IASB has identified few other problems with the existing definitions of income and expense. Some drafting changes may be required, mainly as a result of any changes to the definitions of the other elements.
- 2.42 Some have suggested that the revised *Conceptual Framework* should define different types of income or expense to differentiate:
- (a) revenue from gains, and expenses from losses (see paragraphs 2.43–2.46); and
  - (b) income and expense reported in profit or loss from income and expense reported in OCI (see paragraphs 2.47–2.50).

#### **Differentiating gains from revenue and losses from expenses**

- 2.43 The existing *Conceptual Framework* distinguishes two categories of income:
- (a) revenue, which arises in the course of the ordinary activities of an entity; and
  - (b) gains, which represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of the entity.
- 2.44 Similarly, the existing *Conceptual Framework* distinguishes two categories of expense:
- (a) expenses that arise in the course of the ordinary activities of an entity; and
  - (b) losses, which may, or may not, arise in the course of the ordinary activities of the entity.
- 2.45 The existing *Conceptual Framework* notes that:
- (a) gains are no different in nature from revenues (they both represent increases in economic benefits); and
  - (b) losses are no different in nature from other expenses (they both represent decreases in economic benefits).

Hence, the existing *Conceptual Framework* does not treat these four categories as four separate elements. Nevertheless, the *Conceptual Framework* does state that gains are usually presented separately from other income and losses are usually presented separately from other expenses. In addition, the *Conceptual Framework* notes that gains (losses) are often reported net of related expenses (income).

<sup>18</sup> See paragraphs BC45–BC53 of IFRS 2.

- 2.46 If differentiating gains from revenue and losses from expenses is useful then, arguably, gains, revenue, losses and expenses should each be defined as separate elements. However, in order to do this it would be necessary to define more clearly the differences between these four items. Among other things, this would require the IASB to define ordinary activities. The IASB believes that the process of deciding whether to distinguish these four items would be best carried out in a project to review Standards on financial statement presentation and not in a project to revise the *Conceptual Framework*. Consequently, the IASB intends to leave the discussion of gains, revenue, expenses and losses largely unchanged.

#### **Differentiating items in profit or loss from items in OCI**

- 2.47 Some have suggested that the *Conceptual Framework* could improve the reporting of financial performance by defining separate elements for:
- (a) income (expenses) reported in profit or loss; and
  - (b) income (expenses) reported in OCI.
- 2.48 To define those separate elements, the IASB would have to answer exactly the same questions as it would have to answer in developing the presentation guidance discussed in Section 8 (ie when should a change in an asset or a liability be reported in OCI and when should it be reported in profit or loss?).
- 2.49 There are disadvantages to using definitions to distinguish income and expense reported in OCI from income and expense reported in profit or loss, rather than relying on presentation guidance:
- (a) using definitions may be a clear way to implement an approach that states when an item **must** be reported in OCI, but may not be a clear way to implement an approach that states when an item **could** be reported in OCI. Section 8 recommends providing guidance about when an item **could** be included in OCI.
  - (b) defining one set of elements for use in profit or loss and a separate set of elements for OCI may not be straightforward, particularly if the IASB decides that an entity should report in OCI only a component of a change in the carrying amount of an asset or a liability rather than the entire change (for example, that part of the change in the fair value of an asset or a liability that arises from changes in interest rates).
- 2.50 Consequently, this Discussion Paper proposes not to define separate elements of income or expense to describe what should be reported in profit or loss and what should be reported in OCI. Instead, the revised *Conceptual Framework* would provide presentation guidance addressing this topic (see Section 8).

#### **Capital maintenance adjustments**

- 2.51 As explained in paragraphs 4.24 and 4.36 of the existing *Conceptual Framework*, the recognition and measurement of income and expenses, and hence of profit, depends in part on the concepts of capital and capital maintenance used in preparing financial statements. The revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity. Although these increases

or decreases meet the definition of income and expenses, they are not included in the income statement under some concepts of capital maintenance. Instead, these items are included in equity as capital maintenance adjustments or revaluation reserves. The existing *Conceptual Framework* does not state whether these items form part of total comprehensive income. Section 9 refers to concepts of capital maintenance.

### Other definitions

2.52 The existing *Conceptual Framework* does not define separate elements for the statement of cash flows and for the statement of changes in equity. It may be helpful for the *Conceptual Framework* to define elements for each primary financial statement. The elements not discussed so far in this Section would be:

- (a) statement of cash flows, whether prepared using the indirect method or the direct method:
  - (i) cash receipts; and
  - (ii) cash payments.
- (b) statement of changes in equity:
  - (i) contributions to equity;
  - (ii) distributions of equity; and
  - (iii) transfers between classes of equity.

This Discussion Paper does not propose definitions for these elements. The IASB does not foresee great difficulties in developing definitions of these elements for inclusion in an Exposure Draft of the revised *Conceptual Framework*.

### Questions for respondents

<b>Question 2</b>
<p>The definitions of an asset and a liability are discussed in paragraphs 2.6–2.16. The IASB proposes the following definitions:</p> <ul style="list-style-type: none"> <li>(a) an asset is a present economic resource controlled by the entity as a result of past events.</li> <li>(b) a liability is a present obligation of the entity to transfer an economic resource as a result of past events.</li> <li>(c) an economic resource is a right, or other source of value, that is capable of producing economic benefits.</li> </ul> <p>Do you agree with these definitions? Why or why not? If you do not agree, what changes do you suggest, and why?</p>

**Question 3**

Whether uncertainty should play any role in the definitions of an asset and a liability, and in the recognition criteria for assets and liabilities, is discussed in paragraphs 2.17–2.36. The IASB’s preliminary views are that:

- (a) the definitions of assets and liabilities should not retain the notion that an inflow or outflow is ‘expected’. An asset must be capable of producing economic benefits. A liability must be capable of resulting in a transfer of economic resources.
- (b) the *Conceptual Framework* should not set a probability threshold for the rare cases in which it is uncertain whether an asset or a liability exists. If there could be significant uncertainty about whether a particular type of asset or liability exists, the IASB would decide how to deal with that uncertainty when it develops or revises a Standard on that type of asset or liability.
- (c) the recognition criteria should not retain the existing reference to probability.

Do you agree? Why or why not? If you do not agree, what do you suggest, and why?

**Question 4**

Elements for the statement(s) of profit or loss and OCI (income and expense), statement of cash flows (cash receipts and cash payments) and statement of changes in equity (contributions to equity, distributions of equity and transfers between classes of equity) are briefly discussed in paragraphs 2.37–2.52.

Do you have any comments on these items? Would it be helpful for the *Conceptual Framework* to identify them as elements of financial statements?

## Section 3—Additional guidance to support the asset and liability definitions

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### Introduction

- 3.1 This Section considers areas in which the IASB could add further guidance to the *Conceptual Framework* to support the revised definitions of an asset and a liability.
- 3.2 There are three reasons for adding more guidance for those definitions:
- (a) as discussed in Section 2, this Discussion Paper proposes changes to aspects of the definitions. Further guidance would help to explain the terms used within the proposed new definitions.
  - (b) some aspects of the existing definition of a liability are unclear: there is little guidance in the *Conceptual Framework* and the principles underlying different Standards can appear inconsistent. For example, it is unclear whether an entity can have a present obligation while any requirement to transfer an economic resource remains conditional on the entity's future actions. As a result, the IASB, the IFRS Interpretations Committee (the 'Interpretations Committee') and others have had difficulty reaching conclusions on whether and when some transactions give rise to liabilities. Additional guidance could establish principles on which to develop future requirements.
  - (c) other aspects of the existing asset and liability definitions have become clearer in recent years as the IASB has developed requirements and guidance within individual Standards. For example, several existing and proposed Standards now give guidance on the nature of liabilities—such as insurance contract liabilities—whose outcome is conditional on events that are outside the entity's control. In addition, several Standards now give guidance on identifying the substance of contractual rights and obligations. The IASB thinks that it would be helpful to revise the *Conceptual Framework* to include the general principles underlying that guidance.
- 3.3 To fulfil those objectives, this section considers the need for further guidance on various aspects of the asset and liability definitions, specifically:
- (a) to support the definition of an **asset**, the guidance will cover:
    - (i) the meaning of 'economic resource' (see paragraphs 3.4–3.15); and
    - (ii) the meaning of 'control' (see paragraphs 3.16–3.34).
  - (b) to support the definition of a **liability**, the guidance will cover:
    - (i) the meaning of 'transfer an economic resource' (see paragraphs 3.35–3.38);
    - (ii) constructive obligations (see paragraphs 3.39–3.62); and
    - (iii) the meaning of 'present' obligation (see paragraphs 3.63–3.97).
  - (c) to support **both definitions**, the guidance will cover:

- (i) reporting the substance of contractual rights and contractual obligations (see paragraphs 3.98–3.108); and
- (ii) executory contracts (see paragraphs 3.109–3.112).

### **Economic resource**

- 3.4 As discussed in Section 2, this Discussion Paper proposes to define an asset as “a present economic resource controlled by the entity as a result of past events” and to define an economic resource as “a right, or other source of value, that is capable of producing economic benefits”. The IASB thinks that further guidance would help to explain the proposed new definition of ‘economic resource’. The Discussion Paper proposes that the further guidance should cover the matters set out in paragraphs 3.5–3.15.
- 3.5 Economic resources may take various forms:
- (a) enforceable rights established by contract, law or similar means, such as:
    - (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 economic resource if the holder of the right chooses to exercise that right (an option to acquire the underlying economic resource) or is required to exercise that right (a forward contract to buy the underlying economic resource). Examples include options to receive other assets, net rights under forward contracts to buy or sell other assets and rights to receive services for which the entity has already paid.
    - (iv) enforceable rights to benefit from the stand-ready obligations of another party (see paragraphs 3.70–3.71).
    - (v) enforceable intellectual property rights (for example, registered patents).
  - (b) rights arising from a constructive obligation of another party (see paragraphs 3.39–3.62).
  - (c) other sources of value if they are capable of generating economic benefits. Examples of such economic resources include:
    - (i) know-how;
    - (ii) customer lists;
    - (iii) customer and supplier relationships;
    - (iv) an existing work force; and

- (v) goodwill. The IASB concluded in paragraphs BC313–BC323 of the Basis for Conclusions on IFRS 3 *Business Combinations* that goodwill does meet the definition of an asset. However, paragraph 4.9(c) of this Discussion Paper explains that recognising internally generated goodwill does not provide relevant information.
  - (d) some assets, particularly many services, that are consumed immediately on receipt.
- 3.6 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, for example, by:
- (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;
  - (d) using the asset to reduce expenses;
  - (e) leasing the asset to another party;
  - (f) selling or exchanging the asset;
  - (g) receiving services from the asset;
  - (h) pledging the asset to secure a loan; and
  - (i) holding the asset.
- 3.7 The guidance would further 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, 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 principle. Both full ownership and the lease give rise to assets, and both provide rights to use the underlying machine, albeit for a period that may be less than the useful life in the case of the leased asset:
- (a) in the case of the right to use under a lease, the lessee’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; and
  - (b) in the case of full, unencumbered legal ownership, the owner’s right is to obtain all of the benefits generated by the machine throughout its useful life.
- 3.8 In many cases, economic resources will comprise various different rights. For example, if an entity has legal ownership of a physical object, the economic resource will comprise rights such as:
- (a) the right to use the object;
  - (b) the right to sell the object;
  - (c) the right to pledge the object; and

- (d) legal title to the object (ie any rights conferred by legal title that are not mentioned separately in (a)–(c)).
- 3.9 In many cases, one party holds all these rights. Sometimes, as in a lease, different parties each hold some of the rights. In those cases, the IASB would need to decide how each party accounts for the rights.
- 3.10 In many cases, an entity treats all of the rights it holds as a single asset. Nevertheless, an entity would treat some of the rights as one or more separate assets if such a separation produces information that is relevant to users of financial statements and provides a faithful representation of the entity's resources, at a cost that does not exceed the benefits of doing so. Whether rights should be accounted for separately or combined into a single asset is discussed further in Section 9.
- 3.11 An entity should describe an economic resource in a manner that is clear, concise and understandable. For example, if an entity has legal ownership of a machine and all rights associated with that machine, strictly speaking the entity's asset is the bundle of all rights associated with that machine. However, it would generally be perfectly clear, concise and understandable to describe the entity's asset as a machine, rather than as rights to a machine. More detailed and sophisticated descriptions of the asset would be needed only in less common circumstances in which a summarised or non-technical description would not convey the nature of the asset. Furthermore, it would typically be acceptable, and indeed preferable, to use a concise label on the face of the statement of financial position, providing any necessary details in the notes.
- 3.12 Sometimes, a single resource contains obligations as well as rights. For example, contracts create a series of rights and obligations for each party. The unit of account (see Section 9) will determine whether the entity accounts for that package as a single asset or a single liability or as one or more separate assets and one or more separate liabilities. Generally, when a package of rights and obligations arises from the same source, an entity will account for them at the highest level of aggregation that enables it to depict the rights and obligations, and the changes in those rights and obligations, in the most relevant, faithful and understandable manner.
- 3.13 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. Offsetting is not the same as having a single (net) right or a single (net) obligation. When a single (net) right or a single (net) obligation exists in a particular case, the entity has only a single asset or a single liability. For example, suppose that an entity holds an option to buy an asset if it pays CU100 and that the asset has an expected value of CU140.<sup>19</sup> The entity does not have an asset of CU140 and a liability to pay the strike price of CU100. Instead, the entity has an asset of CU40. In contrast, offsetting arises when an entity has both an asset and a liability and recognises and measures them separately, but presents them as a single (net) amount (possibly with disclosure of the separate asset and liability).

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<sup>19</sup> In this Discussion Paper, currency amounts are denominated in 'currency units' (CU).



- 3.14 Paragraph 3.5(a) refers to enforceable rights. A right is enforceable if the holder of the right can ensure that it is the party that will receive, and can 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 its share of any dividends that the issuer chooses to pay, even if the holder cannot compel the issuer to declare a dividend.
- 3.15 The following are examples of items that do not meet the definition of an economic resource and hence do not meet the definition of an asset:
- (a) debt or equity instruments issued by the entity and repurchased and held by it (for example, treasury shares). Similarly, in consolidated financial statements, debt or equity instruments issued by one member of the consolidated group and held by another member of that group are not economic resources of the group. Those instruments are not capable of providing economic benefits to the reporting entity because the reporting entity cannot have a claim on itself. (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 of the equity instruments 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.)

### **Control of an economic resource**

- 3.16 The definition of an asset proposed in Section 2 includes a requirement for the economic resource to be controlled by the entity. The existing *Conceptual Framework* does not define the term 'control'. However, the IASB has defined control in some individual Standards. The IASB proposes to build on these definitions to define the meaning of control in the context of the definition of an asset.

### **Existing definitions of control**

- 3.17 The concept of control is used in the IASB's Exposure Draft *Revenue from Contracts with Customers* (the 'draft Revenue Standard'), published in November 2011, and in IFRS 10 *Consolidated Financial Statements*.
- 3.18 The draft Revenue Standard uses the concept of control to determine when an entity has transferred an asset to another party and has, consequently, satisfied a performance obligation. In paragraph 31 it states that "An asset is transferred when (or as) the customer obtains control of that asset."
- 3.19 Paragraph 32 of the draft Revenue Standard defines control of an asset in this context as "... the ability to direct the use of and obtain substantially all of the remaining benefits from the asset."

- 3.20 IFRS 10 uses the concept of control to determine when one entity should consolidate another entity. In Appendix A of IFRS 10, control of an entity is defined as follows:

An investor controls an investee when the investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

- 3.21 IFRS 10 explains the meaning of ‘power over the investee’ as follows:

An investor has power over an investee when the investor has existing rights that give it the current ability to direct the *relevant activities*, ie the activities that significantly affect the investee’s returns.

- 3.22 The definitions of control in the draft Revenue Standard and in IFRS 10 necessarily differ from each other: the former is defining control of an asset, whereas the latter is defining control of an entity. However, the definitions are based on the same basic concepts, ie that the entity has the ability to direct the use of the asset (or the entity) so as to obtain benefits (or returns).

**Definition proposed for the *Conceptual Framework***

- 3.23 The IASB proposes to use the same basic concepts to define control of an economic resource in the *Conceptual Framework*. It proposes the following definition:

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

- 3.24 This proposed definition differs in one respect from the definition of control used in the draft Revenue Standard. The draft Revenue Standard proposes that a customer controls an asset when the customer is able to direct the use of and obtain substantially all of the remaining benefits from the asset. The definition of control proposed in this Discussion Paper refers to ‘the economic benefits that flow from the economic resource’, rather than to ‘substantially all’ of those economic benefits. This is because the term ‘substantially all’ would be redundant, and potentially confusing, if an entity recognises only the rights it controls. For example, suppose that Entity A has the right to obtain 20 per cent of the economic benefits from a building. Entity A does not have all, or even substantially all, of the economic benefits from the building. However, Entity A’s asset is not the building, it is the right to obtain 20 per cent of the economic benefits from the building. Entity A has the ability to direct the use of that right and to obtain all of the economic benefits that flow from that right.

- 3.25 A threshold such as ‘substantially all’ is necessary only if a Standard requires an entity:

- (a) to account for a group of rights as a single asset (unit of account); and
- (b) to derecognise, on transfer of a sufficient proportion of the rights, the whole of the original asset and recognise a new asset for the rights retained.

In such situations, the Standard also needs to specify a threshold to identify when a sufficient proportion of the rights have been transferred for

derecognition to occur. The draft Revenue Standard specifies ‘substantially all’. It proposes that, if the entity does not transfer substantially all the remaining benefits from the asset to the customer, it either continues to recognise the original asset or accounts for the contract as a lease, depending on the circumstances. (Section 4 discusses various ways in which an entity might report the consequences of transferring some, but not all, of the rights associated with a resource.)

### Further guidance on the definition of control

- 3.26 Further guidance could be added to the *Conceptual Framework* to clarify the proposed definition of control. The IASB proposes that this guidance could cover the topics discussed in paragraphs 3.27–3.34.
- 3.27 For an entity to control an economic resource, the economic benefits arising from the resource must flow to the entity (either directly or indirectly) rather than to another party. This requirement does not imply that the entity can ensure that the resource will generate economic benefits in all circumstances. Instead it means that, if the resource generates economic benefits, the entity is the party that will receive them.
- 3.28 An entity has the ability to direct the use of an economic resource if it has the right to deploy that economic resource in its activities or to allow another party to deploy the economic resource in that other party’s activities. Many economic resources take the form of legally enforceable rights, such as legal ownership or contractually enforceable rights that establish the entity’s ability to direct the use of the economic resource. However, sometimes an entity establishes its ability to direct the use of an economic resource by having access that is not available to others, for example, by having possession of the economic resource and being able to prevent access to it by others. This can be particularly relevant for assets such as know-how and customer lists.
- 3.29 An entity does not control an economic resource if it does not have the present ability to direct the use of the economic resource. Consequently, the following are not assets of an entity:
- (a) rights of access to public goods, such as open roads, if similar rights are available to any party at no cost.
  - (b) fish in water to which access is not restricted. Although a potential source of economic benefits, this is not an economic resource of any one entity because those benefits are available to any party. (An exclusive right to catch fish would be an asset of an entity that has that right. Similarly, if fishing quotas are introduced, the quota of each party would become an asset of that party, though the rights associated with possession of the fish would still not become an economic resource until the fish are caught.)
  - (c) knowledge that is in the public domain and freely available to anyone without significant effort or cost. No party controls such knowledge.
- 3.30 When determining whether an entity controls an economic resource, it is important to identify the economic resource correctly. For example, Entities A, B and C may jointly own 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. In the absence of any other agreements that modify control, each party controls its proportionate interest in the underlying economic resource (in this example, the real estate). No single party controls the underlying real estate in its entirety.

*Control: principal and agent*

- 3.31 An agent is a party that is primarily engaged to act on behalf of, and for the benefit of, another party (the principal). If an entity holds a resource as agent, rather than as principal, the economic benefits arising from the resource flow to the principal rather than to the agent. Consequently, the agent does not control the resource and does not have an asset. (Accordingly, the agent also has no obligation to transfer the economic benefits derived from the asset.)
- 3.32 If an entity holds a resource, and is bound by a separate requirement, such as a contractual requirement or legislation, to pass through to another party all the economic benefits flowing from that resource, the entity holds that resource as agent for the other party. Thus, the entity has no asset or liability.

**Corresponding guidance for liabilities**

- 3.33 The proposed definition of a liability specifies that the obligation must be an obligation of the entity. In other words, the entity must be the party that is bound by the obligation. This feature of the definition corresponds to the fact that the proposed definition of an asset specifies that the entity must be the party that controls the asset. The identity of the party bound by an obligation will often be evident from the contracts, statutes or other evidence that establish that the obligation exists.
- 3.34 If a liability exists for one party, an asset always exists for another party or parties, except perhaps for some obligations to clean up damage to the environment. However, for some assets, such as rights over physical objects, no corresponding liability exists.

**To transfer an economic resource**

- 3.35 As discussed in Section 2, the IASB proposes to define a liability as a present obligation to transfer an economic resource. The phrase “to transfer an economic resource” is a change to the existing definition. It is consistent with the proposal in the draft Revenue Standard to define a performance obligation as a “promise ... to transfer a good or service to the customer.”
- 3.36 An obligation to transfer an economic resource may result in an entity paying cash, transferring assets other than cash, granting a right to use an asset, rendering services or standing ready to make a payment on the occurrence of a future event that is outside the entity’s control.
- 3.37 In some cases, an entity may have an obligation that it will settle by exchanging it for a second obligation, for example, by issuing a financial liability. If that second obligation requires the entity to transfer an economic resource, then the first obligation is also an obligation to transfer an economic resource.

- 3.38 The following **do not** give rise to a present obligation to transfer an economic resource:
- (a) a requirement to provide economic resources only if, at the same time or earlier, the entity expects to receive economic resources of equal or greater value (see also the discussion on executory contracts in paragraphs 3.109–3.112); and
  - (b) an obligation that an entity is permitted (or required) to fulfil by issuing its own equity instruments as ‘currency’. Although those equity instruments are a resource for the holder, they are not an economic resource for the issuer. Consequently, an obligation to issue equity instruments is not an obligation to transfer an economic resource. As explained in paragraph 3.15(a), this is the case even if the issuer previously held those equity instruments as ‘treasury shares’ (see Section 5 for a discussion of the distinction between liabilities and equity instruments).

## Constructive obligations

### Existing requirements and guidance

- 3.39 The IASB proposes to define a liability as an ‘obligation’. The existing *Conceptual Framework* describes an obligation as “a duty or responsibility to act or perform in a certain way.” It then states that, although obligations may be legally enforceable as a consequence of a binding contract or statutory requirement, they also arise from “normal business practice, custom and a desire to maintain good business relations or act in an equitable manner” (see paragraph 4.15 of the existing *Conceptual Framework*).
- 3.40 IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* notes that a liability can arise from a legal obligation or from a ‘constructive obligation’, and defines the latter as follows:
- A *constructive obligation* is an obligation that derives from an entity’s actions where:
- (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
  - (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.
- 3.41 As an example of a constructive obligation that meets the definition in paragraph 3.40, the Implementation Guidance on IAS 37 refers to an entity’s obligation to clean up contamination in order to comply with a widely published policy of the entity, even in a country with no environmental legislation.<sup>20</sup>
- 3.42 IAS 19 *Employee Benefits* also refers to constructive obligations—it requires entities to account for both legal and constructive obligations for employee benefits. It describes legal obligations as arising from the formal terms of employment contracts or benefit plans, and constructive obligations as arising from the

<sup>20</sup> See Example 2B of Section C in the Implementation Guidance on IAS 37.

entity's informal practices. It states that informal practices, such as paying bonuses in excess of those to which employees are contractually entitled, give rise to a constructive obligation if they leave the entity with no realistic alternative but to pay benefits, for example, if a change in those practices would cause unacceptable damage to the entity's relationship with its employees.<sup>21</sup>

- 3.43 IFRS 2 *Share-based Payment* also uses the notion of constructive obligations, though without using that specific term. In paragraph 41 it states that an entity has a present obligation to settle a share-based payment transaction in cash if “the entity has a past practice or a stated policy of settling in cash, or generally settles in cash whenever the counterparty asks for cash settlement.”

### Problems in practice

- 3.44 Some people using IFRS have reported that it can be difficult to judge whether, and to what extent, an entity's past practices, policies or statements are sufficient, in the absence of legal enforceability, to have created a valid expectation among other parties that the entity will accept specific responsibilities.
- 3.45 Furthermore, it can be difficult to interpret the definition of ‘constructive obligation’. Some people have argued that it encompasses situations in which an entity is economically compelled to take a particular course of action in the future because that action will be so much more economically advantageous—or less economically disadvantageous—than any of the available alternatives. However, the IASB and the Interpretations Committee have taken a different view. For example, when the European Union issued a directive that prompted IFRIC 6 *Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment*, questions arose about whether a constructive obligation existed. The directive required manufacturers of electrical and electronic equipment to contribute to the costs of the disposal of equipment that was manufactured in earlier periods (‘historical waste’), with each manufacturer's contribution being proportional to its market share in a specified period (the ‘measurement period’). Some people argued that manufacturers had a constructive obligation for the costs of historical waste before the measurement period: “when it would be necessary for the entity to undertake an unrealistic action in order to avoid the obligation then a constructive obligation exists and should be accounted for” (see paragraph BC9 of IFRIC 6). However, the Interpretations Committee rejected this argument, concluding that “a stated intention to participate in a market during a future measurement period does not create a constructive obligation for future waste management costs” (see paragraph BC10 of IFRIC 6).
- 3.46 It is perhaps not surprising that people think that economic compulsion can be sufficient to create a constructive obligation. Some (older) Standards identify

<sup>21</sup> See paragraph 4(c) of IAS 19. The description of a constructive obligation in IAS 19, including the notion of ‘no realistic alternative’, was based on the Exposure Draft that preceded IAS 37. The IASB's predecessor, the IASC, did not conform the wording in IAS 19 to the final wording in IAS 37 because it did not have a practice of making consequential amendments to other Standards.

constructive obligations in situations in which the entity might be economically compelled to act in a particular way, but does not necessarily have an obligation to another party to do so. For example:

- (a) paragraph 72 of IAS 37 identifies an entity as having a ‘constructive obligation’ to restructure a business once it has announced, or started to implement, a detailed restructuring plan; and
- (b) IAS 34 *Interim Financial Reporting* identifies a lessee as having a constructive obligation for contingent lease rentals at its interim reporting date, if it expects to achieve, by the end of the period, a specified level of sales above which contingent lease rentals would become payable.

3.47 In the contingent lease rental example, any obligation that the lessee has to the lessor is a legal (contractual) one. There is no constructive obligation arising in advance of the contractual obligation—the lessee does not have a constructive obligation to continue to make sales for the rest of its reporting period. The term ‘constructive obligation’ appears to have been used in IAS 34 to justify the recognition of a liability before the contractual obligation has become unconditional, ie while the outcome depends on the entity’s future actions.

#### Possible solutions

3.48 People might be less likely to mis-label contractual liabilities (such as contingent lease rentals) as constructive obligations if the IASB provides additional guidance on obligations that are conditional on future events. Potential guidance is discussed in paragraphs 3.63–3.97. If the *Conceptual Framework* clarifies that obligations can give rise to liabilities before all conditions have been satisfied, people might be less inclined to use the notion of a ‘constructive obligation’ as the justification for recognising a liability in these situations.

3.49 The IASB could take further steps to improve comparability and distinguish constructive obligations from economic compulsion. These steps could involve:

- (a) adding further guidance to support the definition of a constructive obligation (see paragraphs 3.50–3.54); or
- (b) limiting the definition of a liability to obligations that another party could enforce against the entity (see paragraphs 3.55–3.61).

#### *Add further guidance to support the definition of ‘constructive obligation’*

3.50 One approach would be to add guidance to support the definition of ‘constructive obligation’. Additional guidance could emphasise that, for an entity to have a constructive obligation:

- (a) it must have a duty or responsibility **to another party or parties**. It is not sufficient that an entity will be economically compelled to act in its own best interests or in the best interests of its shareholders.
- (b) the other party or parties must be those who would benefit from the entity fulfilling its duty or responsibility or suffer loss or harm if the entity fails to fulfil its duty or responsibility. In other words, the other

party or parties must be those to whom, or on whose behalf, the entity is required to transfer an economic resource.

- (c) as a result of the entity's past actions, the other party or parties can reasonably rely on the entity to discharge its duty or responsibility.
- 3.51 Further guidance could be added to clarify (as paragraph 20 of IAS 37 already does) that it is not necessary to know the identity of the party or parties to whom the obligation is owed—indeed the obligation may be to the public at large.
- 3.52 Adding this guidance should not undermine existing requirements for well-understood examples of constructive obligations—such as to rehabilitate land to a standard beyond that required by law, or to pay employee benefits in excess of those to which the employee is contractually entitled. For such obligations, there is usually a counterparty that is reasonably relying on the entity to discharge its responsibilities. However, the guidance would clarify that, although an entity might be economically compelled to continue to operate in a particular market or to restructure an underperforming business, such economic compulsion does not in itself amount to a constructive obligation.
- 3.53 The IASB proposed this approach in June 2005 in its *Exposure Draft of Proposed Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits*. The IASB proposed additional guidance similar to that set out in paragraph 3.50 and, on the basis of that guidance, concluded, in paragraph 15 of that Exposure Draft, that an entity does not have a constructive obligation to restructure a business, even if it has announced, or started to implement, a detailed restructuring plan. This is because it has no obligation to others and is not bound by its plan, and so it can avoid an outflow of resources (as discussed in paragraph BC68 in that Exposure Draft). Consequently, the IASB proposed to delete from IAS 37 the requirements for recognising restructuring provisions and replace them with a statement that “a cost associated with a restructuring is recognised on the same basis as if that cost arose independently of the restructuring” (see paragraph 62 of that Exposure Draft).
- 3.54 The proposed changes to the requirements for restructuring costs—which would have aligned IAS 37 with US generally accepted accounting principles (US GAAP), and would still have required entities to identify liabilities for some individual costs associated with a restructuring—were supported by most of those commenting on this aspect of the Exposure Draft. However, the IASB never implemented the proposed changes to IAS 37 because it halted its project to amend that Standard in the light of comments received on some other changes proposed in the Exposure Draft.
- Limit the definition of a liability to obligations that another party could enforce against the entity*
- 3.55 Alternatively, the IASB could make a more substantial change. Instead of emphasising the need for an obligation to be to another party, the IASB could limit the definition of a liability to obligations that another party could enforce against the entity.



- 3.56 The IASB developed such an approach during the Elements and Recognition phase of its *Conceptual Framework* project in 2007–2008. The IASB tentatively approved a working definition of a liability that would require the obligation to be “enforceable against the entity by legal or equivalent means.” Additional draft guidance explained that ‘equivalent means’ would be those in which there was both an enforcement mechanism and a separate party to operate the mechanism. Examples of equivalent means included:
- (a) the disciplinary procedures of a self-regulatory body; and
  - (b) an arbitration mechanism set up by a commodity exchange to resolve disputes between member traders.
- 3.57 Legally enforceable obligations include those that are established by contract or imposed by government. In some jurisdictions, some constructive obligations (as defined in IAS 37) may also be legally enforceable. However, in other cases, they may not be.
- 3.58 Defining a liability as an obligation that is enforceable by legal or equivalent means could eliminate the need to define a constructive obligation.
- 3.59 Any requirement for an obligation to be enforceable by legal or equivalent means would refer to the **mechanism** that creates an obligation. It would not affect the assessment of **when** that obligation arises. In other words, it would not rule out obligations that would become enforceable only on the occurrence of an uncertain future event. It could therefore be applied with any of the approaches discussed in paragraphs 3.75–3.89.
- 3.60 In favour of restricting the definition of a liability to obligations that are enforceable by legal or equivalent means, it could be argued that:
- (a) if a future transfer of resources is not enforceable against the entity, it is not an obligation. An entity is not bound by another party ‘reasonably relying’ on it to continue its past practices or policies. The entity retains the discretion to balance the benefits of transferring resources (such as maintaining good relationships or avoiding reputational damage) against the costs. If the entity faces financial difficulties, it could change its policies or practices and avoid the transfer of resources. In other words, any future transfer will be discretionary and should be recognised when discretion is exercised.
  - (b) restricting liabilities to enforceable obligations could improve comparability. Identifying a constructive obligation requires the entity to judge whether another party can ‘reasonably rely’ on the entity to discharge specified responsibilities. Such judgements could be subjective. Arguably, evidence of enforceability is the most tangible evidence that the other party could rely on the entity to discharge its responsibilities.
  - (c) restricting liabilities to enforceable obligations would provide users of financial statements with relevant information about the obligations that an entity cannot avoid. For some transactions, it might also be appropriate to require disclosure of information about other (unenforceable) costs that the entity expects to incur in the future in

relation to past activities (for example, for discretionary rehabilitation of previous environmental damage). Any disclosure requirements could be considered in individual Standards.

- 3.61 However, arguments against restricting the definition of a liability to enforceable obligations include:
- (a) an approach that excludes some constructive obligations could provide less relevant information to users of financial statements about the entity's future cash flows relating to past activities. For example, suppose a mining company has a well-publicised policy of restoring environmental damage to the same standard throughout the world. If, for each jurisdiction in which it operates, it recognised a liability for only the costs that it could be forced to incur as a result of the legal requirements in that jurisdiction, it would not recognise the full expected costs of its mining activities for the period.
  - (b) if the IASB is concerned about comparability for any particular types of transaction it could, when developing or revising a Standard, require recognition of liabilities for that type of transaction only if the liabilities are legally enforceable. The US national standard-setter, the Financial Accounting Standards Board (FASB) took this approach when setting its requirements for asset retirement obligations. The definition of a liability in paragraphs 36 and 40 of the FASB *Concepts Statement No. 6 Elements of Financial Statements* encompasses legal, equitable and constructive obligations, including obligations that are not legally enforceable. However, the FASB's requirements for asset retirement obligations (Topic 410-20-15 *Asset Retirement and Environmental Obligations* of the FASB *Accounting Standards Codification*<sup>22</sup>) apply only to legal obligations.<sup>22</sup> The FASB concluded that determining when a constructive obligation exists can be very subjective, so restricting the requirements to legal obligations would achieve a more consistent application (see paragraph B16 of FASB Statement No. 143 *Accounting for Asset Retirement Obligations*).

#### *Preliminary view on constructive obligations*

- 3.62 The IASB's preliminary view is that the *Conceptual Framework* should not limit the definition of a liability to obligations that are enforceable by legal or equivalent means. The IASB tentatively favours retaining the existing definition of a liability—which encompasses both legal and constructive obligations—and adding more guidance to help distinguish constructive obligations from economic compulsion. The guidance should clarify the matters listed in paragraph 3.50.

#### **'Present' obligation**

- 3.63 The IASB proposes to define a liability as a 'present' obligation to transfer an economic resource as a result of past events. A present obligation is one that

<sup>22</sup> The FASB Codification defines a legal obligation as: "An obligation that a party is required to settle as a result of an existing or enacted law, statute, ordinance, or written or oral contract or by legal construction of a contract under the doctrine of promissory estoppel."

exists at the reporting date. The economic resource to be transferred need not exist at that date, nor need the entity control it already at that date. In many cases, an entity has a present obligation that it will fulfil with economic resources that it will acquire in the future.

- 3.64 To identify a liability it is necessary to distinguish between present obligations and possible future obligations.
- 3.65 A present obligation must have arisen 'as a result of past events'. An entity typically incurs an obligation to transfer an economic resource in exchange for receiving a different economic resource or as a result of conducting an activity for which another party seeks payment from the entity. For example:
- (a) an entity incurs an obligation to transfer goods and services to a customer in exchange for consideration received from that customer.
  - (b) an entity may incur an obligation to pay a tax or a levy as a result of earning revenue or profits. The amount of the obligation would be determined by reference to the revenues or profits earned.
  - (c) an entity may incur an obligation to compensate an injured party as a result of having committed an act of wrongdoing.
- 3.66 A liability can be viewed as having arisen from past events if the amount of the liability will be determined by reference to benefits received, or activities conducted, by the entity before the end of the reporting period. Activities conducted by the entity could include, for example, making sales, earning profits or even operating on a particular date—the important fact is that the amount of the liability is determined by reference to that activity.
- 3.67 However, difficulties are encountered in practice because it is unclear whether those past events are **sufficient** to create a present obligation to transfer an economic resource if such a transfer remains conditional on future events that have not occurred, or on further actions that the entity has not taken, by the reporting date.
- 3.68 These difficulties have arisen both for the IASB, when developing new Standards, and for the Interpretations Committee and others, when interpreting existing Standards. The frequent difficulties suggest that the existing *Conceptual Framework* is not sufficiently clear in this area and that further guidance is required.
- 3.69 There can be two types of future events on which an obligation remains conditional:
- (a) those whose occurrence is outside the control of the entity (see paragraphs 3.70–3.71); and
  - (b) those whose occurrence depends on the entity's future actions (see paragraphs 3.72–3.97).

#### **Future events outside the control of the entity**

- 3.70 With some obligations, the requirement to transfer an economic resource will depend on the occurrence of future events that are outside the control of the entity. Such obligations include, for example:

- (a) an insurer's obligation to compensate a policyholder on the occurrence of an insured event, such as damage to property;
- (b) a guarantor's obligation to compensate a lender if a borrower defaults;
- (c) an entity's obligation to redeem a financial instrument for cash if the holder of the instrument exercises an option to require redemption; or
- (d) an entity's obligation to make an additional payment for purchased plant or equipment if the plant or equipment proves to be capable of operating to standards specified in the purchase contract.

3.71 Obligations of this kind are sometimes called 'stand-ready obligations'. Although the entity does not know at the reporting date whether it will be required to transfer resources, it has an unconditional obligation to stand ready to transfer the resources if the specified future event occurs. The IASB has concluded that these unconditional obligations are present obligations that meet the definition of a liability. The requirements of several recent and proposed Standards—such as the draft Revenue Standard and the Exposure Draft *Insurance Contracts* that was published in June 2013—reflect this conclusion. The IASB thinks that it will be helpful if the *Conceptual Framework* also states the conclusion in general terms.

#### **Future events that depend on the entity's future actions**

3.72 There has also been debate about whether a 'present' obligation exists if the eventual need to transfer economic resources depends on the entity's future actions. Is it sufficient that the entity has already received an economic resource or conducted an activity that will determine the amount of any future transfer? Or is it also necessary that the entity has no ability to avoid the future transfer through its future actions? The existing *Conceptual Framework* does not address this question and the principles underlying individual Standards can appear to be inconsistent.

3.73 The following scenarios are examples of transactions for which this question arises.<sup>23</sup>

#### **Scenario 1: employee bonus with vesting conditions**

Under the terms of its employment contracts with a group of employees, an entity will pay a bonus to each employee who completes five years' service with the entity. The employees have completed two of the five years' service at the end of the reporting period. If the entity terminates an employment contract before the end of the vesting period (ie before the five years' service is complete), it will not be required to pay any bonus to the employee.

#### **Scenario 2: levy on revenues above a threshold**

A government charges a levy on entities that operate trains on the national rail network. The levy is charged at the end of each calendar year. The levy is 1 per cent of revenue earned in the year in excess of CU500 million. A train operator

<sup>23</sup> As explained in paragraphs 1.22 and 1.24, this Discussion Paper includes examples to illustrate the problems that the IASB is seeking to address. The IASB will not necessarily amend existing requirements for the transactions illustrated in the examples.

is preparing financial statements for its financial reporting year to 30 June. It has earned revenue of CU450 million between 1 January and 30 June. It expects to have earned revenue of CU900 million by the end of the calendar year and hence to be charged a levy of CU4 million for the year.<sup>24</sup>

**Scenario 3: levy on revenues**

A government imposes a levy on entities that supply electricity to a domestic energy market on or after 1 April each year. The levy charged on that date is measured as a percentage of the operator’s revenue in the previous calendar year. An electricity supplier is preparing financial statements for the period ending on 31 December 20X0. In that year, it earned revenue of CU100 million. It will be charged a levy only if it is still supplying electricity to the specified market on 1 April 20X1.

**Scenario 4: levy that accumulates over the reporting period**

A government imposes a levy on banks. The levy is charged on any entity that is operating as a bank at the end of its financial reporting period. The levy is calculated as a percentage of the bank’s liabilities at the end of that period. The percentage depends on the length of the bank’s reporting period and on the rates in force during that period. In 20X2, the rates are 0.1 per cent per month from January–June and 0.2 per cent per month from July–December. A bank’s financial reporting period began on 1 April 20X2. The bank is preparing interim financial statements at 30 September 20X2.

**Scenario 5: levy on market share**

Legislation will require manufacturers of electronic equipment to contribute, at a future date, to the costs of disposing of ‘historical waste’, ie equipment that was manufactured before the legislation came into force. Each manufacturer will be charged an amount that is proportional to its share of the market in 20X4. An electronic equipment manufacturer is preparing financial statements as at 31 December 20X3.

**Scenario 6: variable lease payments**

An entity enters into an agreement to lease a retail unit in a shopping mall. The lease agreement requires the entity to pay a variable rental of 1 per cent of its monthly sales to the lessor. The lease commences on the last day of the entity’s reporting period. The first variable payment will be calculated by reference to the entity’s sales in the first month of the next reporting period.

**Scenario 7: contingent consideration**

A contract for the sale of a business requires the acquirer to make an additional payment of CU5 million to the seller if the acquired business meets specified earnings targets in the three years after acquisition. The acquirer is preparing financial statements at the acquisition date. Available evidence suggests that it is highly likely that the acquired business will exceed the earnings targets.

3.74 In each of the scenarios set out in paragraph 3.73, any requirement to transfer an economic resource is conditional on the entity’s future actions. The question

<sup>24</sup> (CU900 million – CU500 million) × 1%

is whether, in such situations, the entity has a present obligation. Three alternative views are discussed in paragraphs 3.75–3.97.

*View 1: a present obligation must have arisen from past events and be strictly unconditional*

- 3.75 One view is that a present obligation must have arisen from past events and be strictly unconditional. The amount of a future transfer might be determined by reference to the entity's past activities. But, for as long as the entity could, at least in theory, avoid the transfer of resources through its future actions, it does not have a present obligation. In other words, if an entity must take a series of actions before it has an unconditional obligation, no liability exists until it has taken all of the actions.
- 3.76 Applying this view, there would not be a present obligation in any of the scenarios set out in paragraph 3.73. In each case, the future transfer is conditional on a future action that the entity could, at least in theory, avoid taking.

**Table 3.1: applying View 1 to the scenarios**

	Scenario	Present obligation?	Reason
1	Employee bonus with vesting conditions	No	The employer could terminate employment contracts before the end of the vesting period.
2	Levy on revenues above a threshold	No	The rail operator, electricity supplier, bank and electronic equipment manufacturer could stop operating in the relevant market before the date or threshold at which a levy would become chargeable.
3	Levy on revenues	No	
4	Levy that accumulates over the reporting period	No	
5	Levy on market share	No	
6	Variable lease payments	No	The lessee could avoid making sales from the leased retail unit.
7	Contingent consideration	No	The acquirer could conduct the operations of the acquired business so that it fails to meet specified earnings targets.

*View 2: a present obligation must have arisen from past events and be practically unconditional*

- 3.77 The view described in paragraph 3.75 requires a present obligation to be strictly unconditional. It identifies a present obligation by reference to the last in the series of actions that an entity must take before it is unconditionally required to transfer a resource to another party. However, the last action might be a

relatively minor one—an incidental condition that may have some commercial substance but that the entity does not have the practical ability to avoid in its particular circumstances.

- 3.78 It could be argued that, in such circumstances, treating the last event or action as the one that creates a present obligation does not faithfully represent the entity's financial position. A more faithful representation would identify as liabilities all obligations to transfer an economic resource:
- (a) that have arisen as a result of past events, ie that will be measured by reference to benefits received, or activities conducted, by the entity before the end of the reporting period (see paragraph 3.66); and
  - (b) that the entity has no practical ability to avoid through its future actions.
- 3.79 The assessment of whether an entity has the practical ability to avoid any remaining conditions would require judgement. Guidance might be needed (possibly in individual Standards) to identify the types of condition that an entity might not have the practical ability to avoid. Arguably, these conditions might include, for example, conditions that the entity could avoid only by ceasing to operate as a going concern, significantly curtailing operations or leaving specific markets.
- 3.80 Further guidance might be needed to address situations in which the amount of the future transfer will depend on the extent to which the entity carries out an activity, for example, if future lease payments are a proportion of the entity's future revenue. A lessee might have the practical ability to avoid some, but not all, of the future activity.
- 3.81 The judgement about whether an entity has no practical ability to avoid a future transfer will depend on the specific facts and circumstances. Table 3.2 illustrates the judgements that might be reached in the scenarios set out in paragraph 3.73.

**Table 3.2: applying View 2 to the scenarios**

	Scenario	Present obligation?	Reason
1	Employee bonus with vesting conditions	Yes, depending on circumstances	<p>The bonus is payable in exchange for, and measured by reference to, service received from employees. The employer has received two years' service at the reporting date.</p> <p>The employer can avoid paying the bonus only by terminating the employment contracts of all eligible employees before the end of the vesting period. It might argue that it has no practical ability to do so.</p> <p>The present obligation would be for the portion of the total expected bonus attributable to the benefits already received, ie the first two years of service.</p>
2	Levy on revenues above a threshold	Yes, in most circumstances	The rail operator has started to receive the benefits (earn the revenue) by reference to which the levy will be measured. The rail operator would need to curtail its operations significantly to avoid the levy. In most circumstances, it will not have the practical ability to take such action to avoid a levy.
3	Levy on revenues	Yes, in most circumstances	The electricity supplier has received the benefits (revenues) on which the levy will be calculated. It could avoid the levy only by leaving the market before 1 April of the following year. In most circumstances, it will not have the practical ability to leave the market before that date.
4	Levy that accumulates over the reporting period	Yes, in most circumstances	<p>The bank has operated in the period over which the levy accumulates. In most circumstances, it will not have the practical ability to stop operating as a bank before the end of its financial reporting period.</p> <p>(The portion of the levy that would be attributable to the first half year is 0.9 per cent of the bank's expected period-end liabilities.)<sup>(a)</sup></p>
5	Levy on market share	No	There is no past event from which an obligation has arisen. The requirement to pay a levy will be measured by reference to only one activity, namely participation in the market in 20X4. The entity has not started this activity at the reporting date.
6	Variable lease payments	Yes, to the extent that the retailer does not have the practical ability to avoid future sales <sup>(b)</sup>	The lessee has received a right-of-use asset in exchange for which it will have to pay the lessor 1 per cent of sales it makes during the lease period. In many circumstances, it will not have the practical ability to avoid making any sales.
7	Contingent consideration	Maybe, depending on the circumstances	The acquirer has received the acquired business, in exchange for which it will have to pay CU5 million if the business meets earnings targets. The managers of the acquired business would have to take steps to reduce earnings below the target to avoid the payment. Whether they can do so might depend on the facts and circumstances.

(a) [Three months (April–June) × 0.1%] + [three months (July–September) × 0.2%].

(b) This view assumes that the lessee's right of use and obligation to transfer a proportion of the proceeds of use should be accounted for as a separate asset and liability. An alternative view might be that the lessor has a smaller asset (an encumbered right of use) and no separate liability.



3.82 The **identification** of a liability in each of these scenarios would not necessarily lead to the **recognition** of that liability. The liability might not satisfy the recognition criteria discussed in Section 4. For example, in developing or amending requirements for leases in accordance with the criteria in this Discussion Paper, the IASB might decide that:

- (a) recognition of a lessee's present obligation to make variable lease payments—and an equal amount as a right-of-use asset—would provide users of financial statements with information that is not relevant, or not sufficiently relevant to justify the cost; or
- (b) no measure would result in a sufficiently faithful representation of the obligation to make variable lease payments, and of changes in that obligation, even if all necessary descriptions and explanations are disclosed.

3.83 An entity might have no practical ability to avoid some **future** operating costs—such as the following month's employee salaries. However, these future costs do not give rise to a liability at the reporting date if the amount of the obligation is determined solely by reference to future receipts or activities. Even if the entity has entered a binding contract to purchase goods or services, it does not have a net obligation to transfer an economic resource unless the contract is onerous. Until it receives the goods or services, the contract is executory and, as discussed further in paragraph 3.111, executory contracts to receive or deliver goods or services are typically measured at zero in practice, unless the contracts are onerous.

*View 3: a present obligation must have arisen from past events but may be conditional on the entity's future actions*

3.84 The first two views discussed in this section are that, for a present obligation to exist, it is not sufficient that the entity has received an economic resource or conducted an activity on which the amount of possible future transfer will be determined. It is also necessary that the obligation is either strictly unconditional (View 1) or practically unconditional (View 2).

3.85 An alternative view is that the past event **is** sufficient to create a present obligation: it is not necessary for the obligation to be (strictly or practically) unconditional. An obligation arises when the entity receives a resource or conducts an activity, in exchange for which another party will be able to demand a transfer of resources if the entity meets further conditions. As soon as the entity has received the resource or conducted the activity, it no longer has complete discretion to avoid a future transfer. The future transfer may be conditional on the entity's future actions but the obligation has arisen from past events (the past receipt or activity) and so is a present obligation.

3.86 The entity has a liability if, on meeting the further conditions specified, it will be required:

- (a) to transfer an economic resource that it would not have been required to transfer without the past receipt or activity; or

- (b) to exchange economic resources with another party on more onerous terms than would have been required without the past receipt or activity.

3.87 The rationale for this third view is similar to the rationale given in paragraph 72 of IAS 19 for requiring entities to recognise liabilities for the estimated costs of unvested employee benefits, ie that “at the end of each successive reporting period, the amount of future service that an employee will have to render before becoming entitled to the benefit is reduced.”

**Table 3.3: applying View 3 to the scenarios**

	Scenario	Present obligation?	Reason
1	Employee bonus with vesting conditions	Yes	The bonus is payable in exchange for, and measured by reference to, service received from employees. The employer has received two years' service at the reporting date.
2	Levy on revenues above a threshold	Yes	The rail operator has started to receive the benefits (earn the revenue) by reference to which the levy will be measured.
3	Levy on revenues	Yes	The electricity supplier has received the benefits (revenues) on which the levy will be calculated.
4	Levy that accumulates over the reporting period	Yes	The bank has operated in the period over which the levy accumulates. (The portion of the levy that is attributable to its first half year is 0.9 per cent of the bank's expected period-end liabilities.) <sup>(a)</sup>
5	Levy on market share	No	There is no past event from which an obligation has arisen. The requirement to pay a levy will be measured by reference to only one activity, namely participation in the market in 20X4. The entity has not started this activity at the reporting date.
6	Variable lease payments	Yes <sup>(b)</sup>	The lessee has received a right-of-use asset in exchange for which it will have to pay the lessor 1 per cent of sales it makes during the lease period.
7	Contingent consideration	Yes	The acquirer has received the acquired business, in exchange for which it will have to pay CU5 million if the business meets earnings targets.

(a)  $[\text{Three months (April–June)} \times 0.1\%] + [\text{three months (July–September)} \times 0.2\%]$ .  
(b) This view assumes that the lessee's right of use and obligation to transfer a proportion of the proceeds of use should be accounted for as a separate asset and liability. An alternative view might be that the lessor has a smaller asset (an encumbered right of use) and no separate liability.

- 3.88 As explained in paragraph 3.82, the identification of a liability in each of the scenarios would not necessarily lead to the recognition of that liability. In some of the cases the liability might not satisfy the recognition criteria discussed in Section 4.

*Common features of the three views*

- 3.89 Whichever of these views is applied, the following would not meet the definition of a present obligation:
- (a) requirements to make payments that would arise only on liquidation (for example, payments to ordinary shareholders on liquidation and costs that the entity would incur only on liquidation). As noted in paragraph 4.1 of the existing *Conceptual Framework*, financial statements are normally prepared on the assumption that an entity is a going concern and will continue to operate for the foreseeable future. Whether the going concern assumption has any other implications for financial reporting is discussed in Section 9.
  - (b) losses that an entity expects to incur if it chooses to stay in business, but will avoid if it closes the business. A future loss does not arise from a past event. Consequently, it does not create a present obligation to transfer an economic resource.

*Implications of the three views for emissions trading schemes*

- 3.90 The IASB has on its agenda a research project on emissions trading schemes.
- 3.91 Emissions trading schemes are designed to achieve a reduction of greenhouse gases through the use of tradable emission allowances. One of the common types of scheme is a 'cap and trade' scheme, in which a central authority (for example, the government) sets an overall cap on the amount of emissions that can be released in a specified compliance period. The central authority implements the cap by issuing a limited number of tradable 'emission allowances'. Each emission allowance provides a right to emit a specified quantity of a greenhouse gas. The central authority typically issues these allowances either:
- (a) in a process referred to as 'allocation', whereby participants receive allowances free of charge; or
  - (b) in an auction, whereby participants pay to acquire allowances.
- 3.92 An entity that participates in the scheme has an obligation to deliver back allowances for the greenhouse gas it has emitted during the compliance period. Entities can trade their allowances. Accordingly, an entity that has allowances in excess of its actual or likely emissions can sell its allowances to another entity that requires allowances because of growth in emissions or an inability to make cost-effective reductions in emissions.
- 3.93 One question that arises is how an entity should measure in its financial statements any assets (tradable allowances) that it has received free of charge in an allocation process. Another question is when an entity should recognise a liability for its obligation to return allowances.

- 3.94 Any guidance added to the *Conceptual Framework* on the meaning of ‘present’ obligation could affect the conclusions that the IASB reaches on the latter question. Applying View 1 (a present obligation must be strictly unconditional), the IASB might conclude that the receipt of allowances through allocation does not give rise to a present obligation to return any allowances—such a liability arises only as the entity emits greenhouse gases. Applying View 2 (a present obligation is one that the entity has no practical ability to avoid through its future actions), the IASB might conclude that a liability to return allowances received through allocation arises on receipt of the allowances, but only to the extent that the entity does not have the practical ability to avoid emitting greenhouse gases. Applying View 3 (a present obligation must arise from past events but may be conditional on the entity’s future actions), the IASB might conclude that a conditional obligation to return allowances received through allocation arises when the allowances are received, with that obligation reducing over the compliance period as the entity earns the right to keep (and sell) some allowances, or increasing as the entity emits allowances at a rate that implies it will need to buy more in the market.
- 3.95 However, applying any of the views, the IASB’s conclusions might depend on factors that are not considered in this Discussion Paper—such as the way in which allowances are recognised and measured as assets, and the ways in which the IASB analyses the entity’s package of rights and obligations arising under the scheme. The IASB intends to consider those matters in more depth as part of its research project.

*Preliminary view on the meaning of ‘present’ obligation*

- 3.96 The IASB has tentatively rejected the view that an obligation must be strictly unconditional (View 1). It does not think that an entity should omit from its financial statements liabilities that have arisen from past events and that the entity has no practical ability to avoid. Doing so would exclude relevant information about the inevitable future costs of the entity’s past actions.
- 3.97 The IASB has not reached a preliminary view on whether the definition of a liability should include only those liabilities that the entity has no practical ability to avoid (View 2) or whether it should also include conditional obligations that the entity might be able to avoid through its future actions but that have nevertheless arisen as a result of past events (View 3).

## **Reporting the substance of contractual rights and contractual obligations**

### **Introduction**

- 3.98 An important class of resources and obligations arises under contracts. Entering into a contract gives rise to contractual rights and obligations if those rights and obligations are enforceable.
- 3.99 This section considers whether there should be more guidance in the *Conceptual Framework* on identifying the substance of contractual rights and contractual obligations.

### Existing requirements and guidance

- 3.100 To give a faithful representation of an entity’s contractual rights and obligations, financial statements should report their substance. Paragraph 4.6 of the existing *Conceptual Framework* states that “in assessing whether an item meets the definition of an asset, liability or equity, attention needs to be given to its underlying substance and economic reality and not merely its legal form.” Some individual Standards also refer to substance. For example, paragraph 18 of IAS 32 *Financial Instruments: Presentation* states that “the substance of a financial instrument, rather than its legal form, governs its classification in the entity’s statement of financial position”.
- 3.101 The existing *Conceptual Framework* gives little further guidance on assessing the substance of contractual rights and obligations. However, several Standards give guidance for specific types of transaction, for example:
- (a) several Standards require entities to disregard contractual terms that have ‘no commercial substance’, ‘lack commercial substance’ or are ‘not substantive’. For example, paragraph B23 of IFRS 4 *Insurance Contracts* requires entities to identify the existence of significant insurance risk “excluding scenarios that lack commercial substance”. Paragraph 41 of IFRS 2 states that an entity with a choice of settling a share-based payment transaction either in cash or by issuing equity instruments “has a present obligation to settle in cash if the choice of settlement in equity instruments has no commercial substance”. And paragraph B22 of IFRS 10 requires an investor to consider only substantive rights in assessing whether it controls an investee.
  - (b) paragraph B22 of IFRS 10 provides guidance that “for a right to be substantive, the holder must have the practical ability to exercise that right”. IFRS 10 also gives several examples of factors that might affect an acquirer’s practical ability to exercise its rights relating to an investee. These factors include, for example, barriers—such as financial penalties and incentives—that prevent or deter the holder from exercising its rights (see paragraph B23(a) of IFRS 10).
  - (c) paragraph B23 of IFRS 4 defines a scenario that lacks commercial substance as one that has “no discernible effect on the economics of the transaction.”

### Proposed guidance

- 3.102 Consistent principles underlie the guidance in those Standards. The IASB thinks that it would be helpful to add those underlying principles to the *Conceptual Framework* itself. The *Conceptual Framework* could state that:
- (a) an entity should report the substance of a contract. In some cases, the legal form of a contract is an important part of the substance of the contract. In other cases, the legal form is only a minor part of the substance of the contract.

- (b) a group or series of contracts that achieves, or is designed to achieve, an overall commercial effect should be viewed as a whole. One situation in which this treatment may be particularly important is if rights or obligations in one contract entirely negate obligations or rights in another contract.
- (c) conversely, if a single contract 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 the different sets of rights as if they were separate contracts.
- (d) all terms—whether explicit or implied—should be taken into consideration. Implied terms could include, for example, obligations imposed by statute, such as statutory warranty obligations imposed on entities that enter into contracts for the sale of goods to customers.
- (e) terms that have no commercial substance should be disregarded. A term has no commercial substance if it has no discernible effect on the economics of the contract. Terms that have no commercial substance could include, for example:
  - (i) terms that bind neither party; and
  - (ii) rights (including options) that the holder will not have the practical ability to exercise.
- (f) if, after disregarding options with no commercial substance, an option holder has only one remaining option, that option is in substance a requirement.

### **The role of economic compulsion in assessing the substance of contractual obligations**

#### *Problems in practice*

- 3.103 Some people have asked the IASB for further guidance on the role of economic compulsion in assessing the substance of contractual obligations. They have noted that existing guidance on this matter can appear inconsistent. For example, in 2006, the IASB discussed the role of economic compulsion in identifying contractual obligations within financial instruments. It stated that “a contractual obligation could be established explicitly or indirectly, but it must be established through the terms and conditions of the instrument. Thus, by itself, economic compulsion would not result in a financial instrument being classified as a liability applying IAS 32.”<sup>25</sup> In contrast, in some more recent projects, the IASB has tentatively decided to require an entity to take into account ‘significant economic incentives’ when assessing the extent of its contractual rights and obligations. For example, in its Exposure Draft *Leases*, published in May 2013, the IASB proposes that the lease payments included in a lessee’s lease liability should include the exercise price of a purchase option if the lessee has a significant economic incentive to exercise that option.

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<sup>25</sup> IASB *Update*, June 2006.

- 3.104 Problems that arise in practice often relate to the role of economic compulsion when the entity is determining the appropriate classification—ie as liabilities or equity—of particular types of financial instrument, such as that described in Example 3.1.

**Example 3.1: financial instrument with ‘dividend blocker’ and ‘step-up’ clauses**

The terms of a financial instrument are such that the issuer has no contractual obligation to pay an annual dividend to the holder, and no contractual obligation ever to redeem the financial instrument. However:

- (a) the issuer has an option to pay a dividend of a specified amount. Unless the issuer pays the full amount, it cannot pay any dividend to its ordinary shareholders.
- (b) the issuer has an option to redeem the financial instrument at a specified future date. If it does not redeem the financial instrument on that date, the dividend ‘steps up’ to an amount that would give a cost of finance higher than the issuer would otherwise have to incur.

- 3.105 In this example, the issuer appears to have options, but not obligations. However, the ‘step-up’ clause may economically compel the issuer to redeem the financial instrument on the specified date. Otherwise, it could suffer a higher cost of finance than it would otherwise have to incur. Thus, the holders can be reasonably assured of receiving the redemption proceeds (including any ‘discretionary’ dividends not already paid before redemption), ie the same benefits as the holders of fixed-rate debt.

*Possible solutions*

- 3.106 Depending on the specific terms of the step-up clause, the guidance proposed in paragraph 3.102 might be sufficient to lead to a conclusion that the financial instrument is in substance a liability. If the terms of the step-up clause are so disadvantageous to the issuer that the financial instrument is priced and behaves like fixed-term debt, it could be argued that the option to **not** redeem the financial instrument on the specified date has ‘no discernible effect on the economics of the transaction’. In that case, applying the guidance proposed in paragraph 3.102(e), the entity would disregard this option. The issuer would have only one remaining ‘option’, namely to redeem the financial instrument. Applying the guidance proposed in paragraph 3.102(f), this single remaining ‘option’ would be regarded as a requirement—an obligation to redeem—which would mean that the financial instrument contains a liability.
- 3.107 However, the analysis might be less straightforward if the terms of the step-up clause give some commercial substance to the issuer’s option not to redeem. Although it is highly likely that the issuer will redeem the financial instrument on the specified date, it is possible that in some circumstances it will opt not to, for example, if it is in severe financial difficulties at the time.
- 3.108 The IASB thinks that, even if the option not to redeem the financial instrument has some commercial substance, the overall substance of some such financial instruments might still be that of a liability, not equity. Although economic

compulsion does not in itself create an obligation in the absence of a contract or other legal mechanism, it might be appropriate to take economic compulsion or significant economic incentives into account when determining whether a contractual claim against the entity is a liability or part of equity. However, the IASB thinks that it should consider any further requirements or guidance on this matter in the context of specific transactions, ie when developing or revising particular Standards, rather than in the *Conceptual Framework*. Hence, it proposes to limit the guidance in the *Conceptual Framework* to widely applicable principles, such as those set out in paragraph 3.102.

### **Executory contracts and other forward contracts**

3.109 Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent (see paragraph 3 of IAS 37). Paragraph 4.46 of the existing *Conceptual Framework* briefly refers to such contracts, stating that:

In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements. However, such obligations may meet the definition of liabilities and, provided the recognition criteria are met in the particular circumstances, may qualify for recognition.

3.110 The IASB thinks it could improve this guidance by explaining the nature of the rights and obligations that arise under executory contracts and other forward contracts and **why** those rights and obligations might not be recognised as an asset or a liability. It proposes to clarify that:

- (a) in principle, a net asset or a net liability arises under an executory contract if the contract is enforceable.
- (b) 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 obligations to the other party. Accordingly, it is usually the case that neither party recognises a net asset or a net liability at contract inception. After contract inception, one or both parties may need to recognise its asset or liability, depending on the measurement basis applied.
- (c) the nature of the purchaser's rights and obligations under an executory contract or other forward contract 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, as explained in paragraph 3.111.
  - (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. The distinction between offsetting separate assets and obligations, and having a single net right or net obligation, is discussed in paragraph 3.13.



- 3.111 To understand the effect of the decisions on whether to recognise rights and obligations arising under executory contracts and forward contracts, it is worth considering how those rights and obligations might be measured. Individual Standards—rather than the *Conceptual Framework*—would continue to specify the measurement requirements. In current practice, executory contracts and other forward contracts are typically measured as follows:
- (a) if the contract will result in the receipt by the entity of assets that will be measured on a cost basis, the contract will be measured at zero, unless the entity prepays for the assets or unless the contract is, or has become, onerous:
    - (i) if the entity prepays for the assets, the contract is measured at the amount paid, adjusted for any impairment loss (if the contract has become onerous) and possibly also for the time value of money (accretion of interest).
    - (ii) if an executory contract has become onerous, that does not mean that a new liability has arisen at that point. The liability arose when the entity entered into the contract, but until it became onerous it was measured at zero, which had the same practical effect as non-recognition until that point.
  - (b) if the contract will result in the delivery by the entity of goods or services, the contract will be measured at zero, unless the contract is, or has become, onerous. If the counterparty prepays for the goods or services, the contract is measured at that amount, adjusted if the contract has become onerous and possibly also adjusted for the time value of money (accretion of interest).
  - (c) if the contract will result in the receipt or delivery of financial instruments that will be measured both initially and subsequently at fair value, the contract will be measured at fair value.
- 3.112 In current practice, a forward contract is sometimes treated as equivalent to the underlying asset or liability. For example, when trade date accounting is used for some financial instruments, an entity accounts for the underlying financial instrument as if it had already been delivered at the trade date. In contrast, when settlement date accounting is used, an entity accounts for the forward contract until delivery, and then accounts for the underlying financial instrument from the delivery date. Strictly speaking, trade date accounting is inconsistent with the concepts discussed in this Discussion Paper. The purchaser's asset is not the underlying asset, it is the right to receive the underlying asset or, perhaps, depending on the circumstances, a single net right and obligation to exchange cash for the underlying asset.

## Questions for respondents

### Question 5

Constructive obligations are discussed in paragraphs 3.39–3.62. The discussion considers the possibility of narrowing the definition of a liability to include only obligations that are enforceable by legal or equivalent means. However, the IASB tentatively favours retaining the existing definition, which encompasses both legal and constructive obligations—and adding more guidance to help distinguish constructive obligations from economic compulsion. The guidance would clarify the matters listed in paragraph 3.50.

Do you agree with this preliminary view? Why or why not?

### Question 6

The meaning of ‘present’ in the definition of a liability is discussed in paragraphs 3.63–3.97. A present obligation arises from past events. An obligation can be viewed as having arisen from past events if the amount of the liability will be determined by reference to benefits received, or activities conducted, by the entity before the end of the reporting period. However, it is unclear whether such past events are sufficient to create a present obligation if any requirement to transfer an economic resource remains conditional on the entity’s future actions. Three different views on which the IASB could develop guidance for the *Conceptual Framework* are put forward:

- (a) View 1: a present obligation must have arisen from past events and be strictly unconditional. An entity does not have a present obligation if it could, at least in theory, avoid the transfer through its future actions.
- (b) View 2: a present obligation must have arisen from past events and be practically unconditional. An obligation is practically unconditional if the entity does not have the practical ability to avoid the transfer through its future actions.
- (c) View 3: a present obligation must have arisen from past events, but may be conditional on the entity’s future actions.

The IASB has tentatively rejected View 1. However, it has not reached a preliminary view in favour of View 2 or View 3.

Which of these views (or any other view on when a present obligation comes into existence) do you support? Please give reasons.

### Question 7

Do you have comments on any of the other guidance proposed in this section to support the asset and liability definitions?

## Section 4—Recognition and derecognition

### Recognition

- 4.1 Paragraph 4.37 of the existing *Conceptual Framework* defines recognition as follows:

Recognition is the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the criteria for recognition set out in [the existing *Conceptual Framework*]. It involves the depiction of the item in words and by a monetary amount and the inclusion of that amount in the balance sheet or income statement totals.

- 4.2 In practice, questions about recognition (and derecognition) relate mainly to assets and liabilities. Answers to those questions affect the statement of financial position. They may also affect the timing of the recognition of income and expense in the statement(s) of profit or loss and other comprehensive income (OCI).

- 4.3 The recognition criteria set out in paragraph 4.38 of the existing *Conceptual Framework* state that an entity recognises an item that meets the definition of an element if:

- (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and
- (b) the item has a cost or value that can be measured with reliability.

- 4.4 In addition, as with all other aspects of the existing *Conceptual Framework*, the cost constraint applies. Thus, if the IASB concludes for a particular Standard that the benefits of recognising a particular asset or liability do not justify the costs, the IASB would not require its recognition (and to enhance comparability would perhaps even prohibit its recognition).

#### **Should an entity recognise all its assets and liabilities?**

- 4.5 Part of the information that is useful to users of financial statements for their decisions about providing resources to an entity is information about the entity's resources and obligations and about how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.<sup>26</sup> The most understandable and concise way to provide a complete summary of an entity's resources and obligations is to recognise them all in the statement of financial position, unless the IASB identifies valid reasons to do otherwise.

- 4.6 The failure to recognise items that qualify for recognition is not rectified by disclosure of the accounting policies used nor by notes or explanatory material.<sup>27</sup>

- 4.7 As noted in paragraph 4.3 of this Discussion Paper, the existing *Conceptual Framework* includes recognition criteria. Because existing Standards are based on the *Conceptual Framework*, they do not require entities to recognise all their assets

<sup>26</sup> See paragraphs OB2–OB4 of the existing *Conceptual Framework*.

<sup>27</sup> See paragraph 4.37 of the existing *Conceptual Framework*.

and liabilities. This section discusses whether the revised *Conceptual Framework* should include recognition criteria that refer to:

- (a) probability (see paragraph 4.8);
- (b) relevance and cost constraint (see paragraphs 4.9–4.11);
- (c) faithful representation (see paragraphs 4.12–4.21); and
- (d) the enhancing qualitative characteristics (comparability, verifiability, timeliness, understandability) discussed in Chapter 3 of the *Conceptual Framework* (see paragraphs 4.22–4.23).

### **Probability**

- 4.8 As noted in paragraph 4.3 of this Discussion Paper, the existing criteria do not result in recognition if it is not probable that any future economic benefit associated with the item will flow to or from the entity. As explained in paragraphs 2.17–2.36, the IASB believes that it should delete references to probability from the recognition criteria in the *Conceptual Framework*.

### **Relevance and the cost constraint**

- 4.9 Information is relevant to users of financial statements if it is capable of making a difference in the decisions made by those users.<sup>28</sup> In most cases, recognising resources and obligations provides users of financial statements 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:
- (a) if the level of uncertainty in an estimate is too large, the relevance of that estimate is questionable.<sup>29</sup> In such circumstances, if no other available measure of the asset or the liability would provide relevant information to users of financial statements, it may be appropriate not to recognise the asset or the liability. Some argue that this is the case for some litigation, for at least some research and development projects and for internally generated goodwill.
  - (b) recognising particular resources and obligations may produce information that some may view as not relevant, incomplete or not understandable if related resources and obligations are also not recognised, or do not yet exist. For example, some argue that relevant information does not result from recognising derivatives used to hedge normal purchases of commodities used in a production process if the underlying purchases have not yet been recognised. (However, others argue that recognising such derivatives always or sometimes produces relevant information, perhaps using techniques such as hedge accounting if that makes the presentation of that information more understandable.)
  - (c) currently, entities do not recognise internally generated goodwill, although they do recognise goodwill acquired in a business combination. As explained in paragraphs BC313–BC323 of the Basis for Conclusions on

<sup>28</sup> See paragraph QC6 of the existing *Conceptual Framework*.

<sup>29</sup> See paragraph QC16 of the existing *Conceptual Framework*.

IFRS 3 *Business Combinations*, goodwill meets the definition of an asset. That conclusion applies equally to internally generated goodwill and to acquired goodwill. However, the IASB has concluded that recognising internally generated goodwill is unnecessary to meet the objective of financial statements. Financial statements are not designed to show the value of a reporting entity.<sup>30</sup> Measuring internally generated goodwill would require an estimate of the value of the reporting entity. Consequently, recognising internally generated goodwill does not provide relevant information. In contrast, at the time of a business combination, recognising the goodwill acquired depicts more completely the economic resources acquired to be used by management, and the economic resources transferred (or equity instruments delivered) to the vendors.

- (d) the benefits of measuring some internally-generated intangible assets may not outweigh the costs if the resulting measures are not relevant to users of financial statements, or if identifying those assets and measuring them is too costly.

4.10 In the IASB's preliminary view, the *Conceptual Framework* should state that the IASB should not require the recognition of an asset or a liability if the IASB concludes that recognising that asset or liability would result in information that is irrelevant, or not sufficiently relevant to justify the cost of preparing it.

4.11 The *Conceptual Framework* is not a Standard, and does not override Standards. Consequently, when a Standard requires the recognition of an asset or a liability, a preparer could not use the recognition criteria in the *Conceptual Framework* to override that requirement.

### **Faithful representation**

4.12 The recognition criteria in the existing *Conceptual Framework* state that an entity recognises an asset or a liability only if it has a cost or value that can be measured with reliability. Before its revision in 2010, the *Conceptual Framework* stated that information is reliable if it is free from material error and bias, and users of financial statements can depend on it to represent faithfully what it either purports to represent or could reasonably be expected to represent. Paragraphs 35–38 of the pre-2010 *Conceptual Framework* explained that, to be reliable, information must:

- (a) account for, and present, transactions in accordance with their substance and economic reality and not merely their legal form.
- (b) be neutral, that is, free from bias. That version of the *Conceptual Framework* also argued, under the heading of prudence, for a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated.
- (c) be complete within the bounds of materiality and cost.

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<sup>30</sup> See paragraph OB7 of the existing *Conceptual Framework*.

4.13 When the IASB revised the *Conceptual Framework* in 2010, it added to the recognition criteria a footnote stating that information is reliable “when it is complete, neutral and free from error”.<sup>31</sup> Similarly, Chapter 3 of the *Conceptual Framework* now states that a perfectly faithful representation would be complete, neutral and free from error.<sup>32</sup> Of course, perfection is seldom, if ever, achievable. The IASB’s objective is to achieve as faithful a representation as possible:

- (a) completeness might suggest that an entity should recognise all its economic resources and obligations, unless the IASB identifies valid reasons to do otherwise;
- (b) neutrality might suggest that, unless the IASB identifies valid reasons to do otherwise, the recognition criteria should apply symmetrically to resources and to obligations, and that the criteria should apply symmetrically, whether recognition results in a gain, a loss or no gain and no loss; and
- (c) freedom from error might suggest that an asset or a liability should not be recognised if either the process of determining whether to recognise that asset or liability, or its measurement, is likely to be unusually prone to error, for example, if they depend on inputs that are unusually difficult to estimate. In such cases, recognising the asset or the liability may not result in relevant information.

4.14 The term ‘reliability’ no longer appears in the *Conceptual Framework*, although much of the content of that concept is covered by the existing *Conceptual Framework*’s fundamental characteristic of faithful representation and its enhancing characteristic of verifiability. Paragraphs BC3.23–BC3.24 and BC3.34–BC3.36 of the Basis for Conclusions on the *Conceptual Framework* explain that:

- (a) the comments of respondents to numerous proposed Standards indicated a lack of a common understanding of the term ‘reliability’. Some focused on verifiability or free from material error to the virtual exclusion of faithful representation. Others focused more on faithful representation, perhaps combined with neutrality. Some apparently thought that reliability referred primarily to precision.
- (b) the term ‘faithful representation’ encompasses the main characteristics that the former *Conceptual Framework* included as aspects of reliability.
- (c) a lack of verifiability does not necessarily render information useless, but users of financial statements are likely to be more cautious because there is a greater risk that the information does not faithfully represent what it purports to represent. Many forward-looking estimates cannot be directly verified, but are important when providing relevant financial information. Accordingly, the IASB positioned verifiability in the existing *Conceptual Framework* not as an aspect of faithful representation, but as an enhancing qualitative characteristic: very desirable but not necessarily required.

<sup>31</sup> See paragraph 4.38(b) of the existing *Conceptual Framework*.

<sup>32</sup> See paragraph QC12 of the existing *Conceptual Framework*.

4.15 Although the existing *Conceptual Framework* does not retain reliability as a qualitative characteristic of useful financial information, it retains that notion in the recognition criteria, and provides the following guidance in that context:

The second criterion for the recognition of an item is that it possesses a cost or value that can be measured with reliability. In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. When, however, a reasonable estimate cannot be made the item is not recognised in the balance sheet or income statement. For example, the expected proceeds from a lawsuit may meet the definitions of both an asset and income as well as the probability criterion for recognition; however, if it is not possible for the claim to be measured reliably, it should not be recognised as an asset or as income; the existence of the claim, however, would be disclosed in the notes, explanatory material or supplementary schedules.<sup>33</sup>

4.16 Because the existing *Conceptual Framework* no longer defines reliability, the recognition criteria cannot retain that term. Paragraphs 4.17–4.21 of this Discussion Paper consider whether the recognition criteria should include anything corresponding to reliability, or to any other aspect of faithful representation.

4.17 Under the existing recognition criteria, questions about reliability of measurement arise if measurement uses significant estimates. Paragraph QC16 of the existing *Conceptual Framework* states that an estimate “can be a faithful representation if the reporting entity has properly applied an appropriate process, properly described the estimate and explained any uncertainties that significantly affect the estimate. However, if the level of uncertainty in such an estimate is sufficiently large, that estimate will not be particularly useful. In other words, the relevance of the asset being faithfully represented is questionable. If there is no alternative representation that is more faithful, that estimate may provide the best available information.”

4.18 It follows that if a measure of an asset or a liability depends on estimates, the questions for the IASB to consider in relation to recognition are:

- (a) would that measure provide relevant information to users of financial statements? If not, would some other measure provide relevant information? If no available measure would provide relevant information, or if the information would not be sufficiently relevant to justify the cost of preparing it, paragraph 4.10 of this Discussion Paper suggests that the asset or the liability should not be recognised.
- (b) if a measure of an asset or a liability would provide relevant information to users of financial statements, is it possible to represent that asset or liability faithfully? If yes, what is the most faithful way to represent it:
  - (i) by recognising it (with supporting disclosure, if needed); or
  - (ii) by not recognising it (with supporting disclosure, if needed)?

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<sup>33</sup> See paragraph 4.41 of the existing *Conceptual Framework*.

- 4.19 When the IASB considers whether it is possible to provide a faithful representation of a resource or obligation, the IASB needs to consider not just its description and measurement on the face of the statement of financial position, but also:
- (a) related disclosures: a complete depiction includes all information necessary for a user of financial statements to understand the phenomenon being depicted, including all necessary descriptions and explanations;<sup>34</sup> and
  - (b) the depiction of the resulting income and expense: for example, if an entity acquires an asset in exchange for consideration, the failure to recognise the asset would result in an expense and reduce the entity's profit and equity. In some cases, for example if the entity does not consume the asset immediately, that result could provide a misleading representation that the entity's financial position has deteriorated.
- 4.20 As noted in paragraph 4.10 of this Discussion Paper, the IASB's preliminary view is that the IASB should not require the recognition of an asset or a liability if, in the IASB's view, recognition would result in information that is not relevant. Some believe that there are no circumstances when recognising an asset or a liability would provide information that is relevant but yet would not result in a faithful representation of that asset or liability and of changes in that asset or liability. Accordingly, in their view, there is no need for the recognition criteria to refer separately to faithful representation. However, in the IASB's preliminary view, the recognition criteria should refer separately to faithful representation. Thus, an entity should not recognise an asset or a liability if no measure of the asset or the liability would result in a faithful representation of a resource or obligation of the entity and of a change in its resources or obligations, even if all necessary descriptions and explanations are disclosed.
- 4.21 When considering how to represent faithfully its recognised assets and recognised liabilities, an entity would need to consider which measurement to use, how to present the asset or the liability and what disclosures to provide about it (see Sections 6–8).

### **Enhancing qualitative characteristics**

- 4.22 The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable.<sup>35</sup> These enhancing qualitative characteristics have the following implications for recognition:
- (a) unless the IASB identifies valid reasons to do otherwise, recognising an entity's assets or liabilities is likely to make the entity's financial statements more comparable and understandable, and to provide users of financial statements with more timely information about the entity's resources and obligations and about changes in those resources and obligations.

<sup>34</sup> See paragraph QC13 of the existing *Conceptual Framework*.

<sup>35</sup> See paragraph QC4 of the existing *Conceptual Framework*.



- (b) verifiability helps to assure users of financial statements that information faithfully represents what it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. Quantified information need not be a single-point estimate to be verifiable. A range of possible amounts and the related probabilities can also be verified.<sup>36</sup> However, as noted in paragraph 4.17 of this Discussion Paper, if the level of uncertainty in an estimate is too large to permit such observers to reach such a consensus, the estimate lacks verifiability to such an extent that it may not result in relevant information. This Discussion Paper identifies no separate role for verifiability in decisions about recognition.
- (c) on occasions, recognising an asset or a liability might, arguably, make the statement of financial position less understandable if that asset or liability is closely linked to another asset or liability that is unrecognised. Disclosure might be needed in such cases.

4.23 This Discussion Paper identifies no need for recognition criteria relating to the enhancing characteristics of comparability, verifiability, timeliness and understandability.

#### **Summary of preliminary views on recognition**

4.24 In the IASB's preliminary view, an entity should recognise all its assets and liabilities, except as discussed in paragraphs 4.25–4.26. The failure to recognise an asset or a liability is not rectified by disclosure of the accounting policies used nor by the notes or explanatory material.<sup>37</sup> If some assets or liabilities are not recognised, the resulting depiction of the entity's resources and obligations would be incomplete and would thus provide a less faithful representation of the entity's financial position.

4.25 In the IASB's preliminary view, the *Conceptual Framework* should state that the IASB might decide in developing or revising particular Standards that an entity need not, or should not, recognise an asset or a liability:

- (a) if recognising the asset (or the liability) would provide users of financial statements with information that is not relevant, or not sufficiently relevant to justify the cost; or
- (b) if no measure of the asset (or the liability) would result in a faithful representation of the asset (or the liability) and of changes in the asset (or the liability), even if all necessary descriptions and explanations are disclosed.

4.26 The *Conceptual Framework* could provide further guidance to help the IASB to assess when recognising an asset or a liability might not provide relevant information. For example, such guidance could suggest that the following are some indicators that recognition might not provide relevant information:

<sup>36</sup> See paragraph QC26 of the existing *Conceptual Framework*.

<sup>37</sup> See paragraph 4.37 of the existing *Conceptual Framework*.

- (a) if the range of possible outcomes is extremely wide and the likelihood of each outcome is exceptionally difficult to estimate: this might be the case in, for example, some major litigation.<sup>38</sup> In such cases, the most relevant information for users of financial statements might relate to the range of outcomes and the factors affecting their likelihoods. When that information is relevant (and can be provided at a cost that does not exceed the benefits), the entity should disclose that information, regardless of whether the entity also recognises the asset or the liability. However, in some cases, trying to capture that information in a single number as a measure for recognition in the statement of financial position may not provide any further relevant information.
  - (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: in some such cases, the IASB might conclude that users of financial statements would be unlikely to include information about that inflow (or outflow) directly in their analysis. Moreover, in some such cases, measures of the resource or obligation may be exceptionally sensitive to small changes in the estimate of the probability and there may be little evidence to support such estimates.
  - (c) if identifying the resource or obligation is unusually difficult: for example, this may be the case for some intangible assets, particularly some of those that are generated internally instead of being acquired in a separate transaction.
  - (d) if measuring a resource or obligation requires unusually difficult or exceptionally subjective allocations of cash flows that do not relate solely to the item being measured.
  - (e) if recognising an asset is not necessary to meet the objective of financial reporting. As noted in paragraph 4.9(c) of this Discussion Paper, this is the case for internally generated goodwill.
- 4.27 To provide relevant information to users of financial statements, the IASB may need to require disclosure about unrecognised assets or unrecognised liabilities, including perhaps disclosure about the factors, specified by the IASB, that led the IASB to conclude that recognition is not appropriate for those assets or liabilities.

### **Derecognition**

- 4.28 IFRS 9 *Financial Instruments* defines derecognition as the removal of a previously recognised financial asset or financial liability from an entity's statement of financial position.
- 4.29 The existing *Conceptual Framework* does not define derecognition and does not describe when derecognition should occur. Because there is no agreed conceptual approach to derecognition, different Standards have adopted different approaches. This risks causing inconsistency, with the further risk of adopting rule-based approaches rather than principle-based approaches.

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<sup>38</sup> Litigation may also be subject to existence uncertainty, as discussed in Section 2.

- 4.30 Paragraphs 4.31–4.51 deal with the following:
- (a) consequences of derecognition (see paragraphs 4.31–4.33);
  - (b) the objective of derecognition (see paragraph 4.34);
  - (c) the control approach and the risks-and-rewards approach (see paragraphs 4.35–4.44);
  - (d) full or partial derecognition (see paragraphs 4.45–4.49); and
  - (e) summary of preliminary views on derecognition (see paragraphs 4.50–4.51).

### **Consequences of derecognition**

- 4.31 Derecognition has the following consequences:
- (a) the entity no longer recognises the previously recognised asset or liability;
  - (b) the entity may need to recognise other assets and liabilities that result from the transaction or other event that gave rise to the derecognition; and
  - (c) income or expense may arise from the derecognition of the previous asset or liability and the recognition of any new asset or liability.
- 4.32 As noted in Section 3, many economic resources comprise a bundle of rights. An entity would recognise, measure and present some of those rights separately if such separation results in the most relevant information, and if the benefits of the separation outweigh the costs. Similarly, when an entity transfers some rights associated with a resource and retains others, it would derecognise the rights that it no longer controls and continue to recognise the rights retained (ie the rights it still controls). For example, a lessor no longer controls the right of use transferred to the lessee but retains a residual interest in the underlying leased item. How an entity should account for the rights it retains in such cases is discussed in paragraphs 4.45–4.51 of this Discussion Paper.
- 4.33 When an asset or a liability is transferred between entities within a consolidated group (a parent and its subsidiaries), the asset or the liability is still an asset or a liability of the group as a whole. Accordingly, in consolidated financial statements, the group continues to recognise the asset or the liability.

### **Approaches to derecognition**

- 4.34 The aim of accounting requirements for a transaction that may result in derecognition should be to represent faithfully both:
- (a) the resources and obligations remaining after the transaction; and
  - (b) the changes in the resources and obligations as a result of the transaction.
- 4.35 Achieving those twin aims is straightforward if an entity disposes of an entire asset or an entire liability. In that case, derecognition represents faithfully two facts: that the entity no longer has rights and obligations relating to that item, and that a transaction or other event eliminated all the previous rights or

obligations. Similarly, if an entity disposes of a proportion (say, 30 per cent) of all features of an asset, derecognition of that 30 per cent will represent faithfully that the entity retains 70 per cent of the asset and has disposed of 30 per cent of it.

- 4.36 However, achieving that twin aim is more difficult if the entity retains a component that exposes the entity disproportionately to the remaining risks or rewards arising from the previously recognised asset or liability. There are two approaches to derecognition in such cases:
- (a) a control approach: derecognition is simply the mirror image of recognition. Thus, an entity would derecognise an asset or a liability when it no longer meets the criteria for recognition (or no longer exists, or is no longer an asset or a liability of the entity). This implies that the derecognition criteria for an asset would focus on the control of the asset (rather than on legal ownership or on risks and rewards) and the derecognition criteria for a liability would focus on whether the entity still has the liability.
  - (b) a risk-and-rewards approach: an entity should continue to recognise an asset or a liability until it is no longer exposed to most of the risks and rewards generated by that asset or liability, even if the remaining asset (or liability) would not qualify for recognition if acquired (or incurred) separately at the date when the entity disposed of the other components. Thus, whether an entity recognises an asset or a liability depends, in some circumstances, on whether the entity previously recognised that asset or liability. As a result, some use the labels ‘history matters’ or ‘stickiness’ for a risk-and-rewards approach.
- 4.37 Proponents of a control approach argue that it treats identical rights or obligations in the same way, regardless of whether they were recognised previously. Doing so may result in financial statements that depict an entity’s economic resources and obligations more neutrally and thus more faithfully. It may also enhance financial statements by making them more comparable. In addition, unlike a risks-and-rewards approach, it avoids the need to determine whether the entity has transferred sufficient risks and rewards to derecognise the asset or the liability.
- 4.38 Proponents of a risks-and-rewards approach focus on cases such as the following, where they believe that derecognition would not faithfully represent the change in circumstances:
- (a) a significant reduction in recognised assets or liabilities with no significant decrease in the risks borne by the entity, for example, when an entity transfers a receivable but guarantees the purchaser against all or most of the future loan losses arising from that asset (see Example 4.1); and
  - (b) revenue, or a gain, that arises on delivering an asset that may or must be returned to the vendor through means such as a forward contract (see Example 4.2), written put option, purchased call option or lease.

- 4.39 Example 4.1 illustrates a case in which an entity sells an asset but retains some of the risk through a guarantee.

**Example 4.1: sale of receivables with partial recourse<sup>39</sup>**

*Fact pattern*

Entity A controls receivables with a carrying amount of CU1,000 and a fair value of CU1,000.<sup>(a)</sup> It sells the receivables to Bank B for cash of CU1,050. Entity A guarantees Bank B against any losses that Bank B suffers above CU140. The fair value of the guarantee is CU50.

*Applying a control approach*

Under a control approach, Entity A would first assess whether Bank B is holding the receivables as agent for Entity A (see paragraphs 3.31–3.32). If Entity A concludes that Bank B is holding the receivables as agent, Entity A would continue to recognise the receivables, measured at CU1,000. Entity A would also recognise cash of CU1,050 and a deposit liability of CU1,050.

If Entity A concludes that Bank B is holding the receivables as principal, Entity A would derecognise the receivables, recognising cash of CU1,050 and a guarantee liability of CU50. Entity A reports the guarantee liability in the same way as if it had issued a stand-alone guarantee of loans that it had never previously controlled.

*Applying a risks-and-rewards approach*

Under a risks-and-rewards approach, assume that Entity A has retained sufficient risks and rewards that it concludes that derecognition would not occur. Entity A would continue to recognise the receivables at CU1,000, and would recognise cash of CU1,050 and a deposit liability of CU1,050. Measuring the receivables at CU1,000 depicts the fact that Entity A is still exposed to some of the credit risk arising from the receivables. However, the transaction eliminated Entity's A exposure to losses below CU140. Continuing to measure the receivables at CU1,000 would not depict the reduction in risk.

(a) In this Discussion Paper, currency amounts are denominated in 'currency units' (CU).

- 4.40 Example 4.2 illustrates a sale combined with a repurchase.

<sup>39</sup> As explained in paragraphs 1.22 and 1.24, this Discussion Paper includes examples to illustrate the problems that the IASB is seeking to address. The IASB will not necessarily amend existing requirements for the transactions illustrated in the examples.

**Example 4.2: sale of a bond with repurchase agreement***Fact pattern*

Entity C controls a quoted zero coupon bond with a carrying amount of CU800 (amortised cost, with an effective interest rate of 5 per cent) and a fair value of CU1,000 (reflecting a market interest rate of 4 per cent). It sells the bond to Bank D for cash of CU1,000, and contracts to buy back the bond for CU1,045 after 12 months (the difference of CU45 reflects market interest rates today for a loan secured by such a bond). Assume that the fair value of Entity C's commitment to repurchase the bond is nil.

*Applying a control approach*

Under a control approach, Entity C would first assess whether Bank D is holding the bond as agent for Entity C (see paragraphs 3.31–3.32). If Entity C determines that Bank D is acting as agent, Entity C would conclude that it retains control of the bond and would:

- continue to recognise the bond at CU800, both before and after the repurchase (and would accrue interest on the bond at 5 per cent);
- recognise cash of CU1,000; and
- recognise a deposit liability of CU1,000, repayable in 12 months with interest at 4.5 per cent.

If Entity C concludes that Bank D holds the bond as principal, not as agent, it would derecognise the bond, recognising:

- cash of CU1,000;
- a repurchase obligation, measured at nil in this fact pattern; and
- a gain of CU200.

On repurchasing the bond, Entity C would recognise the bond and measure it at CU1,045. It would derecognise the repurchase obligation.

If Bank D holds the bond as principal, the consequence of the control approach is that Entity C reports assets and liabilities that are comparable with those that Entity C would have reported for a stand-alone forward contract to buy the bond for CU1,045 in 12 months.

*Applying a risks-and-rewards approach*

Under a risks-and-rewards approach, assume that Entity C has retained sufficient risks and rewards that it concludes that derecognition would not occur. Entity C would account for the bond in the same way as if it concluded that Bank D holds the bond as agent.

Arguably, when Entity C concludes that Bank D is holding the bond as principal, the risks-and-rewards approach portrays more clearly than the control approach the fact that that the transaction had virtually no effect on the amount, timing and uncertainty of Entity C's cash flows, other than receiving cash of CU1,000 and repaying it a year later with interest.

- 4.41 As Examples 4.1–4.2 illustrate, there are two main sources of concern in decisions about derecognition:
- (a) in some cases, derecognition results in smaller amounts in the statement of financial position, even though the entity is still exposed to risks of similar magnitude. In Example 4.1, derecognition would mean that Entity A no longer recognises its receivables (previously carried at CU1,000) even though it is still exposed to much of the credit risk arising from those receivables. Entity A would need to communicate, by appropriate presentation and disclosure, that the guarantee measured at only CU50 still exposes Entity A to much of the credit risk inherent in the receivables (see paragraph 4.43 of this Discussion Paper for one possible approach to communicating this information).
  - (b) in some cases, derecognition produces a gain or loss that would not arise at that time if the entity treated the cash received as arising from a financing transaction. In Example 4.2, Entity C recognises a gain if it derecognises the bond, and it subsequently measures the reacquired bond at more than its original cost.
- 4.42 Continuing recognition would not be the only possible solution to the concerns that Examples 4.1 and 4.2 illustrate—see paragraphs 4.43–4.44 for other possible solutions.
- 4.43 The concern in Example 4.1 arises because derivatives (such as the guarantee in Example 4.1) are more highly leveraged than cash instruments, such as loans. In other words, they expose entities to more concentrated risks than cash instruments do. One solution would be to change the accounting for all derivatives to show that extra leverage more directly. For instance, in Example 4.1, the issuer of such a guarantee might present receivables of CU1,000 and a deposit liability of CU1,050, rather than just a guarantee liability of CU50. If that treatment applied to all guarantees, not just those retained in a transfer, that would eliminate the pressure for continuing recognition in Example 4.1. However, it is not clear that the receivable reported under such an approach would meet the definition of an asset.
- 4.44 The concern in Example 4.2 arises when a sale-and-repurchase agreement could be used to recognise a gain (or perhaps a loss) that would not arise at that time if the entity continued to hold the asset or the liability. That could occur when assets or liabilities are measured on a basis that differs from the price for which they could be transferred to another party. One solution to that concern would be to measure all assets and liabilities at fair value (or perhaps fair value less costs to sell). However, as explained in Section 6, the IASB’s preliminary view is that measuring all assets and liabilities on that basis in all circumstances would not provide users of financial statements with the most relevant information.

#### **Full or partial derecognition?**

- 4.45 The discussion in paragraphs 4.35–4.44 of this Discussion Paper considered whether derecognition should occur when a transaction eliminates some but not all of the rights and obligations contained in an asset (or a liability). If

derecognition does occur, a related question is how to account for the rights and obligations retained. Two approaches might be considered in such cases:

- (a) full derecognition: derecognise the entire asset (or liability) and recognise the retained component as a new asset (or liability). If the carrying amount of the retained component differs from its previous carrying amount, a gain or loss will arise on that component.
- (b) partial derecognition: continue to recognise the retained component and derecognise the component that is not retained. On the retained component, no gain will arise and, unless that component is impaired, no loss will arise.

4.46 The following are two examples where this question arises:

- (a) when the terms of existing rights or obligations are changed by an agreement between two parties to amend a contract or by a change in the law. The modification may eliminate some of the existing rights or obligations and it may create new rights or obligations.
- (b) in a sale-and-leaseback transaction, as illustrated in Example 4.3.

**Example 4.3: sale-and-leaseback transactions**

*Fact pattern*

Entity E controls a machine that has a remaining useful life of 10 years and a carrying amount of CU800. Entity E sells the machine to Lessor F for its fair value of CU1,000, and Lessor F simultaneously leases the machine back to Entity E for the first 6 years for lease rentals at a current market rate. Those rentals have a present value of CU600.

*Applying a full derecognition approach*

If Entity E derecognises the entire machine, it will:

- recognise a new asset: the right to use the machine for years 1–6, measured at CU600;
- recognise the lease obligation, measured at CU600;
- recognise cash of CU1,000; and
- recognise a gain of CU200 on disposal of the machine.

**continued...**



...continued

*Applying a partial derecognition approach*

If Entity E derecognises only part of the machine, it will:

- continue to recognise the retained component of the asset: the right to use the machine for years 1–6. For this example, assume that the retained component is measured at CU480 = CU800 × (6÷10).
- derecognise the right to use the machine from years 7–10, recognising a gain of CU80 = (CU1,000 – CU800) × (4÷10).
- recognise a deposit liability, measured at CU600.
- recognise cash of CU1,000.

4.47 In Example 4.3, the full and the partial derecognition approaches result in different measures of the retained component. In addition, the full derecognition approach may result in the recognition of a gain or loss on the retained component. In contrast, the partial derecognition approach results in no gain or loss on the retained component (although the entity would generally need to test the retained component for impairment). It is likely that the IASB would need to decide whether to apply a full derecognition approach or a partial derecognition approach when it develops or revises particular Standards, because that decision depends on the unit of account. Paragraphs 9.35–9.41 include a discussion of unit of account and explain the IASB’s preliminary view that determining the unit of account is a decision that it would need to take when developing or revising particular Standards.

4.48 In sale-and-leaseback transactions, the IASB’s proposals in its Exposure Draft *Leases*, published in May 2013, together with the conclusions it is expected to reach in its forthcoming Standard on revenue recognition, would typically lead to either no derecognition or full derecognition.

4.49 One other factor to be considered in such transactions is whether the component retained should be regarded as continuing to be a component of the original asset, or whether its character has changed so much that it should be regarded as an entirely new asset. For example, if the new asset exposes the holder to significant credit risk that was not present in the original asset, it may be more appropriate to regard it as a new asset, rather than as a retained component of the original asset.

**Summary of preliminary views on derecognition**

4.50 The derecognition criteria need to reflect how best to portray both an entity’s rights and obligations and changes in those rights and obligations. In most cases, an entity will achieve this by derecognising an asset or a liability when it no longer meets the recognition criteria (or no longer exists, or is no longer an asset or a liability of the entity). However, if the entity retains a component of the asset or the liability, the IASB should determine, when developing or revising particular Standards, how the entity would best portray the changes that resulted from the transaction. Possible approaches include:

- (a) enhanced disclosure;

- (b) presenting any rights or obligations retained on a line item different from the line item that was used for the original rights or obligations, to highlight the greater concentration of risk; or
  - (c) continuing to recognise the original asset or liability, and treating the proceeds received or paid for the transfer as a loan received or granted.
- 4.51 It would also be a decision when developing or revising particular Standards, depending on the unit of account as discussed in paragraphs 9.35–9.41, to determine which of the following approaches to use if an entity retains components of an asset or a liability when derecognition occurs:
- (a) full derecognition approach: derecognise the entire asset or liability and recognise a new asset or liability; or
  - (b) partial derecognition approach: continue to recognise the components retained.

### Questions for respondents

#### Question 8

Paragraphs 4.1–4.27 discuss recognition criteria. In the IASB’s preliminary view, an entity should recognise all its assets and liabilities, unless the IASB decides when developing or revising a particular Standard that an entity need not, or should not, recognise an asset or a liability because:

- (a) recognising the asset (or the liability) would provide users of financial statements with information that is not relevant, or is not sufficiently relevant to justify the cost; or
- (b) no measure of the asset (or the liability) would result in a faithful representation of both the asset (or the liability) and the changes in the asset (or the liability), even if all necessary descriptions and explanations are disclosed.

Do you agree? Why or why not? If you do not agree, what changes do you suggest, and why?

**Question 9**

In the IASB's preliminary view, as set out in paragraphs 4.28–4.51, an entity should derecognise an asset or a liability when it no longer meets the recognition criteria. (This is the control approach described in paragraph 4.36(a)). However, if the entity retains a component of an asset or a liability, the IASB should determine when developing or revising particular Standards how the entity would best portray the changes that resulted from the transaction. Possible approaches include:

- (a) enhanced disclosure;
- (b) presenting any rights or obligations retained on a line item different from the line item that was used for the original rights or obligations, to highlight the greater concentration of risk; or
- (c) continuing to recognise the original asset or liability and treating the proceeds received or paid for the transfer as a loan received or granted.

Do you agree? Why or why not? If you do not agree, what changes do you suggest, and why?

## Section 5—Definition of equity and distinction between liabilities and equity instruments

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### Introduction

- 5.1 This section discusses:
- (a) the definition of equity, including the measurement and presentation of different classes of equity (see paragraphs 5.2–5.21); and
  - (b) whether the distinction between liabilities and equity instruments should be based solely on the definition of a liability (see paragraphs 5.22–5.59).

### Definition of equity

- 5.2 The existing *Conceptual Framework* defines ‘equity’ as the residual interest in the assets of the entity after deducting all its liabilities.<sup>40</sup> The IASB’s preliminary view is that it should not change that definition.
- 5.3 Total equity equals total assets, less total liabilities, as recognised and measured in the financial statements. It does not depict the value of the entity.
- 5.4 Total equity at the end of a period generally equals:
- (a) total equity at the start of the period (restated, if applicable, for changes in accounting policies, and to correct previous errors); plus
  - (b) contributions to equity in the period; minus
  - (c) distributions of equity in the period; plus
  - (d) comprehensive income for the period; plus
  - (e) capital maintenance adjustments, if applicable (see Section 9).
- 5.5 Typically, entities divide total equity into various categories. IFRS does not generally prescribe which categories of equity an entity should present separately, because determining which categories are most relevant to users of financial statements may depend on local legislation and on the reporting entity’s governing constitution. Similarly, IFRS does not generally specify the categories of equity in which an entity should present the effects of particular transactions, measurements or other events. IAS 1 *Presentation of Financial Statements* requires an entity to disclose a description of the nature and purpose of each reserve within equity.
- 5.6 In most cases, total equity is positive, though it can also be negative, depending on whether all assets and liabilities are recognised and on how recognised assets and liabilities are measured. Similarly, the individual categories of equity may be positive or negative.
- 5.7 This Discussion Paper uses the following terms for convenience, without defining them formally:

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<sup>40</sup> See paragraph 4.4(c) of the existing *Conceptual Framework*.

- (a) *equity claim*: a present claim on the equity of an entity (ie a residual interest in the assets of the entity after deducting all its liabilities). For the purposes of this Discussion Paper, an equity claim is either a primary equity claim or a secondary equity claim.
- (b) *primary equity claim*: a present right to share in distributions of equity during the life of the reporting entity or on liquidation.
- (c) *secondary equity claim*: a present right or a present obligation to receive or deliver another equity claim.
- (d) *equity instrument*: an issued financial instrument that creates equity claims and creates no liability.<sup>41</sup>

5.8 Examples of equity instruments include:

- (a) equity instruments that create primary equity claims, including:
  - (i) ordinary shares;
  - (ii) other classes of shares (for example, some preferred shares, some deferred shares); and
  - (iii) non-controlling interests (NCI) in a subsidiary.
- (b) equity instruments that create secondary equity claims, including:
  - (i) forward contracts to buy, sell or issue an entity's own shares; and
  - (ii) options to buy or sell an entity's own shares.
- (c) an equity component of a financial instrument that contains both an equity component and a liability component, if an entity is required or permitted to separate those components. IAS 32 *Financial Instruments: Presentation* requires such separation in some cases. As noted in paragraph 5.54, identifying whether and when to permit, require or prohibit such separation would be a decision for the IASB to make when it develops or revises particular Standards, rather than for the *Conceptual Framework*.

5.9 Whether a financial instrument or other contract creates a liability depends not on the legal form of the contract, but on whether the contract creates a present obligation of the entity to transfer an economic resource as a result of a past event.

5.10 Paragraphs 5.11–5.21 discuss:

- (a) classes of equity claim (see paragraphs 5.11–5.17);
- (b) measuring equity claims (see paragraphs 5.18–5.20); and
- (c) non-controlling interests (see paragraph 5.21).

<sup>41</sup> IAS 32 *Financial Instruments: Presentation* defines an equity instrument as “any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities”.

### Classes of equity claim

- 5.11 Existing and potential investors need information to help them assess the prospects for future net cash inflows to an entity.<sup>42</sup> In addition, information about priorities and payment requirements of existing claims helps users of financial statements to predict how future cash flows will be distributed among those with a claim against the entity.<sup>43</sup> In other words, existing and potential investors need information about both:
- (a) the future net cash inflows to the entity (cash inflows less cash outflows); and
  - (b) the claims that determine how those net cash inflows will be distributed among holders of different claims.
- 5.12 To meet those needs, this Discussion Paper explores an approach in which an entity would provide the following:
- (a) information to help investors assess the amount, timing and uncertainty of future net cash inflows to the entity: in the statements of financial position, profit or loss and other comprehensive income (OCI), and cash flows, and in the notes; and
  - (b) information about the claims on those net cash inflows: in the statement of financial position and the statement of changes in equity. These statements, with related notes, should be designed in a way to enable equity holders to understand:
    - (i) how their own equity claims are affected at the end of the period by other classes of equity claims; and
    - (ii) the changes during the period in the effect of those other classes of equity claims. Those changes are described in paragraph 5.13 as wealth transfers between different classes of equity claims.
- 5.13 This could be achieved by designing the statement of changes in equity in the following way:
- (a) the statement of changes in equity would display a separate column for each class of equity claim. An entity would include equity claims within the same class if they have the same (or perhaps similar) rights.
  - (b) the column for each class of equity claim would be sub-divided (on the face of the statement or in the notes), if applicable, into categories on a basis consistent with legal and other requirements governing the entity. Depending on those requirements, examples of such categories might include share capital, retained earnings and reserves.

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<sup>42</sup> See paragraph OB3 of the existing *Conceptual Framework*.

<sup>43</sup> See paragraph OB13 of the existing *Conceptual Framework*.

- (c) an entity would, at the end of each period, update the measurement of each class of equity claim. This would update the allocation of total equity between the classes of equity claim, but would not affect total equity. Which measurements might be appropriate for this purpose is discussed in paragraphs 5.18–5.20.
  - (d) updating measurements of different classes of equity claim would result in transfers between the amounts of recognised net assets (assets less liabilities) attributed to those classes. These represent transfers of wealth between those classes. In other words, they show how each class of equity claim diluted the net assets attributable to other classes of equity claim during the period. Currently, financial statements do not necessarily provide this information.
- 5.14 The *Conceptual Framework* would not prescribe a specific format for the statement of changes in equity, and would not provide an illustration of a format. Example C2 in Appendix C illustrates a statement designed in this way, as does Example 5.1.
- 5.15 The following points are worth making about Example 5.1:
- (a) the entity (Entity A) in the example has three classes of equity claim: existing shareholders of the parent, NCI and holders of an option written by Entity A.
  - (b) Entity A wrote the option on 17 January 20X2 in exchange for an option premium of CU5,000 paid in cash on that date. That amount was the fair value of the option at that date. If the holder exercises that option, Entity A must issue its own shares in exchange for a cash payment of CU1,500 by the holder.
  - (c) on 31 December 20X2, Entity A updates the measurement of the option to its fair value of CU4,000, recognising CU1,000 (CU5,000 – CU4,000) as a wealth transfer from option holders to existing shareholders of the parent. For illustration purposes, Example 5.1 assumes that the wealth transfers are recognised in retained earnings.
  - (d) the subtotal ‘change in net assets’ summarises the change in equity attributable to each class of equity shareholders as a result of comprehensive income for the year, together with wealth transfers to or from other classes of equity claim.
  - (e) immediately before exercise of the option on 15 December 20X3, its fair value has declined by a further CU800 to CU3,200. Entity A recognises a further wealth transfer of CU800 in 20X3 to depict this decline.
  - (f) when the option holder exercises the option, Entity A receives CU1,500 from the option holder and fulfils its obligation to the option holder by issuing new shares. For illustration purposes, Example 5.1 assumes that the new shares are recognised in share capital.

	Existing shareholders of parent		Non-controlling interests	Obligation to issue shares	Total
	Share capital	Retained earnings			
1 January 20X2	10,000	20,000	4,000	—	34,000
Written option issued on 17 January 20X2	—	—	—	5,000	5,000
Total profit/comprehensive income for 20X2	—	3,500	200	—	3,700
Change in fair value of written option	—	1,000	—	(1,000)	—
Change in net assets	—	4,500	200	(1,000)	3,700
31 December 20X2	10,000	24,500	4,200	4,000	42,700
Total profit/comprehensive income for 20X3	—	3,700	300	—	4,000
Change in fair value of written option	—	800	—	(800)	—
Change in net assets	—	4,500	300	(800)	4,000
New shares issued on 15 December 20X3	4,700	—	—	(3,200)	1,500
31 December 20X3	14,700	29,000	4,500	—	48,200



- 5.16 Many commentators have stated that IFRS does not currently update measures of items classified as equity instruments. However, that is only partly true:
- (a) IFRS generally does not permit entities to update measures of equity instruments **through profit or loss**. There is no existing obstacle to updating those measures through equity (and reporting the resulting changes as transfers within the statement of changes in equity).
  - (b) IFRS requires entities to update measures of NCI for the NCI's share in profit or loss, in OCI and in other equity movements.
- 5.17 Standards do not currently contain a **requirement** to update measures of equity claims through the statement of changes in equity. Such a requirement would achieve two objectives:
- (a) it would give equity holders a clearer and more systematic view of how other equity claims affect them; and
  - (b) as discussed in paragraphs 5.22–5.59, it would provide a way to resolve some liability/equity classification issues that have proved problematic over the years.

### Measuring equity claims

- 5.18 If the IASB decided to introduce a requirement to measure equity claims, it would need to determine when it develops or revises particular Standards what measurement to use for particular classes of equity claim, considering how best to convey how the claims of that class affect the holders of other classes. For example, the IASB might decide:
- (a) to use an allocation of the underlying net assets as the measurement of primary equity claims. As an example, this basis is currently used for NCI. If an entity has more than one class of equity claim, the allocation would reflect the relative priorities of their claims against the total equity that is attributable to holders of all primary equity claims. If those relative priorities would vary across different future circumstances, the allocation would need to consider those variations. An entity would not measure primary equity claims by reference to estimates of the cash flows that holders of those claims will receive because such measures would, in effect, require a measurement of the entity as a whole. As explained in paragraph OB7 of the existing *Conceptual Framework*, showing the value of the entity as a whole is not the objective of general purpose financial statements.
  - (b) to measure secondary equity claims in the same manner as an entity would measure a comparable financial liability, for example:
    - (i) to use amortised cost for a class of secondary equity claims if those claims confer a right to deliver or receive, at a fixed date, equity instruments that have a fixed total value; and
    - (ii) to use fair value for a class of secondary equity claims if those claims confer a right to deliver or receive equity instruments that have a total value that varies because of changes in a price, index

or other variable (perhaps other than the price of the issuer's own equity instruments or its own financial liabilities).

- 5.19 Regardless of the method used to measure equity claims, updating the measurement of those claims would not change total equity, it would simply reallocate total equity between the classes of equity claim. Updating the amount allocated to one class of equity claim causes an offsetting change in the amount allocated to one or more other classes of equity claim.
- 5.20 This Discussion Paper uses the term 'wealth transfer' to describe the reallocations between different classes of equity claim in the statement of changes in equity. Those reallocations depict the change during the period in the allocation of total equity between different classes. That change arises because different classes have different types of interest in equity. Those wealth transfers are not income and expense. They do not change total equity, but are akin to contributions of equity by one or more classes and equal distributions of equity to other classes.

### **Non-controlling interests**

- 5.21 The approach described in paragraphs 5.12–5.14 is largely consistent with, and an extension of, the way in which IFRS treats NCI in a subsidiary. NCI does not meet the existing or proposed definition of a liability, because the entity has no obligation to transfer economic resources. Consequently, IFRS treats NCI as part of equity, not as a liability. IAS 1 already requires entities to display prominently the NCI's share in equity, in profit or loss and in comprehensive income. An entity would display changes in NCI separately in the statement of changes in equity (for example, as a separate column). The treatment described in paragraphs 5.12–5.14 would extend that requirement for a prominent display to all other categories of equity instrument.

### **Distinguishing liabilities from equity instruments**

- 5.22 This section discusses how to apply the definitions of a liability and of equity in distinguishing between liabilities and equity instruments. This distinction currently has several effects:
- (a) the two categories are classified separately in the statement of financial position. If distinguished strictly in accordance with the definition of a liability in the existing *Conceptual Framework*, the classification would distinguish items that oblige the entity to deliver cash or other economic resources from items that create no such obligation.
  - (b) the statement(s) of profit or loss and OCI:
    - (i) include(s) income and expenses arising from liabilities (interest and, if applicable, remeasurement and gain or loss on settlement);
    - (ii) do(es) not report as income or expense the changes, if any, in the carrying amount of the entity's own equity instruments; and
    - (iii) include(s) expenses arising from the consumption of services acquired in exchange for financial liabilities or equity instruments (IFRS 2 *Share-based Payment*).

- (c) in the statement of financial position:
  - (i) the carrying amount of many financial liabilities changes with the passage of time (and for other factors, if the liability is measured at fair value); and
  - (ii) the amount reported for particular classes of equity instruments typically does not, under current practice, change after initial recognition (except for NCI).
- (d) the statement of changes in equity:
  - (i) includes comprehensive income and thus includes implicitly the related change in the carrying amount of assets less liabilities. Thus it shows, albeit implicitly, how those liabilities affect the returns to equity holders.
  - (ii) shows NCI's share of comprehensive income and NCI's interest in recognised net assets.
  - (iii) does not currently show how changes in the value of each class of equity claim (other than NCI) affect the value of, or possible returns to, more subordinated (lower-ranking) classes of equity. Thus, it does not currently show wealth transfers between different classes of equity holder.

5.23 The distinction between financial liabilities and equity instruments is currently governed by IAS 32 and IFRS 2. IAS 32 is supplemented by IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments*. In both IAS 32 and IFRS 2, the starting point is to determine whether the entity has an obligation to transfer economic resources, but there are exceptions to that basic principle. Table 5.1 is a highly condensed summary of the approaches.

5.24 As Table 5.1 shows, the distinction in IFRS 2 (between cash-settled and equity-settled share-based payment transactions) relies almost entirely on the existing definition of a liability in the *Conceptual Framework*. IFRS 2 makes one adjustment to that definition, to address transactions for which the obligation rests with another group entity or other related party. In contrast, IAS 32 overrides that definition with complex exceptions for:

- (a) some obligations that require an entity to deliver its own equity instruments, or that permit an entity to elect to deliver its own equity instruments instead of delivering cash or other economic resources (see paragraphs 5.28–5.54);
- (b) some puttable instruments (see paragraphs 5.55–5.59); and
- (c) some obligations payable on liquidation. Section 3 suggests that no liability results from payments that would arise only on liquidation. It follows that relative priorities on liquidation of the reporting entity would play no role in determining whether instruments are classified as financial liabilities or as equity instruments. This conclusion applies even if the reporting entity has a predetermined limited life (or even if another party can compel liquidation). However, that conclusion may

not be appropriate in consolidated financial statements for obligations that would become payable on liquidation of a consolidated subsidiary before liquidation of the parent.

**Table 5.1 summary of classification under IAS 32 and IFRS 2**

	<b>IAS 32</b>	<b>IFRS 2</b>
Liabilities	<ul style="list-style-type: none"> <li>• obligation to deliver cash or another financial asset.<sup>(a)</sup></li> <li>• obligation (in a derivative or non-derivative) to deliver a variable number of the entity's own equity instruments.</li> <li>• obligation (in a derivative only) that may or must be settled by exchanging a fixed number of the entity's own equity instruments for a variable amount of cash or other financial assets.</li> <li>• derivative obligation that allows either the holder or issuer to elect whether the holder is to settle in cash or in shares.</li> </ul>	<ul style="list-style-type: none"> <li>• obligation to transfer cash or other assets.</li> </ul>
Equity	<ul style="list-style-type: none"> <li>• no obligation to deliver cash or other financial assets (and none of the above features present).</li> <li>• some puttable instruments that entitle the holder to a pro rata share of net assets on liquidation, or earlier repurchase.</li> <li>• obligation to deliver a pro rata share of net assets only on liquidation of the entity.</li> <li>• derivative that must be settled by exchanging a fixed number of the entity's own equity instruments for a fixed amount of cash or other financial assets.</li> </ul>	<ul style="list-style-type: none"> <li>• no obligation to transfer cash or other assets.</li> <li>• no obligation for the entity at all because another group entity or other related party will settle the obligation.</li> </ul>

(a) or to exchange financial assets or financial liabilities under conditions that are potentially unfavourable.

- 5.25 In their joint project on financial instruments with characteristics of equity (FICE), which was suspended in 2010, the IASB and the US Financial Accounting Standards Board (FASB) had tentatively decided to use an approach that classifies, as IAS 32 does:
- (a) some instruments as equity instruments, even though they create obligations to transfer economic resources; and
  - (b) some other instruments as financial liabilities, even though they create no obligations to transfer economic resources.
- 5.26 Thus, the approaches in both IAS 32 and the FICE project may be viewed as overriding the definition of a liability in the existing *Conceptual Framework* with several exceptions. Such approaches have significant disadvantages:
- (a) the exceptions are complex, difficult to understand and difficult to apply, as evidenced by a stream of requests for Interpretations.
  - (b) inconsistency with the definitions in the *Conceptual Framework* makes financial statements less internally consistent and, as a result, less understandable and less comparable.
  - (c) inconsistencies in approach may create opportunities to structure transactions to achieve a more favourable accounting result without changing the economics of a transaction significantly.
  - (d) the approach is not fully consistent with the approach used for share-based payments in IFRS 2. This reduces comparability, creates further opportunities for structuring, and makes it more important to establish whether particular obligations are within the scope of IAS 32 or within the scope of IFRS 2.
  - (e) further inconsistencies arise because under IFRS 2, cash-settled transactions are remeasured but equity-settled transactions are not remeasured. This puts pressure on the distinction between those two types of settlement. It also means that investors receive different information about how those transactions affect their own investments, depending on the form of settlement.
- 5.27 Whether there is a conceptual basis for the exceptions developed in IAS 32 and the FICE project, and whether those exceptions indicate a need to amend the *Conceptual Framework's* definitions of liability and equity, is discussed in paragraphs 5.28–5.59. Specifically, the paragraphs cover:
- (a) obligations to deliver equity instruments (see paragraphs 5.28–5.44).
  - (b) other approaches considered (see paragraphs 5.45–5.52).
  - (c) other factors that would need to be considered in applying the concepts when developing or revising particular Standards (see paragraphs 5.53–5.54).
  - (d) whether the *Conceptual Framework* should indicate that an entity should treat some puttable instruments as equity, even though the issuer has an obligation to transfer cash or other economic resources if the holder so requests (see paragraphs 5.55–5.59).

### Obligations to deliver equity instruments

- 5.28 An equity instrument is not an economic resource of the issuer. Accordingly, an obligation for an entity to deliver its own equity instruments is not an obligation to deliver economic resources. Hence, it does not meet the current or proposed definition of a liability. Such an obligation is one form of a 'secondary equity claim', as described in paragraph 5.7(c).
- 5.29 IAS 32 classifies some equity claims as liabilities and others as equity instruments. It classifies them as liabilities if an entity uses its own equity instruments 'as currency' in a contract to receive or deliver a variable number of shares whose value equals a fixed amount or an amount based on changes in an underlying variable (for example, a commodity price). The Basis for Conclusions on IAS 32 explains that the IASB adopted this approach for the following reasons:
- (a) the entity has an obligation for a specified amount rather than a specified equity interest. For such a contract, the entity does not know, before the transaction is settled, how many of its own shares (or how much cash) it will receive or deliver and it may not even know whether it will receive its own shares or deliver them.
  - (b) precluding equity treatment for such a contract limits incentives for structuring potentially favourable or unfavourable transactions to obtain equity treatment. For example, the IASB believed that an entity should not obtain equity treatment for a transaction simply by including a share settlement clause when the contract is for a specified value, rather than for a specified equity interest.
- 5.30 This Discussion Paper identifies two approaches that could simplify the distinction between liabilities and equity: a narrow equity approach and a strict obligation approach. The narrow equity approach would:
- (a) classify as equity only existing equity instruments in the most residual existing class of equity instrument issued by the parent. (Defining the most residual class might require detailed work when developing or revising particular Standards.)
  - (b) classify as liabilities all other instruments, such as:
    - (i) instruments that create no obligation to transfer assets;
    - (ii) NCI;<sup>44</sup> and
    - (iii) forwards and options on those equity instruments that are classified as equity by the criterion in (a).
  - (c) recognise in profit or loss gains and losses (including, if applicable, interest expense) on all instruments classified as financial liabilities.
- 5.31 The thinking behind the narrow equity approach may underlie some of the exceptions in IAS 32. In addition, some regard the narrow equity approach as being consistent with the proprietary perspective on the reporting entity, and

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<sup>44</sup> A variant on the narrow equity approach might classify NCI as equity.

the strict obligation approach as being consistent with the entity perspective. Appendix B refers to these two perspectives in the context of the IASB's work on the reporting entity.

- 5.32 The narrow equity approach depicts the interests of holders of the most residual existing class of equity claim directly in only one step, by depicting the claims against the entity from the perspective of those investors. It does this by categorising all prior claims against the entity as fundamentally different from those residual claims. Not all of those prior claims create an obligation for the entity to deliver economic resources (ie to deliver assets). A narrow equity approach could be supplemented by a requirement to distinguish prominently those instruments that are classified as liabilities but that create no obligation to transfer economic resources.<sup>45</sup>
- 5.33 Unlike the narrow equity approach, the strict obligation approach depicts interests of holders of the most residual existing class of equity claim in two steps. The first step depicts the entity as a whole from a perspective common to all providers of capital. It does this by identifying economic resources, obligations to deliver economic resources (such as cash), and changes in those economic resources and obligations. The second step enhances that depiction from the perspective of the holders of each class of equity claim by identifying the effects on those holders of all other equity claims.
- 5.34 The strict obligation approach would:
- (a) classify as liabilities only obligations to deliver economic resources. Thus, the statement of financial position would show the entity's economic resources and its obligations to deliver economic resources. The statement(s) of profit or loss and OCI would show changes in those economic resources and obligations.
  - (b) classify as equity all equity claims, in other words:
    - (i) all claims that give the holder the right to receive a portion of any distributions of equity made to holders of that class of claim; and
    - (ii) all obligations to deliver equity instruments.
  - (c) as suggested in paragraph 5.13, reallocate total equity by updating measures of all equity claims. Thus:
    - (i) the equity section of the statement of financial position would show how all equity claims affect other equity claims; and
    - (ii) the statement of changes in equity would show wealth transfers between different classes of equity claims.
- 5.35 Both the narrow equity approach and the strict obligation approach would account in the same way for goods or services acquired in exchange for issuing equity instruments: the goods or services received are an asset; when the entity consumes that asset, it recognises an expense. For many services, an entity

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<sup>45</sup> A narrow equity approach differs from the mezzanine approach mentioned in paragraph 5.51. The narrow equity approach classifies all claims as either liabilities or equity claims, without creating an intermediate category that is neither a liability nor an equity claim.



consumes that asset immediately; if so, the entity recognises the expense at the same time as it recognises the related contribution to equity.<sup>46</sup> However, the two approaches differ in how they account subsequently for any remaining obligation to issue equity instruments:

- (a) the narrow equity approach would recognise and measure that obligation as a financial liability, and would report subsequent changes in its carrying amount in profit or loss (or perhaps in OCI, depending on the approach to profit or loss and OCI).
- (b) the strict obligation approach would recognise that obligation within equity as an equity claim. It would report subsequent changes in its carrying amount as wealth transfers in the statement of changes in equity.

5.36 The main advantages of the narrow equity approach are that:

- (a) it places less emphasis than the strict obligation approach does on the need for equity investors to read and understand the statement of changes in equity. In addition, some may feel that dilution and wealth transfers between different classes of equity holder can be reported simply and understandably only by showing those effects on the face of the statement(s) of profit or loss and OCI, rather than in the statement of changes in equity.
- (b) it does not require an entity to assess whether a particular instrument creates an obligation for the entity to transfer economic resources. In contrast, the strict obligation does require such an assessment, which may sometimes require considerable judgement, especially for some instruments containing an option that permits the issuer to settle by using its own equity instruments, although settlement in cash is more likely. Paragraph 5.42 refers to some of the complexities that may exist.
- (c) all entities that issue financial instruments would classify the most residual class of instruments as equity. This might remove the concerns that led to the exemption for some classes of puttable instruments, as discussed in paragraphs 5.55–5.59. This is an important issue for many co-operatives and mutuals.

5.37 However, in the IASB's preliminary view, the strict obligation approach is preferable to the narrow equity approach because:

- (a) the strict obligation approach is consistent with the existing definition of a liability. As a result, it is also consistent with the existing treatment of non-controlling interest. Amending the definition of a liability to make it consistent with the narrow equity approach would make the definition more complex and less understandable.
- (b) it would separate two important distinctions more clearly than the narrow equity approach does:

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<sup>46</sup> See paragraphs BC45–BC53 of IFRS 2.

- (i) does the entity have an obligation to transfer cash or other economic resources? The answer to this question is important to lenders because such obligations can affect the likely returns to lenders. That answer is also important to investors because such obligations can threaten the entity's survival. The strict obligation approach answers this question by classifying an obligation as a liability if the obligation requires the entity to transfer cash or other economic resources.
  - (ii) does an instrument create a prior (higher-ranking) claim that will affect the returns to existing holders of other classes of equity claim? The strict obligation approach answers this question by reporting each class of equity claim separately in the statement of changes in equity. (In contrast, the narrow equity approach answers this question by classifying prior claims as liabilities.)
  - (c) measuring all equity claims will provide equity holders with clearer and more prominent information about the effects of other equity claims.
  - (d) if applied when developing new or revised Standards:
    - (i) it would eliminate the inconsistency between IAS 32 and IFRS 2.
    - (ii) it would require remeasurement for all share-based payments, thus removing one source of complexity from IFRS 2.
- 5.38 Paragraph 5.29(b) explains that the treatment in IAS 32 limits incentives for structuring potentially favourable or unfavourable transactions to obtain equity treatment. It limits those incentives by using profit or loss to report prominently the effects that those transactions have on holders of existing equity claims. The strict obligation approach also reports those effects prominently, but uses the statement of changes in equity for this purpose.
- 5.39 Discussions on the distinction between liabilities and equity often concentrate on how best to depict leverage. Leverage can refer to two different, but related, conditions, which could be described informally as:
- (a) cash leverage—the ratio of:
    - (i) financing obligations that must be settled by delivering cash (or other economic resources); to
    - (ii) equity financing.
  - (b) return leverage—the ratio of:
    - (i) financing obligations that do not share fully in the returns on the residual interest in an entity's assets less liabilities; to
    - (ii) obligations that do share in those residual returns.
- 5.40 Typical debt instruments contribute to both cash leverage and return leverage. In contrast, obligations that are settled in their entirety by issuing equity instruments contribute to return leverage but not to cash leverage. The strict obligation approach described in this paper uses the distinction between liabilities and equity to depict cash leverage, and it uses presentation in the statement of changes in equity to depict any additional return leverage that is

not apparent from the depiction of cash leverage. On the other hand, the narrow equity approach uses the distinction between liabilities and equity to depict return leverage, and would need to rely on disclosure to depict cash leverage.

- 5.41 In paragraph 5.36 it is noted that the narrow equity approach shows on the face of the statement(s) of profit or loss and OCI all effects on equity investors of changes in the carrying amount of prior claims. In contrast, to see those effects under the strict obligation approach, equity investors would need to look beyond profit or loss or comprehensive income. However, the need to look further would not be new: equity investors already need to do so if they wish to reconcile profit or loss to the numerator used in calculating earnings per share.
- 5.42 The strict obligation approach requires an entity to assess whether an instrument creates an obligation to transfer an economic resource. That assessment may be complex if the instrument results in a transfer of an economic resource in some circumstances but not in others.
- (a) An instrument may require the entity to transfer an economic resource when an event occurs that is beyond the control of both the holder and the issuer. As indicated in paragraphs 3.70–3.71, such a requirement creates an obligation to transfer an economic resource, hence a liability exists.
  - (b) An instrument may require the entity to transfer an economic resource if the counterparty takes some action, for example if it exercises an option. As indicated in paragraphs 3.70–3.71, such a requirement creates an obligation to transfer an economic resource, hence a liability exists.
  - (c) An instrument may require the entity to transfer an economic resource if the entity itself takes some action, for example if it fails to exercise an option. In paragraphs 3.72–3.89, there is a discussion of some factors that would be relevant in assessing whether the entity has a liability in such cases. In addition, paragraphs 3.98–3.102 discuss whether an entity has a liability if it appears to hold an option that enables it to avoid transferring an economic resource, but that option lacks commercial substance.
- 5.43 The informal description of a secondary equity claim in paragraph 5.7(c) includes both obligations to receive or deliver another equity claim and rights to receive or deliver another equity claim. Most of the discussion in this section has focused on equity claims that result in an obligation to deliver equity instruments. Similar considerations apply to rights for the entity to claim delivery of its own equity instruments, such as a purchased call option on its own shares or a forward repurchase of its own shares. Appendix E summarises the rights and obligations that arise under options and forwards on an entity's own shares.
- 5.44 This Discussion Paper contains several appendices to help readers understand some of the implications of different approaches. The IASB does not expect to include detailed appendices of this kind in the *Conceptual Framework*.

- (a) Appendix C provides two examples to illustrate the approaches discussed in this section.
- (b) Appendix D summarises how the strict obligation approach would treat different classes of instrument.
- (c) Appendix E summarises the rights and obligations arising under options and forwards on an entity's own shares.
- (d) Appendix F provides background information on three questions that the IASB might need to address, when revising particular Standards, on how to distinguish liabilities from equity instruments. These questions relate to the measurement of options written by an entity on its own equity and on NCI.

### Other approaches considered

- 5.45 In previous work, the IASB considered some other approaches included by the FASB in 2007 in its Preliminary Views document *Financial Instruments with Characteristics of Equity* and discussed in 2008 in the IASB's Discussion Paper *Financial Instruments with Characteristics of Equity*. Those approaches were labelled as the 'basic ownership approach', the 'ownership-settlement approach' and the 'revised expected outcomes (REO) approach'.<sup>47</sup>
- 5.46 All three approaches refer to a basic ownership instrument, which is defined as an instrument for which the holder:
- (a) has a claim to a share of the assets of the entity that is subordinate to all other claims if the issuer were to liquidate on the date that the classification decision is being made; and
  - (b) is entitled to a percentage of the assets of the entity that remain after all higher priority claims have been satisfied.
- 5.47 The basic ownership approach would classify as equity only basic ownership instruments. It is a narrow equity approach. The advantages and disadvantages of the narrow equity approach are discussed in paragraphs 5.36–5.37.
- 5.48 The basic ownership approach is inconsistent with the existing and proposed conceptual definition of a liability. The FASB Preliminary Views document suggested that a definition similar to the following would be consistent with the basic ownership approach: "A liability is a claim, the probability-weighted outcome of which would reduce the assets available for distribution to basic ownership instruments." Appendix D of that document discusses possible definitions of liabilities and of equity for each of the three approaches discussed there. This Discussion Paper does not reproduce those definitions.
- 5.49 The ownership-settlement approach would classify as equity:
- (a) basic ownership instruments;

<sup>47</sup> The IASB's Discussion Paper and the FASB's Preliminary Views document are available at <http://go.ifrs.org/FICE-Discussion-Papers>

- (b) other perpetual instruments and some derivative instruments that are indexed to, and settled with, the entity's basic ownership instruments; and
  - (c) a component of an instrument that has more than one outcome if one or more of those outcomes provides a return to the holder that has the same general profile as the return to the holder of a basic ownership instrument.
- 5.50 The REO approach would classify as equity:
- (a) basic ownership instruments; and
  - (b) instruments (or components of instruments) whose fair value changes in the same direction as, or in an opposite direction to, the fair value of a basic ownership instrument.
- 5.51 The FASB Preliminary Views document briefly discussed three other approaches:
- (a) a claims approach that does not distinguish liabilities from equity at all;
  - (b) a mezzanine approach that defines an additional element between liabilities and equity; and
  - (c) a loss absorption approach that classifies instruments (or components of instruments) as equity if the instrument's claim on net assets is reduced when the entity incurs a loss.
- 5.52 After reviewing responses to the FASB's Preliminary Views document and the IASB's Discussion Paper, both the IASB and the FASB decided not to pursue the ownership-settlement, REO, claims, mezzanine or loss absorption approaches. Reasons included complexity, lack of understandability and inconsistency with the conceptual definition of a liability. Accordingly, this Discussion Paper does not analyse these approaches.

### **Applying the concepts in Standards**

- 5.53 As noted above, IAS 32, IFRS 2 and some related Interpretations provide the criteria for classifying instruments as financial liabilities or as equity instruments. If the IASB wishes at some future date to consider changing those criteria, the IASB would need to go through its normal due process for adding a project to its agenda, and for developing an Exposure Draft and then an amendment to IFRSs.
- 5.54 In deciding in particular Standards how to distinguish liabilities from equity instruments, the IASB might need to address some other questions not addressed in this Discussion Paper, including:
- (a) whether and when to separate single instruments into two or more components, for example:
    - (i) whether to separate compound instruments into a liability component and an equity component, as IAS 32 requires in some cases.

- (ii) whether to separate some derivatives on an entity's own shares into separate components in some cases when that would produce a different result. For example, a forward contract can be viewed as a combination of a purchased option and a written option. The forward contract might be viewed as creating an obligation to settle that does not exist in the case of the purchased option.
  - (iii) whether puttable shares should be separated into an equity host and an embedded put option. Such a separation might be one way to seek consistency between the treatments of puttable shares and stand-alone written put options. (IAS 32 achieves consistency in a different manner, by requiring a gross presentation for written put options, both free-standing and embedded.)
- (b) similarly, whether to link two or more separate instruments into a single instrument for accounting purposes.
  - (c) whether some obligations within a subsidiary would be reclassified from liability to equity, or vice versa, on consolidation. For example, if an entity has an obligation to transfer economic resources only on liquidation, that obligation would not be a liability of that entity. However, in some circumstances, it might be appropriate to treat it as a liability of the group in the consolidated financial statements of the entity's parent, particularly if liquidation of the entity might occur before liquidation of the parent.
  - (d) whether any specific guidance is needed on contractual terms that have no commercial substance, for example an option that is deeply in the money or deeply out of the money, with no genuine possibility that this will change before expiry. Paragraphs 3.98–3.108 include a discussion of contractual options that lack commercial substance.
  - (e) three questions on which Appendix F provides more background:
    - (i) how to measure the rights and obligations that arise under a written put option on an entity's own shares;
    - (ii) whether changes in liabilities arising under a written put option result in income or expense, or in a distribution of equity or contribution to equity; and
    - (iii) how to measure the rights and obligations that arise under a written put option on NCI, and where to present changes in the measures of those rights and obligations.

### **Puttable instruments**

- 5.55 IAS 32 requires an entity to classify some puttable instruments as equity instruments, even though they create an obligation to transfer assets, and thus meet the definition of a financial liability. To summarise some complex and detailed requirements, this applies to financial instruments that:

- (a) give the holders a pro rata residual interest in the entity's net assets, after deducting all its liabilities; but also
- (b) oblige the entity to deliver cash or other assets to the holders on liquidation, or on early redemption at an amount broadly equivalent to that pro rata share.

Examples of entities that issue such instruments are some co-operative and mutual organisations.

5.56 The Basis for Conclusions on IAS 32 identifies the following concerns that would have arisen from classifying these puttable instruments as liabilities:

- (a) on an ongoing basis, the liability would be recognised at not less than the amount payable on demand. This could result in the entire market capitalisation of the entity being recognised as a liability, depending on the basis for calculating the redemption value of the financial instrument.
- (b) changes in the carrying amount of the liability would be recognised in profit or loss. This would result in counterintuitive accounting (if the redemption value is linked to the performance of the entity) because:
  - (i) when an entity performs well, the present value of the settlement amount of the liabilities increases, and a loss would be recognised; and
  - (ii) when the entity performs poorly, the present value of the settlement amount of the liability decreases, and a gain would be recognised.
- (c) it is possible, again depending on the basis for calculating the redemption value, that the entity would report negative net assets because of unrecognised intangible assets and goodwill, and because the measurement of recognised assets and liabilities may not be at fair value.
- (d) the statement of financial position would portray the entity as wholly, or mostly, debt-funded.
- (e) distributions of profits to shareholders would be recognised as expenses. Hence, it may appear that profit or loss is a function of the distribution policy, not of performance.

5.57 The exception in IAS 32 treats some puttable instruments as if they were equity instruments. The existing *Conceptual Framework* provides no basis for that exception. In the IASB's preliminary view, its reasons given in paragraph 5.56 for creating that exception are still valid and the *Conceptual Framework* should provide a concept that underlies the exception. To reflect that suggestion, the revised *Conceptual Framework* should indicate that an entity should treat some obligations that oblige the issuer to deliver economic resources as if they were equity instruments. One consequence would be that changes in the carrying amount of those obligations would not be recognised in profit or loss. Arguably, this treatment might be appropriate if the obligations are the most subordinated (lowest ranking) class of instruments issued by an entity (such as some co-operatives or mutuals) that would otherwise report no equity. In such

cases, no other class of instrument has a residual interest in the entity's assets less other liabilities. Thus, payments to holders of the most subordinated class of instruments might be regarded as akin to distributions of equity.

5.58 Identifying whether to use such an approach, and if so, when, would continue to be a decision that the IASB would make when developing or revising particular Standards. For example, the following topics might require analysis if the IASB were to undertake a project to amend IAS 32, IFRS 2 or another Standard:

- (a) whether an obligation could be treated as if it were an equity claim if it would arise only on the liquidation of a subsidiary of the reporting entity; and
- (b) whether some or all of these puttable instruments should be separated into an embedded put option (for which a liability would be recognised) and a host equity instrument.

5.59 The most subordinated class of instruments issued by an entity might qualify as equity instruments under the narrow equity approach mentioned in paragraph 5.30. Thus, the narrow equity approach might make it unnecessary to create an exception for puttable instruments in that class. In contrast, without such an exception, the strict obligation approach would not treat these instruments as equity.



## Questions for respondents

### Question 10

The definition of equity, the measurement and presentation of different classes of equity, and how to distinguish liabilities from equity instruments are discussed in paragraphs 5.1–5.59. In the IASB’s preliminary view:

- (a) the *Conceptual Framework* should retain the existing definition of equity as the residual interest in the assets of the entity after deducting all its liabilities.
- (b) the *Conceptual Framework* should state that the IASB should use the definition of a liability to distinguish liabilities from equity instruments. Two consequences of this are:
  - (i) obligations to issue equity instruments are not liabilities; and
  - (ii) obligations that will arise only on liquidation of the reporting entity are not liabilities (see paragraph 3.89(a)).
- (c) an entity should:
  - (i) at the end of each reporting period update the measure of each class of equity claim. The IASB would determine when developing or revising particular Standards whether that measure would be a direct measure, or an allocation of total equity.
  - (ii) recognise updates to those measures in the statement of changes in equity as a transfer of wealth between classes of equity claim.
- (d) if an entity has issued no equity instruments, it may be appropriate to treat the most subordinated class of instruments as if it were an equity claim, with suitable disclosure. Identifying whether to use such an approach, and if so, when, would still be a decision for the IASB to take in developing or revising particular Standards.

Do you agree? Why or why not? If you do not agree, what changes do you suggest, and why?

## Section 6—Measurement

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- 6.1 The existing *Conceptual Framework* provides little guidance on measurement and when particular measurements should be used. This section describes guidance that could be included in a revised *Conceptual Framework* to assist the IASB when developing measurement requirements in new or revised Standards.
- 6.2 Financial statements include descriptions and amounts for items that fit the definitions of elements of financial statements and that meet the recognition criteria. ‘Measurement’, as the term is used in this Discussion Paper, is the process of determining the amounts to be included in the financial statements. The term ‘measures’ refers to the amounts presented or disclosed.
- 6.3 Many transactions are settled in cash or in short-term accounts receivable. An entity whose only activities involve such transactions has few measurement issues and would not be significantly affected by the possible measurement concepts discussed in this section. However, measurement decisions become more important if an entity engages in other, more complicated activities. This section:
- (a) describes how the objective of financial reporting and qualitative characteristics of useful financial information influence measurement requirements (see paragraphs 6.6–6.36);
  - (b) describes and discusses the following three categories of measurement:
    - (i) cost-based measurements (see paragraphs 6.38–6.44);
    - (ii) current market prices including fair value (see paragraphs 6.45–6.50); and
    - (iii) other cash-flow-based measurements (see paragraphs 6.51–6.54).
  - (c) discusses how to identify an appropriate measurement (see paragraphs 6.55–6.109); and
  - (d) describes other cash-flow-based measurements in more detail. These are measurements other than estimates of current prices (see paragraphs 6.110–6.130).
- 6.4 This section does not specifically discuss the measurement of equity instruments issued, although the factors considered in the discussion of initial measurement (see paragraphs 6.58–6.72) would be applicable to the initial measurement of equity instruments. The subsequent updating of measures of equity instruments is discussed in Section 5.
- 6.5 The IASB believes that the issues that are associated with the equity method of accounting and the translation of amounts denominated in foreign currency would be best dealt with when revising Standards on these topics. Consequently, this Discussion Paper does not discuss these topics.

## How the objective of financial reporting and qualitative characteristics of useful financial information influence measurement

### Objective of measurement

- 6.6 The foundation of the *Conceptual Framework* is the objective of financial reporting. That objective, and the fundamental qualitative characteristics of useful financial information, which build on that objective, provides the basis for measurement concepts.
- 6.7 The objective of financial reporting 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.<sup>48</sup>
- 6.8 Financial information that is useful in making those decisions includes information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.<sup>49</sup>
- 6.9 In addition, if financial information is to be useful, it must be relevant and must faithfully represent what it purports to represent.<sup>50</sup> Those two characteristics—relevance and faithful representation—are the fundamental qualitative characteristics of useful financial information.
- 6.10 Applying the objective of financial reporting to measurement, the IASB's preliminary view is that the objective of measurement is to contribute to the faithful representation of relevant information about the resources of the entity, claims against the entity and changes in resources and claims, and about how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.

### Relevance

- 6.11 The IASB could decide to measure all assets and liabilities on the same basis. For example, the IASB could decide:
- (a) to measure all assets and liabilities at a current market price such as fair value. For assets that are not sold, the income or expense arising from the entity's operations would indicate whether management has used resources more or less efficiently and effectively than was implied by market prices; or
  - (b) to measure all assets and liabilities at cost-based amounts. If assets are sold (rather than consumed) or liabilities are transferred (rather than settled), the effects of the decision to sell or transfer would be apparent when the entity accounts for the sale or transfer. Similar assets and similar liabilities would be carried at different amounts if their acquisition costs are different.

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48 See paragraph OB2 of the existing *Conceptual Framework*.

49 See paragraph OB4 of the existing *Conceptual Framework*.

50 See paragraph QC4 of the existing *Conceptual Framework*.

- 6.12 Measuring all assets and liabilities on the same basis would result in all amounts in the financial statements having the same meaning, which would make totals and subtotals more understandable than those in financial statements prepared under existing requirements. For example, under existing requirements, the amount presented as total net assets has little meaning because it is an aggregation of items measured using various different measurements.
- 6.13 However, there are problems with this approach:
- (a) measuring all assets and liabilities on a cost basis may not provide relevant information to users of financial statements. For example, a cost-based measurement is unlikely to provide relevant information about a financial asset that is a derivative.
  - (b) for some assets and liabilities, some users of financial statements may consider information about current market prices to be less relevant than information about margins generated by past transactions. For example, some users find cost-based information about property, plant and equipment that is used in operations to be more relevant than information about its current market price. In addition, estimating current market prices when they cannot be obtained directly can be costly and subjective. Consequently, measuring all assets and liabilities at a current market price may not provide users of financial statements with sufficient benefits to justify the costs of determining (or estimating) those prices.
- 6.14 Because of these problems, the IASB's preliminary view is that the *Conceptual Framework* should not recommend measuring all assets and liabilities on the same basis.
- 6.15 Measurement affects both the statement of financial position and the statement(s) of profit or loss and other comprehensive income (OCI). Both those statements need to provide relevant information for users of financial statements. Selecting measurements by considering either the statement of financial position alone or the statement(s) of profit or loss and OCI alone will not usually produce the most relevant information for users of financial statements.
- 6.16 The IASB believes that the relevance of a particular measurement will depend on how investors, creditors and other lenders are likely to assess how an asset or a liability of that type will contribute to the entity's future cash flows. For example:
- (a) some assets contribute directly to cash flows (for example, by being sold). For an asset of this type, users of financial statements are likely to use information about the asset's current market price to assess its contribution to future cash flows.
  - (b) some assets do not generate cash flows directly or are used in combination with other assets (for example, property, plant and equipment). Information about current market prices may not provide users of financial statements with relevant information about such assets (particularly if the asset has no alternative use). Instead, users of

financial statements will often assess how such assets will contribute to future cash flows by using cost-based information about transactions and the consumption of assets to identify past margins and estimate future margins. Changes in the market price of those assets that happen to be held at the end of a reporting period may not be particularly relevant for this purpose.

- (c) for some types of liability, current market prices will provide the best indication of how that liability will reduce future cash inflows. For other types of liability, current market prices may not provide the best indication of the ultimate cash outflows arising from the liability. For example, the carrying amount of a non-derivative liability with fixed cash flows varies even though the expected cash flows do not and this may obscure information about contractual interest flows. In addition, when a liability is measured at current market prices, the resulting gains and losses may make it difficult for users of financial statements to assess the liability's effect on future cash flows (unless those gains and losses are disaggregated in an understandable way).

6.17 Because the way that an asset or a liability will contribute to future cash flows affects the way that users of financial statements assess the prospects for future net cash inflows to the entity, the IASB's preliminary view is that the selection of a measurement:

- (a) for a particular asset should depend on how it contributes to future cash flows; and
- (b) for a particular liability should depend on how the entity will settle or fulfil that liability.

6.18 Paragraphs 6.73–6.109 discuss the different ways in which:

- (a) assets contribute to future cash flows; and
- (b) liabilities are settled or fulfilled.

6.19 For some financial assets and financial liabilities (for example, derivatives), basing measurement on the way in which the asset contributes to future cash flows, or the way in which the liability is settled or fulfilled, may not provide information that is useful when assessing prospects for future cash flows. For example, this may be the case:

- (a) if the ultimate cash flows are not closely linked to the original cost;
- (b) if, because of significant variability in contractual cash flows, cost-based measurement techniques may not work because they would be unable to simply allocate interest payments over the life of such financial assets or financial liabilities; or
- (c) if changes in market factors have a disproportionate effect on the value of the asset or the liability (ie the asset or the liability is highly leveraged).

Consequently, current market prices are likely to be the most relevant measure for assets and liabilities of this type.

**Faithful representation**

- 6.20 The fundamental qualitative characteristic of faithful representation has fewer implications for measurement than relevance does. However, faithful representation does have some implications.
- 6.21 A perfectly faithful representation is free from error. However, this does not mean that measurements must be perfectly accurate in all respects. An estimate of an unobservable price can be faithfully represented if it is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained and no errors have been made in selecting and applying an appropriate process for developing the estimate.<sup>51</sup>
- 6.22 When deciding whether a particular measurement faithfully represents an entity's financial position and performance, the IASB may need to consider how best to portray any link between items. When assets and liabilities are related in some way, using different measurements for those assets and liabilities can create a measurement inconsistency (sometimes called an 'accounting mismatch'). Measurement inconsistencies can result in financial statements that do not faithfully represent the reporting entity's financial position and performance. Consequently, the IASB may conclude in some circumstances that requiring (or permitting) the same measurement approach for related assets or liabilities may provide more useful information for users of financial statements than using different measurement approaches. This may be particularly likely when the cash flows from one item are contractually linked to the cash flows from another item.

**Enhancing characteristics***Understandability*

- 6.23 The enhancing qualitative characteristic of understandability (see paragraphs QC30–QC32 of the existing *Conceptual Framework*) also has an important implication for setting measurement requirements. Users of financial statements need to be able to understand the measurements used. The more measurements that are used, and the more changes there are in the types of measurement used for particular items, the harder it is to understand how those measurements interact to depict the entity's financial position and financial performance. Consequently, the IASB's preliminary view is that it should limit the number of different measures used to the smallest number necessary to provide relevant information.
- 6.24 The IASB believes that it should also avoid unnecessary changes in the types of measurement used for a particular item and require clear explanations of the reasons for necessary changes, and the effects of those changes. That means that the subsequent measurement should be the same as, or at least consistent with, the initial measurement. To do otherwise would result in recognising income or expense that does not depict transactions or changes in economic conditions. Similarly, optional changes in measurements should be avoided because

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<sup>51</sup> See paragraph QC15 of the existing *Conceptual Framework*.

otherwise entities could manage earnings by choosing to change measurement at an opportune time to recognise a gain or loss.

- 6.25 Avoiding measurement changes would not preclude:
- (a) cost-based measurements such as depreciated cost with adjustments for impairments. Impairment adjustments result from economic changes, rather than from changes in the measurement approach, and therefore provide relevant information that is understandable and can faithfully represent those economic changes.
  - (b) changing measurement requirements to improve the relevance of the information presented. However, the effects of any such changes would need to be transparent.

*Other enhancing characteristics*

- 6.26 In addition to understandability, there are three enhancing characteristics that make financial information useful—timeliness, verifiability and comparability—and the IASB needs to consider each of them when establishing measurement requirements.
- 6.27 Timeliness means providing information while it still has the potential to be useful. Timeliness has no specific implication for measurement that is not already embodied in the fundamental characteristic of relevance. If changes in prices or value are relevant, the measurement used should result in recognising them when they occur (rather than at some point in the future).
- 6.28 Verifiability implies using measurements that can be independently corroborated either directly (such as by observing prices in transactions in which the entity participated or can observe) or indirectly (such as by checking inputs to a model). If a particular measurement cannot be verified, the IASB believes that it should consider using a different measurement, or requiring disclosures that enable users of financial statements to understand the assumptions used.
- 6.29 Comparability implies using measurements that are the same between periods and between entities. Using the smallest number of measurements, as discussed in the context of understandability in paragraphs 6.23–6.25, would contribute to comparability.

**Cost constraint**

- 6.30 The cost constraint described in paragraph QC35 of the existing *Conceptual Framework* should also influence the IASB’s decisions about measurement requirements. Cost depends greatly on the availability of information. Many measurements are estimates, and the information needed for inputs to those estimates may not be freely available. Costs will be incurred in gathering, processing and verifying the information. In general, the costs associated with a particular measurement increase as the subjectivity associated with the measurement increases.
- 6.31 At the same time, even if a measurement is potentially the most relevant, the benefit to users of financial statements declines as it becomes more subjective (and thus more costly to produce). Unfortunately, a measurement with no

subjectivity may not be relevant. For example, a current market price is clearly the most relevant measure for a derivative instrument with no fixed cash flows or an asset that is certain to be sold without significant selling effort. However, if the current market price is unknown and if little or no market information is available about the factors affecting the cash flows of the derivative instrument, any estimate of the current market price would be highly subjective and uncertain.

- 6.32 In such a case, the cost of the estimate is likely to be high and the benefit (relevance) may be low. The cost of a different measure, for example, the original transaction price to acquire the derivative mentioned in the previous paragraph, may be very low and the amount may be certain. However, its benefit (relevance) is zero or nearly zero because the cost provides little or no information about the ultimate cash flow.
- 6.33 Where this is the case, the IASB believes that it will need to balance the costs of providing the most relevant available information (in the example of a derivative in paragraph 6.31: an estimate of a market price) with the benefit to users of financial statements (which, if the estimate is very subjective, may not be great). The IASB also believes that it should consider different measurement when the relevance of a particular measurement is too low or its cost is too high.
- 6.34 Some argue that when the subjectivity of a particular measurement is very high, the measurement cannot be a faithful representation of the item it depicts. However, a highly uncertain estimate will be faithfully represented if it is properly described (for example, not as a market price but as a highly uncertain estimate of a market price). Thus the factors that the IASB will need to consider for a highly uncertain measurement are:
- (a) whether that measurement is relevant; and
  - (b) if that measurement is relevant, how best to disclose information about that measure.

Section 4 covers situations when the IASB might decide that an entity need not or should not recognise an asset or a liability because no measure of the asset or the liability would result in a sufficiently faithful representation of the asset or the liability and of changes in the asset or the liability, even if all necessary descriptions and explanations are disclosed.

### Summary

- 6.35 Consideration of the objective of financial reporting, and of the qualitative characteristics of useful financial information, has led the IASB to the following preliminary views about measurement:
- (a) the objective of measurement is to contribute to the faithful representation of relevant information about the resources of the entity, claims against the entity and changes in resources and claims, and about how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.
  - (b) a single measurement basis for all assets and liabilities may not provide the most relevant information for users of financial statements.



- (c) when selecting the measurement to use for a particular item, the IASB should consider what information that measurement will produce in both the statement of financial position and the statement(s) of profit or loss and OCI.
- (d) the selection of a measurement:
  - (i) for a particular asset should depend on how that asset contributes to future cash flows; and
  - (ii) for a particular liability should depend on how the entity will settle or fulfil that liability.
- (e) the number of different measurements used should be the smallest number necessary to provide relevant information. Unnecessary measurement changes should be avoided and necessary measurement changes should be explained.
- (f) the benefits of a particular measurement to users of financial statements need to be sufficient to justify the cost.

6.36 The rest of this section covers:

- (a) measurement categories (see paragraphs 6.37–6.54);
- (b) how to identify an appropriate measurement (see paragraphs 6.55–6.109); and
- (c) cash-flow-based measurements other than estimates of current prices (see paragraphs 6.110–6.130).

### **Measurement categories**

6.37 This Discussion Paper groups measurements into three categories:

- (a) cost-based measurements (see paragraphs 6.38–6.44);
- (b) current market prices including fair value (see paragraphs 6.45–6.50); and
- (c) other cash-flow-based measurements (see paragraphs 6.51–6.54).

### **Cost-based measurements**

6.38 The definition of cost in IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets* and IAS 40 *Investment Property* is:

the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction ...

If there was an analogous definition for a liability, it would refer to cash or cash equivalents received or the fair value of other consideration received at the time that a liability is incurred.

6.39 IAS 2 *Inventories* states that cost includes costs of purchase, costs of conversion and all other costs incurred in bringing inventories to their present location and condition. IAS 16 also specifies what is to be included in cost.

- 6.40 The initial measures at cost of assets and liabilities are adjusted over time in a variety of ways. The most common reasons are:
- (a) depreciation or amortisation;
  - (b) accrual of interest, accretion of discount, or amortisation of premium; and
  - (c) impairment of assets or increases to the carrying amount of liabilities that have become more onerous.

- 6.41 Cost-based measurements could also be adjusted to reflect price changes, for example:

- (a) cost could be adjusted to reflect general price changes. This may be particularly relevant for entities that operate in high-inflation economies and this adjustment is used in IAS 29 *Financial Reporting in Hyperinflationary Economies*.
- (b) cost could be adjusted to reflect specific price changes. This would result in assets and liabilities being measured at their replacement cost. Some users of financial statements believe that margins that can be derived from using replacement cost are more relevant than margins derived from historic cost.

Adjusting cost to reflect either general price changes or specific price changes is required by some concepts of capital maintenance. As explained in Section 9, this Discussion Paper does not explore possible implications of using these concepts of capital maintenance.

- 6.42 Some have argued that current cost-based measurements can provide more relevant information than measurements that are based on historical cost. For example, a measurement known as deprival value (also called 'value to the business') represents the loss that an entity would suffer if it were deprived of the asset being measured. Deprival value is the lower of:

- (a) the amount the entity would need to pay to replace the asset; and
- (b) the asset's recoverable amount, which is the higher of:
  - (i) the asset's fair value less costs to sell; and
  - (ii) its value in use. Value in use is the future net cash flows from the entity's continued use and ultimate disposal of the asset, discounted at the rate that market participants would use when pricing assets with similar risk.

In many situations, the deprival value of an asset will equal its replacement cost.

- 6.43 However, the incremental cost of using a measurement such as deprival value in the statement of financial position and statement(s) of profit or loss and OCI might not be justified by any additional benefit because:

- (a) determining either the replacement cost or the fair value less costs to sell may be costly and subjective.

- (b) determining value in use could be very subjective and require many internal assumptions that could be difficult to justify. (However, this criticism could also be made of the impairment models used in measurements based on historical cost.)
- (c) some individual assets do not generate separate cash flows. Consequently, to determine value in use, such assets would have to be measured in groups and the carrying amount attributable to acquisitions and disposals could be difficult to determine. (Again, this criticism could also be made of the impairment models used in measurements based on historical cost.)

6.44 The term ‘cost-based measurements’ is used in this Discussion Paper to refer to amortised cost as used for some financial assets and financial liabilities, cost less accumulated depreciation as used for many physical assets, and other measurements commonly referred to as cost or historic cost. However, amortised cost measurement used for financial assets and financial liabilities could equally well be described as a cash-flow-based measurement because it involves updated estimates of cash flows that are discounted using a locked-in discount rate.

### **Current market prices including fair value**

6.45 Fair value is the most frequently used current value measurement in existing IFRSs. IFRS 13 *Fair Value Measurement* defines fair value as the “price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date”.

6.46 The phrase ‘orderly transaction’ implies that neither participant is desperate or otherwise has an unusually weak bargaining position through being forced to sell or buy quickly because of financial distress or other factors.

6.47 Paragraph B13 of IFRS 13 states that:

... A fair value measurement of an asset or a liability using a present value technique captures all the following elements from the perspective of market participants at the measurement date:

- (a) an estimate of future cash flows for the asset or liability being measured.
- (b) expectations about possible variations in the amount and timing of the cash flows representing the uncertainty inherent in the cash flows.
- (c) the time value of money, represented by the rate on risk-free monetary assets that have maturity dates or durations that coincide with the period covered by the cash flows and pose neither uncertainty in timing nor risk of default to the holder (ie a risk-free interest rate).
- (d) the price for bearing the uncertainty inherent in the cash flows (ie a risk premium).
- (e) other factors that market participants would take into account in the circumstances.
- (f) for a liability, the non-performance risk relating to that liability, including the entity’s (ie the obligor’s) own credit risk.

6.48 The factors listed in paragraph 6.47 are reflected in all current market prices. However, current market prices are often not directly observable and need to be estimated using inputs such as those described in paragraph 6.47. In deciding whether to require an estimate of a current market price, the IASB will need to consider:

- (a) whether that measure will result in information that is relevant to users of financial statements;
- (b) what disclosures should be provided to ensure that the information is faithfully represented; and
- (c) whether the costs associated with providing that information are justified by the benefits to users of financial statements.

6.49 Fair value is defined in IFRS 13 as an exit price. Market prices other than fair value can be derived if different markets are specified. This might arise if an asset was acquired in one market and will be sold in another market. For some items that have entry markets that are different from their exit markets, the IASB might consider using an entry price (ie the current market buying price that an entity would pay to acquire an asset, or the current price it would receive to assume or incur a liability), rather than an exit price.

6.50 An exit price is likely to be most relevant when an asset is held for sale because the exit price will reflect the likely proceeds from the sale. In contrast, use of an entry price (for example, replacement cost) might provide more relevant information when:

- (a) assets are held for use rather than for sale; or
- (b) exit prices are unavailable or do not reflect orderly transactions between willing buyers and sellers.

Some existing Standards also use fair value less cost to sell for impairment adjustments or fair value plus transaction costs for initial measurement of assets (minus transaction costs for initial measurement of liabilities).

#### **Other cash-flow-based measurements**

6.51 A few measurements used in existing IFRSs are neither current market prices nor cost-based, but are based on estimates of future cash flows. These other measurements are used now for:

- (a) impairment of financial assets, lease receivables and lease liabilities carried at amortised cost;
- (b) impairment of non-financial assets;
- (c) net realisable value of inventories;
- (d) provisions (liabilities of uncertain timing or amount);
- (e) liabilities for post-employment benefits; and
- (f) deferred tax assets and liabilities.

These measurements are specified in the individual Standards that require them. In addition, the Exposure Draft on *Insurance Contracts* proposes a cash flow-based measurement that is not a current price.

- 6.52 Cash-flow-based measurements are used when:
- (a) cost or a current market price does not provide sufficiently relevant information;
  - (b) there is no cost or proceeds for the item being measured; or
  - (c) a current market price is too difficult or too costly to obtain.
- 6.53 As discussed in paragraph 6.23, limiting the number of measurements that are used makes financial statements more understandable. That would imply not creating new cash-flow-based measurements and reducing the number of existing measurements if possible.
- 6.54 The factors that go into constructing other cash-flow-based measurements are described and discussed in paragraphs 6.110–6.130.

### **Identifying an appropriate measurement**

- 6.55 The following paragraphs set out guidance on how to identify an appropriate measurement. The IASB believes that it should incorporate this guidance in a revised *Conceptual Framework*. The discussion is organised as follows:
- (a) initial measurement (see paragraphs 6.58–6.72);
  - (b) subsequent measurement of assets (see paragraphs 6.73–6.96); and
  - (c) subsequent measurement of liabilities (see paragraphs 6.97–6.109).
- 6.56 Financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. If this assumption becomes inappropriate, a change may occur in how an asset is likely to contribute to future cash flows or how a liability is likely to be fulfilled. Hence, the most relevant measurement for a particular asset or liability may be different for entities that are not a going concern. Section 9 includes a further discussion of the going concern concept.
- 6.57 All assets are capable of contributing in some way to future net inflows of cash or other economic resources, and all liabilities are capable of requiring future net outflows of cash, services or other economic resources. For simplicity in terminology, the remainder of this section refers to future cash flows even though in some cases the flows of value will be in a form other than cash.

### **Initial measurement**

- 6.58 Assets and liabilities are measured initially using one of the following three measurements identified in paragraph 6.37:
- (a) cost-based measurements;
  - (b) current market prices (including fair value); or
  - (c) other cash-flow-based measurements.

- 6.59 IFRS sometimes requires measurements that are based on a deemed cost. IFRS 1 *First-time Adoption of International Financial Reporting Standards* defines deemed cost as an amount used as a surrogate for cost or depreciated cost at a given date. Deemed cost might be used if:
- (a) no consideration is given or if the fair value of the consideration given differs from the fair value of the asset acquired.
  - (b) an entity issues its own equity instruments to acquire an asset that will not be subsequently measured at fair value.
  - (c) an asset is transferred into a category that requires a cost-based measurement from a category that requires another measurement, for example:
    - (i) if a financial asset is reclassified in accordance with IFRS 9 *Financial Instruments* because of a change in the business model (the fair value on the date of the reclassification is deemed to be the instrument's amortised cost); or
    - (ii) if agricultural produce is harvested (prior to harvest, IAS 41 *Agriculture* requires measurement at fair value less costs to sell; at harvest, that amount is deemed to be cost for the purpose of applying IAS 2).
  - (d) determining cost is unduly onerous or impracticable, for example, in some situations when IFRS 1 permits an entity to use another amount as deemed cost.
  - (e) hedge accounting is used and the carrying amount of an asset has been adjusted for changes in value due to the hedged risk.
- 6.60 Assets and liabilities may be recognised initially as a result of:
- (a) exchanges of items with equal value (see paragraphs 6.61–6.64);
  - (b) exchanges of items with different values (see paragraphs 6.65–6.67);
  - (c) non-exchange transactions (see paragraphs 6.68–6.70); or
  - (d) internal construction (see paragraphs 6.71–6.72).

*Exchanges of items with equal value*

- 6.61 For assets recognised as a result of exchanges of items with equal value, initial measurement issues are rarely significant.
- 6.62 In an exchange transaction:
- (a) an asset is acquired in exchange for cash or another asset, or for an obligation to pay cash or another asset;
  - (b) services are acquired in exchange for cash or another asset, or for an obligation to pay cash or another asset; or
  - (c) a liability or equity instrument is issued in exchange for cash or another asset, or for a right to receive cash or another asset.

- 6.63 If an exchange transaction is negotiated by unrelated parties and neither party is in financial distress or otherwise under duress, the consideration given and received can normally be considered to be of equal value. In those cases, the initial measure of an asset or a liability could be described as cost or as fair value because the two are the same. The most understandable way to label it would be to match the label used for the subsequent measure. If the subsequent measure will be fair value, describing the initial measure as cost could be confusing, and the reverse could also be true.
- 6.64 However, the cost or proceeds of an asset or a liability determined according to the fair value of the consideration given or received can differ from its fair value at the recognition date in the following circumstances:
- (a) situations identified by paragraph B4 of IFRS 13:
    - (i) if the transaction is between related parties;
    - (ii) if the transaction takes place under duress or the seller is forced to accept the price in the transaction, for example, because of financial difficulty;
    - (iii) if the unit of account for the transaction and for determining the fair value differ (for example, this might occur if the price for acquiring a group of assets differs from the sum of the prices of the individual assets); or
    - (iv) if the transaction takes place in a market other than the principal or most advantageous market.
  - (b) if a Standard requires cost to include amounts not included in fair value, for example, transaction costs, or to exclude amounts included in fair value.
  - (c) if an asset is constructed internally, in which case the accumulated cost will equal fair value only by coincidence.

*Exchanges of items with different values*

- 6.65 Occasionally, two items of different value are exchanged, presumably because the transaction price is affected by other relationships between the parties or by financial distress or other duress of one of the parties (as noted in paragraph 6.64(a)(i)–(ii)).
- 6.66 Applying the definition of cost in paragraph 6.38, the ‘cost’ of the asset acquired, or the proceeds from incurring the liability, could be considered equal to the fair value of the consideration given or received. However, there are problems with that approach:
- (a) it could result in a failure to recognise an economic loss or gain (for example, an impairment loss or a gain arising from a bargain purchase). In addition, if an asset were initially measured at more than its recoverable amount, an impairment loss would arise at the next measurement date. Similarly, if a liability were measured initially at less than the present value of the resulting cash flows, a loss would arise at the next measurement date. That could mislead users of financial

statements by making it appear that the loss occurred after the transaction instead of as a result of the transaction.

- (b) it could result in a failure to recognise an unstated aspect of the transaction (for example, an obligation to provide services, a contribution to equity or distribution of equity, or a payment for past services).

6.67 Consequently, rather than measuring assets or liabilities arising in an unequal exchange at the fair value of the consideration given or received, an entity could:

- (a) measure the asset acquired or the liability incurred at fair value, and recognise the difference as follows:
  - (i) if the transaction is with equity investors acting in their capacity as investors (or other entities within a consolidated group), recognise a contribution to equity or distribution of equity.
  - (ii) if unstated aspects of the transaction can be identified, account for them. Identifying unstated aspects of a transaction (or verifying that there are no other aspects) may be difficult.
  - (iii) in other cases recognise a gain or loss on the transaction. This approach is counter to the traditional notion that there should be no 'Day 1' gains or losses on acquired assets or incurred liabilities. Apparent gains or losses on exchanges that involve unequal consideration are unusual. However, they can occur if one party is under duress and is desperate to transact. If that happens, a real gain or loss has occurred and reporting it may provide relevant information.
- (b) If the consideration given or received is an entity's own equity instrument, measure that equity instrument at the fair value of the asset received or given, or the fair value of the liability extinguished or incurred. This is consistent with the idea that gains or losses do not arise on an entity's own equity instruments.

#### *Non-exchange transactions*

6.68 Assets and liabilities may be recognised as a result of non-exchange transactions, for example:

- (a) an asset may be acquired or a liability incurred for no consideration (such as an unconditional gift or grant); or
- (b) an asset or a liability may arise from an event other than a transaction (for example, a lawsuit).

6.69 If an entity acquires an asset or incurs a liability for either of the two reasons in paragraph 6.68, the item could be measured at zero, which is indistinguishable from non-recognition. IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* permits that in some cases. However, measuring the item at zero may not provide relevant information. As discussed in paragraph 6.24, unnecessary changes in measurement should be avoided. This suggests that the initial measurement basis should be the same as the subsequent measurement



basis. (However, this does not rule out using a current market price such as fair value, or another cash-flow-based measurement, to establish deemed cost if the subsequent measurement is cost-based.)

- 6.70 Deferred tax assets and liabilities and a few other assets and liabilities recognised because of events other than exchanges of equal consideration are measured using cash-flow-based estimates other than estimates of current market prices. Those measures are discussed in more detail in paragraphs 6.110–6.130.

*Internally constructed assets*

- 6.71 The discussion of understandability in paragraphs 6.23–6.25 suggests that an entity should measure an internally constructed asset (an asset constructed by the entity itself) at completion on the same basis as should be used for subsequent measurement. In other words:

- (a) at cost, if the subsequent measure of the asset will be based on cost. In this case, a current market selling price should not be used as deemed cost. (If the completed asset were measured at completion at a current market price, the entity would normally recognise a gain when it completes the asset, and that gain would, in effect, reverse subsequently as the entity depreciates the asset.)
- (b) at a current market price if the subsequent measure of the asset will be a current market price.
- (c) using another cash-flow-based measurement, if the asset will be measured on that basis.

- 6.72 The alternative view would be that a completed asset is different from an asset under construction. Measuring the asset on its completion date at the price for which it could have been acquired (or sold) would provide information about the efficiency with which the asset was constructed. However, determining that price may not be easy for unique or other custom-made assets. Consequently, this approach may not be possible for many internally constructed assets.

**Subsequent measurement of assets**

- 6.73 As stated in paragraph 6.16, the relevance of a particular measurement will depend on how investors, creditors and other lenders are likely to assess how an asset of that type will contribute to the entity’s future cash flows. Consequently, the IASB’s preliminary view is that the measurement used for a particular asset should depend on how it contributes to future cash flows.

- 6.74 Four general ways in which an asset contributes to future cash flows are:
- (a) using it in business operations to generate revenues or income (see paragraphs 6.78–6.82);
  - (b) selling it (see paragraphs 6.83–6.85);
  - (c) holding it for collection according to terms (see paragraphs 6.86–6.90); and
  - (d) charging others for rights to use it (see paragraphs 6.91–6.96).

- 6.75 The way an asset will ultimately contribute to cash flows will often not be certain. For most assets there are choices, and choices may change. The IASB has to decide how to deal with that uncertainty. Some alternatives are:
- (a) measure based on how the value of the asset is likely to be realised as indicated by current activities (business model), plans, strategies, declared intent or past practices. That measure is most likely to indicate the actual cash flows, but it allows for measuring similar or identical assets differently, which some view as a disadvantage. This approach is closest to what IFRS currently requires.
  - (b) measure based on the most profitable means of contributing. This subsequently shows the cost or benefit of management's decision to depart from the optimal contribution method but could lead users of financial statements to expect cash flows that will not occur. Similar or identical assets would be measured the same way.
- 6.76 Another possible way of dealing with uncertainty about how an asset will contribute to future cash flows would be to provide more than one measure of the asset. This could be done by:
- (a) using one measure in the primary financial statements and disclosing another measure in the notes to the financial statements; or
  - (b) using one measure in the statement of financial position and using a different measure to determine the amounts recognised in profit or loss (presenting the difference between the two measures in OCI). This approach is discussed further in Section 8.
- 6.77 The IASB will decide how to deal with the uncertainty about how an asset will contribute to future cash flows when developing or revising particular Standards but, however the IASB deals with the uncertainty, it will need to consider how an asset will contribute to future cash flows. The following paragraphs discuss the different ways in which an asset can contribute to future cash flows.

#### *Using assets*

- 6.78 Some assets contribute indirectly to future cash flows by being used in:
- (a) purchasing, producing, marketing or delivering assets or services that the entity sells; or
  - (b) administration, treasury or any other function necessary to keep the entity operating.
- 6.79 Measuring at a current market price an asset that generates cash flows indirectly (for example, an asset used by the entity) does not necessarily provide the best information about the cash flows that the asset will generate. Gains and losses due to changes in asset price may not be relevant unless they indicate impairments or reversals of impairments. Prospects for future cash flows from assets used by the entity can be assessed using information about transactions, the consumption of assets, impairment of assets and the fulfilment of liabilities. For assets used by the entity, cost-based measurements normally result in income and expenses that are more relevant and understandable than income

and expenses generated by current market selling prices. In addition, cost-based measurements are simpler and often less expensive to provide than current measurements.<sup>52</sup>

- 6.80 Although inventories will be sold, they are similar to assets that are used in that they cannot generate cash flows independently of the other assets of the entity. Cost-based measurement is more relevant for inventories than for other types of assets that will be sold because:
- (a) unlike the sale of most commodities or financial instruments, the sale of inventories usually requires the seller to undertake significant activities to locate purchasers; and
  - (b) the assessment of prospects for future cash flows from recurring sales of inventories is usually based on expectations about future margins that are derived from cost-based information about past sales, cost of sales and other recurring components of profit or loss. The use of current market selling prices could obscure this information.
- 6.81 In addition, there are many difficulties in determining current market selling prices of inventory, such as determining appropriate units of account and deciding how to deal with transaction costs and obligations for associated services. Those make the benefits of current market selling prices more contentious and uncertain than for other types of assets.
- 6.82 However, there are criticisms of measurements based on historical cost:
- (a) recognition of impairment losses and recoveries tends to lag behind changes in capacity. If an asset's cash flow capacity greatly exceeds its carrying amount, capacity could decline materially before the carrying amount is no longer recoverable and an impairment loss is recognised.
  - (b) alternative depreciation methods are available, some of which track declines in the capacity to generate cash flows more closely than others.
  - (c) recognising impairment losses, but not recognising gains that arise when an asset's ability to generate cash flows increases, is not neutral.
  - (d) cost-based measurements ignore the fact that the entity may decide to sell an asset that has appreciated in value.

### *Selling assets*

- 6.83 An asset to be sold will produce direct cash flows, which in most cases implies that a current exit price (or perhaps a current exit price less costs to sell) is likely to be relevant. The cost of obtaining a current exit price would probably be justified, and in many cases would not be particularly high. Consequently, this Discussion Paper suggests that a current exit price is the most appropriate measure for assets that will be realised through sale, such as investments in

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<sup>52</sup> This Discussion Paper does not consider whether cost-based measurements should use the original cost or the current cost. In current IFRSs, cost-based measurements are generally based on original cost. As noted in Section 9, the IASB believes that issues relating to current costs, and to concepts of capital maintenance, are best discussed in the context of a possible future project to review the IASB's existing requirements on accounting for high inflation.

financial instruments (if not held for collection), traded commodities such as precious metals or grains, and physical assets, other than inventories, that will be sold.

- 6.84 Some have expressed the opinion that the costs of obtaining current market prices for investment properties that are being developed or being held for a long time do not justify the benefits. Current market prices require significant estimation effort and inputs from transactions involving property that may not be similar enough to the property in question. A cost-based measurement would be less expensive and less subjective.
- 6.85 However, for investment properties, cost has little or no relation to future cash flows, especially if the cash flows will not occur for many years. Properties are not homogeneous enough, and sales do not occur frequently enough, to permit using past trends in cash flows and profit or loss to assess future net cash flows. Consequently, current market prices for those assets, although subjective, will often provide more relevant information than cost-based information.

*Holding assets for collection according to terms*

- 6.86 The terms of many financial instruments require the issuer to make payments or to deliver other financial instruments. Although many, if not most, can be sold, an entity can hold them and collect the contractual cash flows.
- 6.87 Loans, bonds and other receivables that have interest-like returns and insignificant variability in contractual cash flows are often held for collection. The economics of those assets are significantly influenced by two factors—the effective yield and the collectability.
- 6.88 Users of financial statements can be expected to assess future prospects for yield by analysing management’s past success in originating or purchasing profitable loans or other receivables. Collectability (or the lack thereof) is always relevant. Cost based interest income, along with bad debt expense as estimated by management, is likely to provide relevant information about effective yield and collectability.
- 6.89 As discussed in paragraph 6.19, for some types of financial assets held for collection, cost-based measurements may not provide relevant information that can be used to assess the prospects for future cash flows. Consequently, current market prices are likely to provide the most relevant information. Assets of this type include:
- (a) net settled derivative instruments, and hybrid instruments that have significant variability in cash flows.
  - (b) derivative instruments, such as credit default swaps and similar instruments, which specify fixed cash flow amounts although it is not certain that the cash flows will occur.
  - (c) other instruments, such as forward contracts to buy or sell foreign currency, which involve an exchange of cash, but for which the ultimate gain or loss has significant variability.
- 6.90 Some derivative instruments (hedging instruments) are held in order to offset changes in fair value or cash flows of other assets, liabilities or forecast

transactions (the hedged item or transaction). Current market prices are appropriate for measuring the derivative instrument because users of financial statements need to assess the cash flows that will result from those derivative instruments. However, if the hedged item is not measured at a current market price, a measurement mismatch occurs, which results in gains or losses in profit or loss that are economically offset in whole or in part by other unrecognised gains or losses. The IASB may need to consider this measurement mismatch when deciding how to measure the hedged item, or how to present gains and losses on the hedging instrument, as discussed in Section 8.

*Charging for rights to use assets*

- 6.91 Holders of physical assets or intellectual property sometimes charge others for the right to use those assets. Some ways of generating such cash flows are leasing, renting, franchising and charging entry fees, parking, landing or docking fees, tolls or royalties.
- 6.92 In some situations, the holder (owner) of the physical asset or intellectual property will no longer recognise that asset in its financial statements and will instead recognise a financial asset and a residual asset. The financial asset is usually held for collection and the discussion in paragraphs 6.86–6.90 is relevant. How the residual asset will contribute to future cash flows will depend on whether ultimately it is sold, re-leased or held for use by the entity.
- 6.93 In situations where an entity continues to recognise the whole of the physical asset or intellectual property, the asset held is different from both financial assets held for collection and assets held for use. Cash flows from charge-for-use assets include both contractual cash flows arising from existing contracts and subsequent cash flows that may result from future contracts or from the ultimate sale of the asset. Current market prices of a charge-for-use asset reflect its ability to generate cash flow by charging for use over its whole economic life, under both existing contracts and possible future contracts.
- 6.94 For large groups of low value charge-for-use items, information about past income, expense and cash flows can be used to assess prospects for future cash flows. Consequently, cost-based information is likely to provide relevant information.
- 6.95 The relevance of information about current market prices is likely to increase as each individual asset owned by the entity becomes more significant to the whole entity (for example, land, buildings, parks, ships, aircraft and similar high-value items). Current market prices or information to use as inputs to a current market price estimate are often available for physical assets of this type. There are accepted techniques in many markets for appraisals of land, buildings and other high-value property for borrowing and insurance purposes. Those measures may not be a current market price, but they could provide input to current market price estimates.
- 6.96 Information about past income and expense and past cash flows from use charges is also useful. Measuring at a current market price does not hide that information if the changes in current market price are reported separately from the charge-for-use income and expense and cash flows.

**Subsequent measurement of liabilities**

- 6.97 In the same way as for assets, the nature of a liability and the way it will be settled are important in identifying the appropriate measurement for that liability.
- 6.98 Liabilities fall into two groups—those with stated terms and those without stated terms.
- 6.99 Liabilities without stated terms can arise from torts or violations of laws or regulations. Liabilities of this type require negotiation or judicial action to determine a settlement amount. For liabilities without stated terms, cost-based measurement is not possible (because the liability does not have a cost) and current market prices are likely to be difficult to determine. Consequently, a cash-flow-based measurement may be the only possible option for liabilities without stated terms. Cash-flow-based measurements are discussed in paragraphs 6.110–6.130.
- 6.100 Some types of contractual liabilities have stated terms but highly uncertain settlement amounts that have not yet been determined (for example, insurance contracts and post-employment benefits). For liabilities of this type, a cost-based measurement is unlikely to provide relevant information and current market prices may be difficult to determine. Consequently, a cash-flow-based measurement may also provide the most relevant information for liabilities of this type.
- 6.101 Liabilities with stated terms are those that come from contracts, statutes or regulations that state either a settlement amount or the method for determining the settlement amount. There are three ways in which an entity might settle a liability with stated terms:
- (a) by paying cash or delivering other assets according to the stated terms;
  - (b) by being released by the creditor on transferring the obligation to another party; or
  - (c) by performing services or paying others to perform services.

***Settling according to the stated terms***

- 6.102 It is likely that most liabilities have contractual terms that specify payments, and almost all of those are settled according to their terms. Few liabilities can be transferred to other entities in a ready market. A transfer normally requires negotiation with the counterparty and may not be a transaction between willing parties. In most such cases, the creditor has a superior bargaining position because the debtor has already agreed to the stated terms.
- 6.103 If a liability cannot be transferred, then measuring that liability at a current market price reflects, in comprehensive income, changes in market prices that cannot, in many cases, be realised and may reverse over the life of the liability. Consequently, these liabilities are viewed as analogous to assets held for collection, and a cost-based measurement will normally provide the most relevant information about liabilities that will be settled according to their terms.

- 6.104 However, some have argued that a current market price is the appropriate measure for at least some financial liabilities with specified terms because the effects of changes in market prices (especially the effects of changes in interest rates) offset the effects of changes in market prices of financial assets that are measured using a current market price. A current market price also distinguishes between two liabilities with similar proceeds that have different repayment requirements because they were incurred in different interest rate environments.
- 6.105 In addition, some users of financial statements may find information about the current market prices of liabilities useful for assessing the risks faced by an entity (for example, exposure to interest rate risk for financial institutions that hold assets and liabilities with different maturities). Hence, the IASB will need to consider whether the benefits of providing current value information about liabilities of this type (perhaps through disclosure) are justified by the cost. The discussion of other cash-flow-based measurements (see paragraphs 6.110–6.130) further describes considerations related to changes in measurements of liabilities as a result of an entity's own credit risk.
- 6.106 Derivative instruments have contractual terms but, as discussed in paragraph 6.19, cost-based measurement is unlikely to provide information that is useful for assessing the prospects for future cash flows. Consequently, like derivatives that are assets (see paragraph 6.89), derivatives that are liabilities should be measured at a current market price or another measure that varies according to the cash flows required by the contract.

*Transferring*

- 6.107 Few liabilities can be transferred to a third party without negotiating for the consent of the creditor. The most relevant measure of a liability that will be settled by transfer would be a current market price, or a current market price plus transaction costs, because that is an estimate of the cash that will be paid in inducing another party to assume the liability.

*Performing services or paying others to perform services*

- 6.108 Liabilities arising from contractual obligations for services ('performance obligations') have specified outcomes instead of stated terms. A cost-based measurement starting with the proceeds received (in some cases, with interest accretion) provides information about recurring components of profit or loss and that information can be used to derive expectations about future margins. Hence, a cost-based measurement is likely to be appropriate for such obligations, especially if the services are a recurring revenue-generating activity. If the proceeds relate to more than one performance obligation, or to an obligation that is only partly performed, the proceeds would be allocated between the different performance obligations: the parts already performed and the parts still to be performed.
- 6.109 However, the current market price of the services may also be relevant information, especially if the entity will pay others to perform the services.

### **Cash-flow-based measurements other than estimates of current prices**

- 6.110 Cash-flow-based measurements, other than estimates of current prices, are currently used to measure assets and liabilities when no transaction prices are available and when estimates of prices are not feasible or are not considered to provide the most relevant information. Because cash-flow-based measurements can be custom-designed to fit a particular asset or liability, it might be possible to create new measurements in each new Standard. In addition, a custom-designed measurement may result in the most relevant information about a particular asset or liability. However, when deciding whether to use a custom-designed measurement, the IASB would need to consider whether it will be understandable for users of financial statements. As discussed in paragraph 6.23, the IASB's preliminary view is that it should limit the number of different measurements in order to make it easier for users of financial statements to understand the amounts presented in financial statements.
- 6.111 The following paragraphs discuss guidance that could be included in the revised *Conceptual Framework* on the factors considered in cash-flow-based measurements.

#### **Factors considered in other cash-flow-based measurements**

- 6.112 By definition, all cash-flow-based measurements start with estimates of the amounts of cash flows. Other factors that may be considered are:
- (a) expectations about possible variations in the amount and timing of the cash flows resulting from the uncertainty inherent in those cash flows (see paragraph 6.113);
  - (b) the time value of money (see paragraph 6.114);
  - (c) the price for bearing the uncertainty inherent in the cash flows (ie a risk premium) (see paragraph 6.115);
  - (d) other factors, such as illiquidity, that market participants would take into account (see paragraphs 6.116–6.117); and
  - (e) for a liability, the non-performance risk relating to that liability, including the entity's (ie the obligor's) own credit risk (see paragraph 6.128–6.130).
- 6.113 Uncertainties about the amount of any cash flows are important characteristics of assets and liabilities. Consider, for example, a liability for which there are three possible amounts (CU10, CU50 and CU80).<sup>53</sup> If there is a 10 per cent chance that the outcome will be CU10, a 60 per cent chance that the outcome will be CU50, and a 30 per cent chance that the outcome will be CU80, the most likely outcome is CU50. However, there are two other possibilities and, as a result, the expected value of the cash flows is CU55.<sup>54</sup> A user of financial statements would probably not view the most likely cash flow of CU50 to be the same as a certain cash flow of CU50.

<sup>53</sup> In this Discussion Paper, currency amounts are denominated in 'currency units' (CU).

<sup>54</sup> The expected value of the cash flow is the sum of the products of each of the possible outcomes multiplied by the probability of occurrence of each outcome. In this case the expected cash flow is CU55 (CU10 X 10% + CU50 X 60% + CU80 X 30%).



- 6.114 Timing of cash flows and the time value of money affect many measures because a payment of CU1,000 to be received tomorrow is more valuable than the same payment to be received in 10 years.
- 6.115 The price for bearing the uncertainty that is inherent in the cash flows depends on the uncertainty, but it is not the same thing. Two assets with expected cash flows of CU100 can have very different ranges of possible outcomes. One might have only two possible outcomes—CU0 or CU200—each with a 50 per cent probability. The other might have two possible outcomes—CU99 and CU101—each with a 50 per cent probability. Most investors would not pay as much for the first asset, because its outcomes are more uncertain. That difference constitutes the price for bearing that additional uncertainty (ie a risk premium).
- 6.116 Not all of the factors in paragraph 6.112 (referred to simply as ‘factors’ from here on) are considered in every cash-flow-based measurement. The factor mentioned in paragraph 6.112(d) (other factors such as illiquidity) is not currently considered in any cash-flow-based measurement except fair value. Illiquidity from a market perspective is considered in the measurement proposed in the Exposure Draft *Insurance Contracts*.
- 6.117 The following discussion of factors to consider does not include illiquidity and similar factors and presumes that they should not be considered in most measurements other than estimates of current market prices. Illiquidity and similar factors may be unidentifiable or difficult to quantify. Consequently, including them in measurement may not provide relevant information.
- 6.118 The important questions to ask about cash-flow-based measurements are:
- (a) which of the factors listed in paragraph 6.112 should be considered?
  - (b) when should these factors reflect the view of market participants and when should they reflect the reporting entity’s perspective?
  - (c) should the asset or the liability be remeasured at the end of every reporting period or remeasured only in response to triggering events?
  - (d) when remeasurement occurs, which factors should be updated and which should be held constant?
- 6.119 If the objective of a cash-flow-based measurement is a current market price estimate, all factors would be considered and would reflect a market participant view. Regular remeasurement would be required and all factors should be updated.
- 6.120 If the objective is to estimate what cost would have been in a market transaction as a starting point for a subsequent cost-based measurement, the initial measure would be the same as a current market buying price. It would not be updated in subsequent measurements unless the asset’s carrying amount is not recoverable from future cash flows or the liability’s carrying amount is not adequate to cover future cash flows.
- 6.121 If the objective of the measurement is to test for impairment of an asset carried at a cost-based amount, consistently with the idea that changes in measurements should be avoided, the measurement might be more relevant if it

includes the effects of changes in estimated cash flows and ignores other changes. That could be done by changing the estimates of cash flows and holding other factors (such as changes in interest rates and changes in the price for bearing the risk of changes in the probability of default) constant.

- 6.122 Cash-flow-based measurements required by existing Standards differ:
- (a) in value-in-use asset impairment tests, as used in IAS 36 *Impairment of Assets*, all factors are considered, but the cash flows are estimated from the entity's perspective instead of from a market perspective. The measurement is performed periodically and all factors are updated, but the carrying amount can never be more than what it would have been without an impairment test.
  - (b) the impairment measure for financial assets subject to cost-based measurements uses updated cash flow estimates from the entity's perspective. No other factors are updated.
  - (c) the measure of post-employment benefits under IAS 19 *Employee Benefits* considers most of the factors from the perspective of the entity. The discount rate is the rate for high quality corporate or government bonds, which does not reflect the degree of uncertainty in the contractual cash outflows and does not include the entity's own credit risk. The measure is updated each period and all factors are updated. Estimates of cash flows are best estimates of the ultimate cost, rather than expected values.
  - (d) the measure of a hedged item in a fair value hedging relationship is updated for changes in value arising from the hedged risk only.
  - (e) the measures of deferred tax assets and deferred tax liabilities do not include any of the factors. They are undiscounted estimates of the income tax cash flows that would arise if the entity recovered the carrying amount of its assets and settled the carrying amount of its liabilities.
- 6.123 The measurement proposed in the Exposure Draft *Insurance Contracts* considers all factors except the entity's own credit risk. All factors, except the time value of money and illiquidity, are from the perspective of the entity.
- 6.124 Two matters deserve further discussion—entity perspective or market perspective (see paragraphs 6.125–6.127) and an entity's own credit risk (see paragraphs 6.128–6.130).

#### **Entity perspective or market perspective?**

- 6.125 Whether to use an entity perspective or a market perspective depends on two things—the availability of market information and the likely relevance of each perspective for the specific asset or liability.
- 6.126 If market inputs are observable, estimation is easier and more readily verifiable. The market participant perspective may be particularly relevant for assets that will be sold without significant selling effort.
- 6.127 The entity-specific perspective may be more relevant for some assets held for use, and for liabilities that will be settled by performing services. Entity-specific

inputs would be relevant for unique and highly uncertain cash flows and may better indicate ultimate cash flows if the entity has plans that are different from plans of typical market participants or has more or better information. One concern about entity-specific estimates is that they may inadvertently reflect synergies with other assets and so may not measure only the item that they purport to measure.

### **An entity's own credit risk**

- 6.128 The possibility exists that an entity will not be able to settle its liabilities when they are due. That uncertainty is reflected in the market prices of loans (the interest rate charged) and in the original issue price of bonds, and is incorporated in some fashion into the pricing of every liability for which there is a transaction price. Consequently, it is automatically included in the initial measures of those liabilities. In those cases, the controversial issue is whether subsequent measurements of liabilities should reflect changes in the expected cash flows due to changes in the probability of non-payment, and whether they should reflect changes in the market price for bearing the risk of changes in the probability of non-payment.
- 6.129 Updating the measure of a liability for changes in credit risk (and market interest rates) adds discriminatory power. In other words, it helps to distinguish between liabilities with similar face values or original proceeds but with different amounts and timings of payments. The concerns generally focus on gains recognised when a liability is discounted at a higher rate because an entity's credit standing is deteriorating or because there has been an increase in the market price for bearing the risk of changes in the probability of default. Recognised gains are normally considered indicators of positive performance, but in that case, a gain indicates that the entity's overall financial position has deteriorated.
- 6.130 For other cash-flow-based measurements, reflecting uncertainty due to an entity's own credit risk is controversial for initial measurement as well. If the uncertainty in a cash flow estimate reflects a market perspective, the estimate would include uncertainty due to the entity's credit standing. However, if the uncertainty is from the entity's own perspective, it may or may not reflect uncertainty due to the entity's credit standing.

## Questions for respondents

### Question 11

How the objective of financial reporting and the qualitative characteristics of useful financial information affect measurement is discussed in paragraphs 6.6–6.35. The IASB's preliminary views are that:

- (a) the objective of measurement is to contribute to the faithful representation of relevant information about:
  - (i) the resources of the entity, claims against the entity and changes in resources and claims; and
  - (ii) how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.
- (b) a single measurement basis for all assets and liabilities may not provide the most relevant information for users of financial statements;
- (c) when selecting the measurement to use for a particular item, the IASB should consider what information that measurement will produce in both the statement of financial position and the statement(s) of profit or loss and OCI;
- (d) the relevance of a particular measurement will depend on how investors, creditors and other lenders are likely to assess how an asset or a liability of that type will contribute to future cash flows. Consequently, the selection of a measurement:
  - (i) for a particular asset should depend on how that asset contributes to future cash flows; and
  - (ii) for a particular liability should depend on how the entity will settle or fulfil that liability.
- (e) the number of different measurements used should be the smallest number necessary to provide relevant information. Unnecessary measurement changes should be avoided and necessary measurement changes should be explained; and
- (f) the benefits of a particular measurement to users of financial statements need to be sufficient to justify the cost.

Do you agree with these preliminary views? Why or why not? If you disagree, what alternative approach to deciding how to measure an asset or a liability would you support?

**Question 12**

The IASB's preliminary views set out in Question 11 have implications for the subsequent measurement of assets, as discussed in paragraphs 6.73–6.96. The IASB's preliminary views are that:

- (a) if assets contribute indirectly to future cash flows through use or are used in combination with other assets to generate cash flows, cost-based measurements normally provide information that is more relevant and understandable than current market prices.
- (b) if assets contribute directly to future cash flows by being sold, a current exit price is likely to be relevant.
- (c) if financial assets have insignificant variability in contractual cash flows, and are held for collection, a cost-based measurement is likely to provide relevant information.
- (d) if an entity charges for the use of assets, the relevance of a particular measure of those assets will depend on the significance of the individual asset to the entity.

Do you agree with these preliminary views and the proposed guidance in these paragraphs? Why or why not? If you disagree, please describe what alternative approach you would support.

**Question 13**

The implications of the IASB's preliminary views for the subsequent measurement of liabilities are discussed in paragraphs 6.97–6.109. The IASB's preliminary views are that:

- (a) cash-flow-based measurements are likely to be the only viable measurement for liabilities without stated terms.
- (b) a cost-based measurement will normally provide the most relevant information about:
  - (i) liabilities that will be settled according to their terms; and
  - (ii) contractual obligations for services (performance obligations).
- (c) current market prices are likely to provide the most relevant information about liabilities that will be transferred.

Do you agree with these preliminary views and the proposed guidance in these paragraphs? Why or why not? If you disagree, please describe what alternative approach you would support.

**Question 14**

Paragraph 6.19 states the IASB's preliminary view that for some financial assets and financial liabilities (for example, derivatives), basing measurement on the way in which the asset contributes to future cash flows, or the way in which the liability is settled or fulfilled, may not provide information that is useful when assessing prospects for future cash flows. For example, cost-based information about financial assets that are held for collection or financial liabilities that are settled according to their terms may not provide information that is useful when assessing prospects for future cash flows:

- (a) if the ultimate cash flows are not closely linked to the original cost;
- (b) if, because of significant variability in contractual cash flows, cost-based measurement techniques may not work because they would be unable to simply allocate interest payments over the life of such financial assets or financial liabilities; or
- (c) if changes in market factors have a disproportionate effect on the value of the asset or the liability (ie the asset or the liability is highly leveraged).

Do you agree with this preliminary view? Why or why not?

**Question 15**

Do you have any further comments on the discussion of measurement in this section?

## Section 7—Presentation and disclosure

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### Introduction

- 7.1 Presentation and disclosure are the mechanisms by which a reporting entity communicates information about its financial position and financial performance to users of financial statements. Some aspects of presentation and disclosure are prescribed by IFRS.
- 7.2 Presentation and disclosure are not addressed in the existing *Conceptual Framework*. Some believe that this has led to disclosure requirements in IFRS that are not always focused on the right disclosures and are too voluminous. This omission is also seen as contributing to a lack of clarity around the presentation of profit or loss and other comprehensive income (OCI). Section 8 deals with the presentation of profit or loss and OCI. This section deals with presentation and disclosure more broadly.
- 7.3 In terms of disclosure, many respondents to the *Agenda Consultation 2011* told the IASB that they think that a framework for disclosure is needed to ensure that information disclosed is more relevant to investors and to reduce the burden on preparers. Responses suggested that such a framework should:
- (a) provide a structured way to review the need for disclosure, simplify the disclosure process and reduce the costs to preparers;
  - (b) consider the costs and benefits of disclosure;
  - (c) include a discussion of materiality in order to ensure that only material and/or relevant amounts are disclosed; and
  - (d) contain clear communication objectives so that disclosure is understandable and relevant.
- 7.4 As a result of this feedback the IASB is looking at ways to address the concerns raised about disclosure. One aspect of that response is the development of material for the *Conceptual Framework* that the IASB would consider when setting disclosure requirements. As mentioned in paragraphs 7.6–7.8, the IASB is also considering further work in the area of disclosure.
- 7.5 The purpose of this section is to discuss the principles that should underlie the decisions that the IASB makes about presentation and disclosure. This section will discuss:
- (a) the meaning of the terms ‘presentation’ and ‘disclosure’ and how they differ (see paragraphs 7.9–7.13);
  - (b) presentation in the primary financial statements, including a discussion of their purpose and the relationship between primary financial statements (see paragraphs 7.14–7.31);
  - (c) disclosure in the notes to the financial statements, including the scope of information to be included in the notes and the form of disclosure requirements (see paragraphs 7.32–7.42);
  - (d) materiality (see paragraphs 7.43–7.46); and

- (e) the form of disclosure and presentation requirements (see paragraphs 7.47–7.52).

### Other work on presentation and disclosure

- 7.6 In 2008, the IASB and the US Financial Accounting Standards Board (FASB) published a Discussion Paper *Preliminary Views on Financial Statement Presentation*.<sup>55</sup> In 2010, the IASB and the FASB posted on their websites a staff draft of an Exposure Draft *IFRS X Financial Statement Presentation*.<sup>56</sup> When relevant, this Discussion Paper incorporates principles developed during the Financial Statement Presentation project. The IASB's current work plan does not include a project to develop a Standard based on the work in that project. However, some of the issues discussed in the Financial Statement Presentation project are being considered in the *Conceptual Framework* project.
- 7.7 In addition, the IASB will assess, in the light of the feedback on its shorter term review of disclosure, the extent to which it should consider undertaking a broader review of presentation and disclosure.<sup>57</sup> In particular, in 2013 the IASB will start a research project reviewing IAS 1 *Presentation of Financial Statements*, IAS 7 *Statement of Cash Flows* and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, including a review of the feedback it received on the Financial Statement Presentation project. The goal will be to replace those Standards, in essence creating a disclosure framework of the type mentioned in paragraph 7.3. This research will be undertaken in parallel with the *Conceptual Framework* project.
- 7.8 The IASB plans other work on disclosures involving possible amendments to IAS 1 and possible guidance on materiality.<sup>58</sup> In the light of the IASB's intention to conduct that work and a research project involving IAS 1, IAS 7 and IAS 8, this section of the Discussion Paper deals with only some aspects of disclosure. This section has been developed in the context of the primary purpose of the *Conceptual Framework*, as described in Section 1, which is to assist the IASB in developing and revising Standards.

### What is meant by the terms 'presentation' and 'disclosure'?

- 7.9 In the context of financial reporting, the term 'presentation' attracts different meanings. Paragraph 1 of IAS 1 prescribes "the basis for presentation of general purpose financial statements to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities."
- 7.10 In this Discussion Paper, we have used the term 'presentation' as meaning the disclosure of financial information on the face of an entity's primary financial statements (see paragraphs 7.14–7.31 for more information on primary financial statements).

55 <http://go.ifrs.org/FSP-2008-DP-Preliminary-Views>

56 <http://go.ifrs.org/FSP-2010-Staff-Draft>

57 <http://go.ifrs.org/PR-Feedback-Statement-on-Disclosure-Forum>

58 <http://go.ifrs.org/Disclosure-Forum-Feedback-Statement-PDF>



- 7.11 'Disclosure' has a broader meaning than presentation. Disclosure is the process of providing useful financial information about the reporting entity to users. The financial statements, including the amounts and descriptions presented in the primary financial statements and the information included in the notes to the financial statements, are, as a whole, a form of disclosure.
- 7.12 The notes to the financial statements disclose useful information that is not presented in the primary financial statements, for example:
- (a) further disaggregation of items presented in the primary financial statements;
  - (b) unrecognised assets and unrecognised liabilities of the entity; and
  - (c) the entity's financial exposure to risks and uncertainties arising from its recognised and unrecognised assets and liabilities.
- 7.13 It is often an entity's own facts and circumstances, rather than guidance in IFRS, that determines what information is presented in the primary financial statements and what information is disclosed in the notes to the financial statements.

## **Presentation in the primary financial statements**

### **What are primary financial statements?**

- 7.14 Collectively, financial statements depict a view of the financial position and financial performance of an entity. IFRS does not currently use the term 'primary financial statements'. This Discussion Paper differentiates between the primary financial statements and the notes to the financial statements. The primary financial statements are:
- (a) the statement of financial position;
  - (b) the statement of profit or loss and OCI (or the statement of profit or loss and the statement of comprehensive income);
  - (c) the statement of changes in equity; and
  - (d) the statement of cash flows.
- 7.15 Primary financial statements convey summarised information about an entity. Each primary financial statement communicates a different facet of that information.
- 7.16 As discussed in paragraph 7.2, the existing *Conceptual Framework* does not include specific guidance on presentation in the primary financial statements. The IASB thinks that such guidance would help it to decide when an item should be presented in the primary financial statements and when it should be disclosed in the notes to the financial statements. Paragraphs 7.17–7.31 set out in broad terms what should, in the IASB's preliminary view, be included in the *Conceptual Framework* as guidance on presentation.

### **Objective of primary financial statements**

- 7.17 On the basis of the objective of financial reporting in Chapter 1 of the *Conceptual Framework*, this Discussion Paper proposes that the objective of primary financial

statements is to provide summarised information about recognised assets, liabilities, equity, income, expenses, changes in equity and cash flows that has been classified and aggregated in a manner that is useful to users of financial statements in making decisions about providing resources to the entity.<sup>59</sup>

- 7.18 Summarised information about recognised assets, liabilities, equity, income, expenses, changes in equity and cash flows provides information about:
- (a) the recognised economic resources of the entity and claims against the entity, ie information about its financial position;
  - (b) changes in those economic resources and claims, including information about the entity's financial performance; and
  - (c) how efficiently and effectively the entity's management have discharged their responsibilities to use the entity's resources.
- 7.19 Primary financial statements do not include unrecognised assets and liabilities and only provide a summarised view of recognised elements. As a result, the view of the entity as conveyed by primary financial statements is incomplete. Users of financial statements also need to consider the information provided by the notes to the financial statements as well as information from other sources when making decisions about providing resources to the entity.

#### **Classification and aggregation**

- 7.20 A key aspect of financial statement presentation is effective communication and making information understandable. Classifying, characterising and presenting information clearly and concisely makes it understandable (see paragraph QC30 of the existing *Conceptual Framework*).
- 7.21 Classification is the sorting of items based on shared qualities. Aggregation involves the adding together of individual items within those classifications. To present information in the primary financial statements that is understandable, an entity classifies and aggregates information about recognised elements and presents it on a summarised basis.
- 7.22 As indicated in paragraph 7.21, the main advantage of aggregation is that it allows an entity to disclose its activities in an understandable way. Aggregation allows an entity to highlight those items, and relationships between items, that are important to an assessment of its financial position and financial performance.
- 7.23 Applied appropriately, aggregation can make primary financial statements more understandable by summarising a large volume of information. However, aggregating information results in the loss of detailed information. Applied inappropriately, aggregation can obscure useful information or even result in misleading information, for example, when dissimilar items are aggregated. Consequently, financial statements should aggregate information so that useful information is not obscured by either the inclusion of a large amount of insignificant detail or by the aggregation of items that have different characteristics.

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<sup>59</sup> See paragraph OB2 of the existing *Conceptual Framework*.

- 7.24 The primary financial statements classify and aggregate information about the recognised elements (including changes in elements and components of elements). Section 2 discusses the elements that are presented in each primary financial statement.
- 7.25 Within each primary financial statement, an entity presents groups of recognised items as separate lines ('line items'). Each line item represents that group by providing a description of the aggregated group of recognised elements (or components of elements) and a monetary amount. Line items, subtotals and totals derived from those line items are used to present useful summarised information.
- 7.26 In order to provide information that is useful to users of financial statements in making economic decisions about providing resources to the entity, the IASB believes that classification and aggregation into line items and subtotals should be based on similar properties, such as:
- (a) the function of the item—that is, the primary activities (and assets and liabilities used in those activities) in which the entity is engaged, such as selling goods, providing services, manufacturing, advertising, marketing, business development or administration;
  - (b) the nature of the item—that is, the economic characteristics or attributes that differentiate between items that respond differently to similar economic events, such as:
    - (i) wholesale revenues and retail revenues;
    - (ii) materials, labour, transport and energy costs; or
    - (iii) fixed-income investments and equity investments; or
  - (c) how the item is measured—Section 6 discusses measurement.
- 7.27 In many cases, an entity will determine what line items, subtotals and totals to present in its primary financial statements based on its individual facts and circumstances and its assessment of what is relevant at a summary level.
- 7.28 In some cases, the IASB may decide to require a particular item to be presented in the primary financial statements (assuming it is material to the entity). The IASB may require this if it considers that information about that item would be essential to providing a summary depiction of the financial position and financial performance of an entity that is useful to the users of its financial statements, ie existing and potential investors, lenders and other creditors.

### **Offsetting**

- 7.29 Because offsetting combines dissimilar items (assets/liabilities, income/expenses, cash receipts/cash payments, contributions to equity/distributions of equity), the IASB believe that offsetting will generally not provide the most useful information for assessing an entity's financial position and financial performance.

- 7.30 However, the IASB may choose to require offsetting when such a presentation provides a more faithful representation of a particular position, transaction or other event. It may also choose to permit offsetting when it considers this necessary on cost-benefit grounds.

### **Relationship between primary financial statements**

- 7.31 No primary financial statement has primacy over the other primary statements and they should be looked at together. The way items are presented in primary financial statements helps users of financial statements to take an overall view of an entity's financial position and performance. This is easier to achieve if relationships between the statements and among items presented in them are made clear.

### **Disclosure in the notes to the financial statements**

- 7.32 As discussed in paragraph 7.2, the existing *Conceptual Framework* does not include specific guidance on disclosures in financial statements. Paragraphs 7.33–7.42 set out in broad terms what should, in the IASB's preliminary view, be included in the revised *Conceptual Framework* as guidance on disclosure.

### **Objective of the notes to the financial statements**

- 7.33 The notes to the financial statements support the primary financial statements. Consequently, based on the objective of financial reporting and the objective of primary financial statements proposed in paragraph 7.17, this Discussion Paper proposes that the objective of the notes to the financial statements is to supplement the primary financial statements by providing additional useful information about:

- (a) the assets, liabilities, equity, income, expenses, changes in equity and cash flows of the entity; and
- (b) how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.

- 7.34 To be useful, the information provided by the notes to the financial statements needs to help users of financial statements understand the amount, timing and uncertainty of an entity's future net cash inflows. In doing so, it should help users understand how the entity's assets, liabilities, equity, income, expenses, changes in equity and cash flows reflect actions taken by management to discharge their responsibilities to use the entity's assets. Such actions could include:

- (a) protecting the entity's assets from unfavourable effects of economic factors such as price and technological changes; and
- (b) ensuring that the entity complies with applicable laws, regulations and contractual provisions.

### **Scope of the notes to the financial statements**

- 7.35 This Discussion Paper proposes that, to meet the objective set out in paragraph 7.33, the *Conceptual Framework* should identify the following as disclosures that

the IASB would normally consider requiring in a general Standard on disclosure (such as IAS 1) or in particular Standards:

- (a) information about the reporting entity as a whole, to the extent necessary to understand:
  - (i) the assets, liabilities, equity, income, expenses, changes in equity and cash flows of the entity; and
  - (ii) how effectively the entity's management and governing board have discharged their responsibilities to use the entity's assets.
- (b) the amounts recognised in the entity's primary financial statements, including changes in those amounts, for example, disaggregation of line items, roll-forwards and reconciliations;
- (c) the nature and extent of the entity's unrecognised assets and liabilities;
- (d) the nature and extent of risks arising from the entity's assets and liabilities (whether recognised or unrecognised); and
- (e) the methods, assumptions and judgements and changes in those methods, assumptions and judgements, that affect amounts presented or otherwise disclosed.

7.36 In setting disclosure guidance in IFRSs, the objective is not to have entities provide information that enables a user of financial statements to recalculate the amounts recognised in the primary financial statements. Instead, disclosure guidance needs to result in entities providing sufficient information to enable a user of financial statements to identify the key drivers of the entity's financial position and performance and to understand the key risks arising from its assets and liabilities, and the key facts that cause uncertainties about measurements used in the financial statements.

7.37 Information about management's view of the entity's performance, position and progress in the context of its stated plans and its strategies for achieving those plans belongs outside financial statements, for example, in management commentary.<sup>60</sup>

#### *Forward-looking information*

7.38 Financial statements, and therefore notes, provide information about existing assets and liabilities, and changes in those existing assets and liabilities. The notes provide further detail of recognised amounts (disaggregation, descriptions, risks) and unrecognised (but existing) assets and liabilities. Notes to the financial statements do not usually include information about plans or future assets and future liabilities.

7.39 Forward-looking information is information about the future, for example, information about prospects and plans. The IFRS Practice Statement *Management Commentary: A framework for presentation* notes that forward-looking information is subjective and its preparation requires the exercise of professional judgement. The IASB's preliminary view is that it should require forward-looking

<sup>60</sup> See paragraphs 12–14 of the IFRS Practice Statement *Management Commentary: A framework for presentation*.

information to be included in the notes to the financial statements only if it provides relevant information about assets and liabilities that existed at the end of the reporting period or during the reporting period. Paragraph 7.35 identifies such information that may be relevant. For example, if the measurement of an asset or a liability is based on future cash flows, information about the methods, assumptions and judgements used to estimate those cash flows is needed in order to understand the reported measures. Information is also needed to understand the sensitivity of those measures to:

- (a) the variability in future outcomes (risk); and
- (b) the range of the assumptions and judgements that management could reasonably have made to arrive at those measures.

7.40 Other types of forward-looking information may provide relevant information and could be presented outside the financial statements, for example, in management commentary if the entity prepares one.

*Types of disclosures in the notes to the financial statements*

7.41 When developing disclosure requirements in IFRSs, the IASB can consider different forms of disclosure (for example, disaggregations, descriptions, roll-forwards, sensitivity analysis) depending on the nature of the item in question. Using the objective of the notes to the financial statements (see paragraph 7.33) and the listing of types of useful information that would meet that objective (see paragraph 7.35), Table 7.1 provides some examples of the types of disclosures that may provide that information. A single note in the financial statements may combine two or more of these types of disclosures. In addition, one disclosure might provide two types of useful information. For example, a maturity analysis of a liability provides further information about the obligation but also provides information about liquidity risk. Similarly, a single note might provide information about a group of assets, transactions relating to those assets, risks arising from them and methods used to account for them.

**Table 7.1: examples of disclosures split by type of useful information**

Type of information	Examples of disclosures in the notes to the financial statements
Reporting entity	<ul style="list-style-type: none"> <li>● Information about subsidiaries, associates, parent etc.</li> <li>● Description of business model.</li> <li>● Going concern.</li> <li>● Description of non-adjusting events after the reporting date.</li> </ul>
Amounts recognised in the primary financial statements	<ul style="list-style-type: none"> <li>● Disaggregation of line items in the primary financial statements, including:                             <ul style="list-style-type: none"> <li>● analysis of a single amount (for example, a line item, transaction or event);</li> <li>● analysis by function, nature or measurement where different to that provided in the primary financial statements;</li> <li>● maturity analysis;</li> <li>● roll-forwards;</li> <li>● operating segments; and</li> <li>● related party transactions.</li> </ul> </li> <li>● Relationship between line items (for example, hedging, offsetting).</li> </ul>
Unrecognised assets or liabilities	<ul style="list-style-type: none"> <li>● Description of amount and nature of unrecognised assets or liabilities.</li> <li>● Description of why the items have not been recognised.</li> </ul>
Risks	<ul style="list-style-type: none"> <li>● The types of financial risks faced by the entity, including its sources and exposures.</li> <li>● How the entity has managed those risks.</li> <li>● How management of risks has impacted its financial statements.</li> </ul>
Methods, assumptions and judgements	<ul style="list-style-type: none"> <li>● Accounting policies.</li> <li>● Description of measurement methodologies, including key assumptions and inputs.</li> <li>● Quantification of the sensitivity of recognised or disclosed measures to changes in key assumptions and inputs to provide information about measurement uncertainty.</li> <li>● Description and quantification of alternative measurements.</li> </ul>

*Comparative information*

- 7.42 A complete set of IFRS financial statements includes information about the preceding period ('comparative information'). Presentation of additional comparative information is permitted and, in some circumstances, required.<sup>61</sup> Comparative information provides trend information from which to assess the financial statements of the current period and therefore provides relevant information. It follows that comparative information is an integral part of an entity's financial statements for the current period.

**Materiality**

- 7.43 Paragraph QC11 of Chapter 3 of the *Conceptual Framework* states that:

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 based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report. Consequently, the Board cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

- 7.44 In addition, IAS 1 states that an entity:
- (a) need not provide a specific disclosure required by a Standard if the information is not material;<sup>62</sup> and
  - (b) should provide additional disclosures when compliance with the specific requirements in IFRS is insufficient to enable users of financial statements to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.<sup>63</sup>
- 7.45 The IASB believes that the concept of materiality is clearly described in the existing *Conceptual Framework*. Consequently, the IASB does not propose to amend, or add to, that description.
- 7.46 However, how the concept of materiality is applied in practice is seen by many as a major cause of the current disclosure problem in financial reporting. That problem is often identified as a failure to use professional judgement when considering materiality. It is thought by some to have resulted in both the disclosure of too much irrelevant information and not enough relevant information. As a result, the IASB is considering providing additional material on the application of materiality, by amending its Standards or by providing educational material (see paragraphs 7.7–7.8). In particular, this additional material on materiality would seek to emphasise the following:
- (a) if information to meet a disclosure requirement in a Standard is not considered material, the entity may omit it from its financial statements;

<sup>61</sup> See paragraphs 10(ea) and 38-44 of IAS 1.

<sup>62</sup> See paragraph 31 of IAS 1.

<sup>63</sup> See paragraph 17(c) of IAS 1.



- (b) disclosures additional to those specifically required by a Standard may be required for material items in order to meet the disclosure objective of that Standard or to meet the objective of financial reporting;
- (c) disclosure of immaterial information can impair the understandability of material information that is also disclosed; and
- (d) just because a line item presented in a primary financial statement is determined to be material, it does not automatically follow that all IFRS disclosures pertaining to that line item are material to the entity's financial statements. An entity would assess the materiality of each disclosure requirement individually.

### **Form of disclosure and presentation requirements**

- 7.47 Paragraphs 7.48–7.52 set out in broad terms what should, in the IASB's preliminary view, be included in the *Conceptual Framework* as guidance on the form and communication aspects of disclosure and presentation requirements.

### **Disclosure objectives**

- 7.48 Each Standard that proposes disclosure and presentation requirements should have a clear objective. This objective would guide entities when identifying the best disclosures and presentation to meet the objective. The IASB should provide guidance that enables an entity to determine whether the specified information would be material in the context of an entity's financial statements. This may result in some disclosures not being made if they are not material or, conversely, additional disclosures being made when they are material.

### **Communication principles**

- 7.49 The objective of financial reporting is to provide useful information to users of financial statements. To achieve this, disclosure guidance in Standards should seek to promote disclosure (including presentation) in the financial statements as a form of communication guided by Standards, as opposed to a mechanism whose sole purpose is compliance with specific requirements of Standards.
- 7.50 Consequently, in developing disclosure guidance in IFRSs, the IASB not only needs to consider what information would be useful in the circumstances of a wide range of entities (ie a faithful representation of relevant information), but should also develop guidance that promotes effective communication of that information. Effective communication reflects the fundamental qualitative characteristic of faithful representation and the enhancing qualitative characteristics of understandability and comparability. As a result, this Discussion Paper proposes that the IASB should consider the following communication principles when it sets disclosure requirements:
- (a) disclosure guidance should seek to promote the disclosure of useful information that is entity-specific. In other words, disclosure guidance should be aimed at emphasising the aspects of transactions, events or circumstances, and the way they have been accounted for, in order to enhance a user's understanding of that entity. Disclosure guidance should therefore discourage the use of 'boilerplate' or generally available

information that is not specific to the entity as this can impair the understandability of useful information.

- (b) disclosure guidance should result in disclosures that are clear, balanced and understandable. Guidance should therefore give entities the flexibility to write disclosures as simply and directly as possible without:
  - (i) a loss of useful information; and
  - (ii) unnecessarily increasing the length of the financial statements.
- (c) disclosure guidance should enable an entity to organise disclosures in a manner that highlights to a user of financial statements what is important. Consequently, where possible, disclosure guidance should enable an entity to determine the order of disclosures or the emphasis given within a single disclosure.
- (d) disclosures should be linked. Disclosure guidance in IFRS should therefore result in disclosures that help users of financial statements to understand the relationships between the items in the primary financial statements and the information disclosed in the notes. Where appropriate, disclosure guidance should require or permit entities to show the relationship between the information disclosed in different notes and also, where possible, with other published information, such as disclosures in management commentary, if there is one. IFRSs should therefore permit the use of cross-referencing where possible and appropriate.
- (e) disclosure guidance should not result in the duplication of the same information in different parts of the financial statements. The IASB should therefore review existing IFRSs when developing new disclosure guidance to minimise any duplication. Links between disclosures (for example, cross-referencing) may be appropriate in some circumstances (see 7.50(d)).
- (f) disclosure guidance should seek to optimise comparability without compromising the usefulness of the information disclosed. When developing disclosure guidance, the IASB needs to weigh up the need for the information to be comparable among entities and across reporting periods against the need to give entities the flexibility to determine what and how information is disclosed in the most understandable manner. This assessment will determine whether the IASB permits or requires disclosures and whether Standards stipulate the form of disclosure, for example, in tables rather than descriptions.

### **Financial statements in an electronic format**

- 7.51 Financial statements can be delivered on paper or electronically. The form of delivery affects the accessibility of information in financial statements rather than the content. For many users of financial statements, accessing financial information electronically, for example, through an entity's website or using eXtensible Business Reporting Language (XBRL), makes it easier to consume the financial information.

- 7.52 When developing presentation and disclosure requirements, the IASB may need to consider the impact of technology and to support advances in its application and wider use. Possible aspects that the IASB may consider include:
- (a) flexibility in the order and level of aggregation of information; and
  - (b) consistent use of terminology, totals and subtotals so that the relationships between different disclosure items and presentation items can be precisely identified and can therefore be faithfully represented in an electronic format.

## Questions for respondents

### Question 16

This section sets out the IASB's preliminary views about the scope and content of presentation and disclosure guidance that should be included in the *Conceptual Framework*. In developing its preliminary views, the IASB has been influenced by two main factors:

- (a) the primary purpose of the *Conceptual Framework*, which is to assist the IASB in developing and revising Standards (see Section 1); and
- (b) other work that the IASB intends to undertake in the area of disclosure (see paragraphs 7.6–7.8), including:
  - (i) a research project involving IAS 1, IAS 7 and IAS 8, as well as a review of feedback received on the Financial Statement Presentation project;
  - (ii) amendments to IAS 1; and
  - (iii) additional guidance or education material on materiality.

Within this context, do you agree with the IASB's preliminary views about the scope and content of guidance that should be included in the *Conceptual Framework* on:

- (a) presentation in the primary financial statements, including:
  - (i) what the primary financial statements are;
  - (ii) the objective of primary financial statements;
  - (iii) classification and aggregation;
  - (iv) offsetting; and
  - (v) the relationship between primary financial statements.
- (b) disclosure in the notes to the financial statements, including:
  - (i) the objective of the notes to the financial statements; and
  - (ii) the scope of the notes to the financial statements, including the types of information and disclosures that are relevant to meet the objective of the notes to the financial statements, forward-looking information and comparative information.

Why or why not? If you think additional guidance is needed, please specify what additional guidance on presentation and disclosure should be included in the *Conceptual Framework*.

**Question 17**

Paragraph 7.45 describes the IASB's preliminary view that the concept of materiality is clearly described in the existing *Conceptual Framework*. Consequently, the IASB does not propose to amend, or add to, the guidance in the *Conceptual Framework* on materiality. However, the IASB is considering developing additional guidance or education material on materiality outside of the *Conceptual Framework* project.

Do you agree with this approach? Why or why not?

**Question 18**

The form of disclosure requirements, including the IASB's preliminary view that it should consider the communication principles in paragraph 7.50 when it develops or amends disclosure guidance in IFRSs, is discussed in paragraphs 7.48–7.52.

Do you agree that communication principles should be part of the *Conceptual Framework*? Why or why not?

If you agree they should be included, do you agree with the communication principles proposed? Why or why not?

## Section 8—Presentation in the statement of comprehensive income—profit or loss and other comprehensive income

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### Introduction

- 8.1 The purpose of this section is to discuss the presentation of profit or loss and other comprehensive income (OCI) focusing on the following main topics:
- (a) the purpose of the statement(s) of profit or loss and OCI (see paragraphs 8.5–8.7);<sup>64</sup>
  - (b) current IFRS guidance about presentation of profit or loss and OCI (see paragraphs 8.8–8.18);
  - (c) whether the *Conceptual Framework* should require a profit or loss total or subtotal and require (or permit) recycling (see paragraphs 8.19–8.26); and
  - (d) approaches to profit or loss and recycling (see paragraphs 8.27–8.97, including Table 8.5).
- 8.2 The existing *Conceptual Framework* does not specifically discuss presentation of financial performance in the statement(s) of profit or loss and OCI.
- 8.3 Respondents to the IASB’s *Agenda Consultation 2011* identified the reporting of financial performance, including the use of OCI and recycling, as a priority topic that the IASB should address. Views expressed by respondents included:<sup>65</sup>
- (a) the use of non-GAAP measures by many preparers to explain their results is an indication that profit or loss and total comprehensive income may not be useful measures of the entity’s performance;
  - (b) there is a lack of clarity on the roles of profit or loss and OCI when measuring and reporting an entity’s performance, which has meant that OCI is perceived as a ‘dumping ground’ for anything controversial;
  - (c) many users of financial statements ignore changes reported in OCI because they are not caused by operating flows from which long-term trends can be inferred; and
  - (d) the interaction between profit or loss and OCI is unclear, especially the notion of recycling and when or which OCI items should be recycled.
- 8.4 Many of the questions and views raised by respondents involving profit or loss and OCI stem from the fundamental question: ‘how can financial statements best portray the entity’s performance during the period?’

### Purpose of the statement(s) of profit or loss and OCI

- 8.5 Building on the purpose of primary financial statements described in Section 7 and the objective of financial reporting, it follows that the purpose of the statement(s) of profit or loss and OCI is to depict summarised information about

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64 In this Discussion Paper the statement(s) of profit or loss and OCI refers to either: (a) one statement, namely a combined statement of profit or loss and OCI; or (b) two statements, being the statement of profit or loss and the statement of comprehensive income.

65 Comments received on the *Agenda Consultation 2011* (see Agenda Papers 5A and 5B of the January 2012 IASB Meeting): <http://www.ifrs.org/Meetings/Pages/IASB-January-2012.aspx>

recognised items of income and expense that have been classified and aggregated in a manner that is useful to users of financial statements when making decisions about providing resources to an entity.

- 8.6 To be useful, information about recognised items of income and expense should help users of financial statements to understand the return that the entity has produced on its economic resources and how efficiently and effectively management have used the entity's resources. This information helps users to assess the entity's prospects for future returns.<sup>66</sup> Consequently, items of income and expense should be presented in a way that makes the components of the entity's returns, and the variability of those returns, understandable.
- 8.7 Grouping together items of income and expense that are similar, or that have similar predictive value, can make the information more understandable and easier to use. One potentially effective way of organising the information is to use subtotals such as profit or loss.

### **Statement(s) of profit or loss and OCI—current IFRS**

- 8.8 Most items of income and expense are included in profit or loss, including those that result from initial recognition and from other transactions and events such as consumption of assets, satisfaction of performance obligations and impairment. This means that profit or loss includes all amounts resulting from cost-based measurements and most realised gains and losses. Some other items, mostly unrealised gains and losses resulting from remeasurements, are included in OCI. Some gains and losses recognised in OCI are reclassified to profit or loss when realised or at a time specified by particular Standards. Such reclassification is sometimes referred to as 'recycling'.
- 8.9 All items of income and expense, excluding capital maintenance adjustments, as discussed in Section 9, are included in total comprehensive income. Total comprehensive income is the change in the entity's recognised assets and liabilities during a period, other than those changes resulting from capital maintenance adjustments, contributions to equity, distributions of equity, and transactions that are not capable of changing equity, for example, an equal exchange of assets. Taken together, the items included in total comprehensive income depict the return that an entity has made on its economic resources.
- 8.10 IAS 1 *Presentation of Financial Statements* requires total comprehensive income to be split into two categories: profit or loss and OCI. Paragraph 10A of IAS 1 permits entities to present those categories in a single statement or two separate statements. This Discussion Paper does not explore whether the statement(s) of profit or loss and OCI should be presented as one or two statements, because the IASB views this as an issue that it should resolve when it develops or revises IFRSs. Any decision to develop or revise Standards would require the IASB to go through its normal process for adding a project to its agenda. The IASB has no current plans to undertake a project on this issue.

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<sup>66</sup> See paragraph OB16 of the existing *Conceptual Framework*.

## Financial performance

- 8.11 As highlighted in the IASB's *Agenda Consultation 2011* (see paragraph 8.3) some are of the view that the IASB should define what is meant by the term 'financial performance'. In their view, a definition of financial performance would provide the basis for distinguishing between items that should be recognised in profit or loss and items that should be recognised in OCI. The existing *Conceptual Framework* already refers to financial performance. Some of these references are cited or described in paragraph 8.12–8.14.
- 8.12 Paragraph OB15 states:
- Changes in a reporting entity's economic resources and claims result from that entity's financial performance ... and from other events or transactions such as issuing debt or equity instruments ...
- 8.13 Paragraph OB16 states:
- Information about a reporting entity's financial performance helps users to understand the return that the entity has produced on its economic resources. Information about the return the entity has produced provides an indication of how well management has discharged its responsibilities to make efficient and effective use of the reporting entity's resources. Information about the variability and components of that return is also important, especially in assessing the uncertainty of future cash flows. Information about a reporting entity's past financial performance and how its management discharged its responsibilities is usually helpful in predicting the entity's future returns on its economic resources.
- 8.14 According to paragraphs OB18–OB19, information about financial performance:
- (a) is useful in assessing the entity's capacity for generating net cash inflows through its operations; and
  - (b) may also indicate the extent to which events such as changes in market prices or interest rates have increased or decreased the entity's economic resources and claims, thereby affecting the entity's ability to generate net cash inflows.
- 8.15 The existing *Conceptual Framework* implies that all items of income and expense are the result of an entity's financial performance and are included in total comprehensive income. As required by IAS 1, entities separate total comprehensive income into two categories—profit or loss and OCI.
- 8.16 As a summary performance measure, profit or loss is more frequently used than total comprehensive income. There are also a number of other commonly used performance measures derived from the statement(s) of profit or loss and OCI. These include:
- (a) line items, such as revenue from operations or operating income;
  - (b) gross profit; and
  - (c) earnings (profit) before interest, taxes, depreciation and amortisation (EBITDA).
- 8.17 In addition, information about financial performance can be derived using many aspects of an entity's financial statements, not only the statement(s) of



profit or loss and OCI. For example, some believe that the statement of cash flows provides useful information about performance, as do disclosures of operating segments and risk disclosures. Also, a comparative statement of financial position showing changes in financial leverage provides information about performance that is not shown in the statement(s) of profit or loss and OCI.

- 8.18 The discussion in paragraph 8.17 illustrates that the statement(s) of profit or loss and OCI provide(s) a subset of the available information about an entity's financial performance. However, all items recognised in the statement(s) of profit or loss and OCI provide some information about financial performance. As a result, this Discussion Paper does not equate financial performance with either 'total comprehensive income' or 'profit or loss' or with any other total, subtotal or other commonly used performance measure. Instead, this Discussion Paper explores how all recognised items of income and expense can be presented, using totals and subtotals, in a way that is useful for users of financial statements in their decisions about providing resources to the entity.

## **Profit or loss and recycling in the *Conceptual Framework***

### **Total or subtotal for profit or loss**

- 8.19 The IASB has previously acknowledged that many investors, creditors, preparers and others view profit or loss as a useful performance measure and that 'profit or loss' as a subtotal or a phrase is deeply ingrained in the economy, business and investors' minds. Users from all sectors incorporate profit or loss in their analyses, either as a starting point for further analysis or as the main indicator of an entity's performance.<sup>67</sup>
- 8.20 Those in favour of retaining profit or loss as a total or subtotal argue that:
- (a) users of financial statements are primarily interested in information about profit or loss and its consequences on the entity's capacity to pay dividends and to meet its obligations. Presenting profit or loss as a total or subtotal therefore supports users' needs.
  - (b) profit or loss excludes remeasurement gains and losses that are potentially less predictive of future net cash inflows because they are not likely to persist or recur and are subject to future changes in estimates or prices. In addition, some remeasurements, such as those that result from factors such as changes in interest rates, tend to unwind automatically over the life of the remeasured asset or liability. Consequently, the profit or loss total or subtotal has more predictive value than total comprehensive income.
  - (c) profit or loss can be more closely aligned to an entity's business model than total comprehensive income and therefore provides information from the perspective of management about how the entity's resources have been used.

- 8.21 Those who do not favour retaining profit or loss as a total or subtotal argue that:

<sup>67</sup> See paragraph 3.35 of the 2008 IASB Discussion Paper *Preliminary Views on Financial Statement Presentation*.

- (a) presenting line items of income and expense without the priority or prominence imposed by the profit or loss subtotal is the most effective way of communicating information about the return that an entity has made on its economic resources during a period. For example, it prevents entities from:
  - (i) excluding some items of income and expense from profit or loss as a means of emphasising more (or less) favourable aspects of financial performance; and
  - (ii) hiding volatile items of income and expense outside profit or loss, thereby making the entity appear less risky.
- (b) because of the focus on profit or loss, some users of financial statements may overlook the information that is presented in OCI.
- (c) identifying a single number within comprehensive income as the primary indicator of information about the return an entity has made on its resources oversimplifies the performance of an entity.

8.22 The IASB is persuaded by the arguments set out in paragraph 8.20 for retaining a concept that would require profit or loss to be presented as a total or subtotal on the statement(s) of profit or loss and OCI. It is therefore the IASB's preliminary view that the *Conceptual Framework* should require profit or loss as a total or subtotal.

### Recycling

8.23 In discussing whether the *Conceptual Framework* should include a concept for profit or loss, the arguments for and against recycling also need to be considered. This is because, if there is no recycling, then profit or loss is no different in nature from other totals or subtotals. Consequently, if there is no recycling, the *Conceptual Framework* need not specify whether an entity should present profit or loss, or any other total or subtotal, and the decision whether to require or permit profit or loss, or any other total or subtotal, is one that the IASB could take when it develops or revises particular IFRSs.

8.24 Those who support recycling argue that:

- (a) recycling protects the integrity of profit or loss as the primary source of information about the return an entity has made on its economic resources, because all items of income and expense would be recognised in profit or loss at some point;
- (b) recycling can provide users of financial statements with relevant information about a transaction or event that occurred in the period (for example, realisation or settlement); and
- (c) recycling can enhance the comparability of profit or loss in some situations where IFRS permits or requires similar items of income or expense to be recognised in either profit or loss or OCI. For example, recycling makes the profit or loss of an entity that elects to revalue its property in accordance with IAS 16 *Property, Plant and Equipment* more comparable with the profit or loss of another entity that has not elected

to revalue its property. This is because both entities would recognise any gain or loss on the sale of the property in profit or loss in the same period.

- 8.25 Those who do not support recycling argue that:
- (a) the amounts recycled often provide little or no useful information about financial performance during that period.
  - (b) recycling adds complexity to financial reporting and therefore impairs the understandability of information provided by the statement(s) of profit or loss and OCI. For example, recycling may obscure the income and expenses relating to the period.
  - (c) recycling results in items being recognised in the statement(s) of profit or loss and OCI more than once.
  - (d) the reclassification adjustments made on recycling may not meet the definitions of income or expense if they do not arise from a change in the entity's recognised assets and liabilities in the period, ie the change may have occurred in a previous period.
  - (e) profit or loss can be susceptible to earnings management as a result of recycling, particularly if recycling is triggered by realisation.
- 8.26 Having considered the arguments set out in paragraphs 8.24–8.25, the IASB's preliminary view is that the *Conceptual Framework* should require a profit or loss total or subtotal that also results, or could result, in some items of income or expense being recycled.

### **Approaches to profit or loss and recycling**

- 8.27 The rest of this section considers three approaches to profit or loss and recycling. The first approach prohibits recycling, addressing the views of those who think that the *Conceptual Framework* should prohibit recycling. This approach would mean profit or loss is conceptually no different from any other primary financial statement subtotal or total. It would mean that the *Conceptual Framework* need not specify whether an entity should present profit or loss, or any other total or subtotal. The decision whether to require or permit profit or loss, or any other total or subtotal, is one that the IASB could take when it develops or revises particular IFRSs. This is described as 'Approach 1' and is discussed in paragraphs 8.29–8.33.
- 8.28 This Discussion Paper also considers two approaches that explore the IASB's preliminary view that the *Conceptual Framework* should require a profit or loss total or subtotal that also results, or could result, in some items of income or expense being recycled. Both of these approaches treat profit or loss items as the default category and describe the types of items that could be recognised in OCI, namely:
- (a) Approach 2A: a 'narrow' approach to describing which items could be recognised in OCI (see paragraphs 8.40–8.78); and
  - (b) Approach 2B: a 'broader' approach to describing which items could be recognised in OCI (see paragraphs 8.79–8.94 including Table 8.3).

### Approach 1: prohibit recycling

- 8.29 Approach 1 reflects the view that items of income and expense should be recognised in the statement(s) of profit or loss and OCI only once and should therefore never be recycled. Those with this view are persuaded by the arguments against recycling described in paragraph 8.25.
- 8.30 The IASB sees a total or subtotal for profit or loss that involves no recycling as, conceptually, no different from other totals or subtotals in the primary financial statements. Consequently, Approach 1 suggests that there is no need for the *Conceptual Framework* to describe or define profit or loss. Accordingly, this Discussion Paper has not sought to describe which items of income or expense should be reported in profit or loss in the absence of recycling.
- 8.31 Approach 1 would not preclude the IASB from describing or defining a profit or loss total or subtotal when developing or revising particular IFRSs.
- 8.32 Approach 1 prompts the important question: how best to present the results of cash flow hedge accounting. Possible approaches that the IASB might consider for gains and losses on derivatives that qualify for cash flow hedge accounting include:
- (a) recognise and present all gains or losses on these derivatives in a separate line item of the statement(s) of profit or loss and OCI;
  - (b) recognise all gains and losses on the effective portion of these derivatives in equity (not in OCI) and 'recycle' them to profit or loss when the hedged transactions affects profit or loss; or
  - (c) allow or require the effective portion of these derivatives to be measured at amortised cost.
- 8.33 For the IASB to consider any amendment to cash flow hedge accounting, it would need to go through its normal due process for adding a project to its agenda, and for developing an Exposure Draft and then an amendment to the relevant Standard. The IASB has no current plans to undertake a project to consider changing how OCI is used in cash flow hedge accounting.

### Approaches that retain the concept of profit or loss and recycling

- 8.34 To develop the IASB's preliminary view that the *Conceptual Framework* should require a profit or loss total or subtotal that also results, or could result, in some items of income or expense being recycled, it is necessary to address two questions:
- (a) what distinguishes items of income and expense that are recognised in profit or loss from those recognised in OCI?<sup>68</sup>
  - (b) what items recognised in OCI in one period should be reclassified (recycled) into profit or loss and why?

<sup>68</sup> In this Discussion Paper, a reference to a recognised item of income or expense also includes a reference to a component of those items. It also refers to reclassification (recycling) adjustments where relevant.

- 8.35 In addressing these questions, this Discussion Paper has not sought to define or directly describe profit or loss. Given the broad range of items included in profit or loss, this Discussion Paper proposes to distinguish between profit or loss and OCI items by describing the types of items that could be recognised in OCI, rather than what could be recognised in profit or loss. This approach means that profit or loss is treated as the default category.
- 8.36 Further, treating profit or loss as a default category is in line with current IFRS that results in the use of OCI only when permitted or required by IFRS. This Discussion Paper proposes to maintain that limitation. It follows that entities would not be able to use OCI by analogy.
- 8.37 However, some are of the view that profit or loss should be defined explicitly, and not merely as a default category that contains all items of income and expense not included in OCI. Those with this view often suggest a particular attribute or factor as a basis for that definition. Some of the commonly suggested distinguishing attributes are described in Table 8.1, along with the arguments for and against the use of each in isolation. The IASB considers that, although many of these attributes or factors provide some insight into a possible distinction between profit or loss and OCI, none of them can be used in isolation to define what should be included in profit or loss.

<b>Table 8.1: common suggestions for an attribute (or factor) to distinguish between profit or loss and OCI</b>		
<b>Distinguishing OCI attribute</b>	<b>Arguments for use in isolation</b>	<b>Arguments against use in isolation</b>
<p><b>Unrealised</b></p> <p>Unrealised items of income or expense (ie remeasurements) are recognised in OCI.</p> <p>Recycled into profit or loss on realisation.</p>	<p>Most remeasurements result from changes in price or estimates which can be transitory.</p> <p>Realised income or expense is more certain and therefore more useful in predicting future cash flows.</p>	<p>Importance of realisation as an indicator of performance will depend on how the underlying asset is expected to contribute to future cash flows.</p> <p>Realisation may not provide useful information about financial performance, for example, sale of a liquid financial instrument or receipt of cash from a derivative contract.</p> <p>The timing of realisation is susceptible to earnings management.</p>
<p><b>Non-recurring</b></p> <p>Non-recurring items of income or expense are recognised in OCI.</p> <p>No basis for recycling.</p>	<p>Income and expenses that result from past transactions that are expected to recur in future years are more likely to have predictive value than those that are not expected to recur.</p>	<p>Difficult (and perhaps arbitrary) to determine which items of income or expense are non-recurring.</p> <p>Different users of financial statements have different views about what is recurring.</p> <p>What is considered to be recurring/non-recurring varies across industries and even within industries.</p>
<p><b>Non-operating</b></p> <p>Non-operating items of income or expense are recognised in OCI.</p> <p>No basis for recycling.</p>	<p>To the extent that they are defined by management, operating items reflect management's view of the components of the entity's financial performance that are likely to be predictive of those same components in the future.</p>	<p>The determination of what is 'non-operating' will be based on management judgement and could therefore decrease comparability across entities.</p> <p>What is 'operating' or 'non-operating' would be difficult to define in a Standard that is applicable broadly, due to the range of operating environments across reporting entities.</p>
<p><b>Measurement uncertainty</b></p> <p>Items of income and expense that are subject to too much measurement uncertainty are recognised in OCI.</p> <p>Possibly recycle when the measurement becomes less uncertain.</p>	<p>Items of income or expense that result from an asset or a liability with less measurement uncertainty are more likely to predict actual future cash flows.</p> <p>Measurements of a short-term nature are more certain and therefore more likely to reflect actual cash flows.</p>	<p>Difficult (and perhaps arbitrary) to determine the point when a measurement is so uncertain that it should be recognised in OCI.</p> <p>Income or expenses arising from uncertain measurements may economically offset items arising from measurements that are certain.</p> <p>Changes in measurements of some items that can have significant uncertainty (for example, impaired goodwill or allowances for loan losses) are in profit or loss and few would support recognising them in OCI.</p>

continued...

...continued

<b>Table 8.1: common suggestions for an attribute (or factor) to distinguish between profit or loss and OCI</b>		
<b>Distinguishing OCI attribute</b>	<b>Arguments for use in isolation</b>	<b>Arguments against use in isolation</b>
<p><b>Long term</b></p> <p>Items of income or expense that will be realised in the long term are recognised in OCI.</p> <p>Possibly recycle when the asset or the liability becomes short term.</p>	<p>Some items of income or expense not likely to be realised in the short term are more likely to reverse or otherwise change before realisation and therefore have less predictive value.</p>	<p>Difficult (and perhaps arbitrary) to determine what is 'short term'.</p> <p>What is perceived as 'long term' will vary across asset and liability classes, industries and businesses.</p>
<p><b>Outside management control</b></p> <p>Items of income or expense that arise as a result of events outside management's control are recognised in OCI.</p> <p>No basis for recycling.</p>	<p>Items of income or expense that are outside management's control are not a good indicator of the entity's and its management's performance.</p>	<p>Difficult (and perhaps arbitrary) to determine what is 'under management's control'. For example would a fair value gain on a debt instrument resulting from changes in market interest rates be under management's control if it was held for trading?</p> <p>Management chooses what risk to be exposed to, so it can ultimately control all or most risks.</p>

- 8.38 As discussed in paragraph 8.37 and described in Table 8.1, the IASB believes that no single attribute can operationally and meaningfully distinguish between those items that should be recognised in profit or loss and those that should be recognised in OCI. In addition, many of the attributes are or can be interrelated, for example, management may define operating activities to exclude things that would also be considered non-recurring items.
- 8.39 With this background, the remainder of this section discusses possible approaches to describing what could be included in OCI.

## **Approach 2A: narrow approach to OCI**

### **Principles to distinguish profit or loss from OCI items**

- 8.40 Based on the purpose of the statement(s) of profit or loss and OCI (see paragraphs 8.5–8.7) and the reasons why the IASB is persuaded to retain the concepts of profit or loss and recycling (see paragraphs 8.20 and 8.24), Approach 2A would apply the following principles to determine whether items of income and expense are eligible to be recognised in profit or loss or in OCI:
- (a) Principle 1: items of income and expense presented in profit or loss provide the primary source of information about the return an entity has made on its economic resources in a period.
  - (b) Principle 2: all items of income and expense should be recognised in profit or loss unless recognising an item in OCI enhances the relevance of profit or loss in that period.
  - (c) Principle 3: an item recognised in OCI must subsequently be reclassified (recycled) to profit or loss—this occurs when the reclassification results in relevant information.

- 8.41 The following paragraphs discuss each of these principles in turn.

### **Primary source of information about the return on economic resources**

- 8.42 The IASB has previously acknowledged that users of financial statements from all sectors incorporate profit or loss in their analyses, either as a starting point for further analysis or as the main measure of an entity's financial performance. Information about profit or loss helps users understand the entity's financial performance, including the return that the entity has made on its economic resources.
- 8.43 Recognising items separately in profit or loss and OCI clearly identifies different components of the return an entity has made on its resources during a period. Typically, this distinction can help communicate differences in those components in a way that is useful for assessing the prospects for future cash flows arising from them.
- 8.44 In proposed Principle 1, the term 'primary' refers to the pool of items that most prominently highlights that information.



8.45 'Primary' implies that there is a 'secondary' and that items presented outside profit or loss may still provide relevant information that will help a user of financial statements understand the return that an entity has made on its economic resources.

**Recognise an item in OCI if that enhances the relevance of profit or loss**

8.46 Because items within profit or loss provide the primary source of information about the return an entity has made on its economic resources, the IASB's presumption is that recognising an item in OCI would be appropriate only when such a presentation enhances the relevance of profit or loss for making decisions about providing resources to an entity. Recognising an item of income or expense in OCI will enhance the relevance of profit or loss if that:

- (a) makes the return on economic resources presented in profit or loss more understandable, ie makes the different components of a single item of income or expense more transparent; or
- (b) enhances the predictive value of the items in profit or loss.

8.47 To many, the information about transactions provided by cost-based measurements provides important information about the return that the entity has made on its economic resources. As a result, few have argued for using OCI to report income and expense arising from cost-based measurements. Consequently, this Discussion Paper takes the position that presenting in OCI items of income or expense resulting from cost-based measurements would not enhance the relevance of profit or loss.

8.48 In contrast, some changes in the current measures of assets and liabilities (ie measures based on fair value or other current market prices, and other measures based on estimated cash flows) may not have the same predictive value as cost-based information about transactions, consumption and impairment of assets, and fulfilment of liabilities. Thus, including them in profit or loss could, in some cases, obscure, or otherwise make it difficult to understand, the different components of that remeasurement that have different predictive values.

8.49 Changes in current measures may reflect the effects of changes in a number of factors or events that have different predictive values. Paragraph 6.47 identifies the elements captured in a fair value measurement and paragraph 6.112 identifies the factors to consider in constructing other cash-flow-based measurements. For example, the fair value of a debt instrument may change because of the passage of time, or changes in benchmark interest rates, in expected cash flows, in market spreads for counterparty credit risk or liquidity, or in market demand. Although measuring the debt instrument at fair value may provide useful information that warrants presentation in the statement of financial position, changes in some of the factors that contribute to that measure may have different predictive values.

8.50 Consequently, the IASB's preliminary view is that the use of OCI should be limited to items of income or expense resulting from changes in current

measures of assets and liabilities (remeasurements). However, not all such remeasurements would be eligible for recognition in OCI.

8.51 There may also be different views as to what constitutes a remeasurement. As this Discussion Paper proposes that recognition of items in OCI would not apply where an asset or a liability is measured using a cost-based measurement (including amortised cost), OCI would not be used for changes in cost-based measurements, such as the following:

- (a) depreciation or amortisation;
- (b) accrual of interest, accretion of a discount, or amortisation of a premium; or
- (c) impairment of assets or increases to the carrying amount of liabilities that have become onerous.

### **Recycle all OCI items**

8.52 Approach 2A proposes that all items of income or expense should be recognised in profit or loss at some point. Consequently, under Approach 2A, all items that have previously been recognised in OCI should be reclassified (recycled) to profit or loss in the subsequent period(s) when the reclassification results in relevant information. In many cases this will be on realisation, settlement or impairment, although in some cases recycling may need to occur at another time, such as in some forms of hedge accounting.

8.53 Applying this principle, it follows that if recycling would not result in relevant information in any subsequent period, the item of income or expense would not be eligible for recognition in OCI under Approach 2A.

### **Approach 2A: applying the principles**

8.54 Based on these three principles, Approach 2A proposes that only two groups of items would be eligible for recognition in OCI. These are described as ‘bridging items’ (see paragraphs 8.55–8.61) and ‘mismatched remeasurements’ (see paragraphs 8.62–8.68).

#### **Bridging items**

##### *What are ‘bridging items’?*

8.55 When an asset or a liability is remeasured, reflecting the effects of that remeasurement entirely in profit or loss will normally provide the most relevant and understandable information for users of financial statements. However, the IASB may occasionally decide that an asset or a liability should be remeasured, but that information in profit or loss should be based on a measurement that differs from the one used in the statement of financial position provided both measurements are meaningful, understandable and clearly describable.

8.56 In order to base information in profit or loss on a measurement different from the measurement used in the statement of financial position, the change in the difference between those two measures would be presented as a bridging item in OCI. The cumulative amount recognised in OCI would be the difference between the two measures. In other words, it provides a bridge between them.

8.57 For example, in its 2012 Exposure Draft *Classification and Measurement: Limited Amendments to IFRS 9* (the 'IFRS 9 2012 ED'), the IASB proposes that, in specified circumstances, debt instruments should be measured at fair value in the statement of financial position, but measured at amortised cost to determine the amounts recognised in profit or loss.<sup>69</sup> The cumulative amount recognised in OCI is the difference between the fair value of the debt instruments and their amortised cost. In the IASB's view, this presentation (reporting two measurements) best reflects the entity's financial position and performance in the specified circumstances, based on the business model within which the debt instrument is held, and therefore provides users of financial statements with the most relevant information for estimating the amount, timing and uncertainty of future cash flows.

*When should two measurements be used?*

8.58 If the IASB has decided that two measurements for a single asset or liability provide relevant information to users of financial statements (see paragraphs 8.55–8.57), it should consider whether those two measurements should appear in the statement of financial position and in profit or loss, with a resulting item in OCI. That consideration would be based on whether such presentation provides more relevant information than either:

- (a) recognising the entire amount of income or expense in profit or loss (possibly using more than one line item); or
- (b) recognising the results of one measure in the primary financial statements with disclosure of the other measure in the notes to the financial statements.

8.59 For the IASB to consider the use of two different measurements, both would need to provide useful information about different facets of the entity's financial position and financial performance. For this to be the case, the cumulative amount recognised in profit or loss since the entity acquired the asset or incurred the liability should be consistent with the results of a meaningful, understandable and clearly describable measure of the asset or the liability. Given the greater emphasis that users of financial statements place on information presented in profit or loss, it is important that all amounts presented within that total or subtotal reflect a measurement that is consistent with the concepts in the *Conceptual Framework*. How to determine an appropriate measurement is discussed in Section 6.

8.60 Requiring or permitting the use of two measurements would incur costs and might make the financial statements less understandable. The IASB would need to consider whether the benefits of the additional information would outweigh those disadvantages.

*Recycling bridging items*

8.61 In line with Principle 3, the amounts in OCI recycle into profit or loss as an automatic consequence of the measurement used to determine the income and expense recognised in profit or loss. For example, if a debt instrument is

<sup>69</sup> See paragraphs 4.1.2A, 5.7.1A and BC17–BC30 of the IFRS 9 2012 ED.

measured at fair value in the statement of financial position, but recognised in profit or loss using amortised cost, then amounts previously reported in OCI need to be recycled into profit or loss on impairment or disposal of the debt instrument. This is consistent with the amounts that would be recognised in profit or loss if the debt instrument was to be measured at amortised cost.

### **Mismatched remeasurements**

#### *What are 'mismatched remeasurements'?*

- 8.62 In some cases, an item of income or expense represents the effects of only part of a linked set of assets, liabilities, or past or planned transactions. This may arise when one of the items (or part of an item) within that linked set is regularly remeasured to a current value and the linked item is not remeasured or is not recognised until later, if at all. A mismatched remeasurement arises when the item of income or expense represents the linked set of items so incompletely that, in the opinion of the IASB, the item provides little relevant information about the return that the entity has made on its economic resources in the period. In this case, recognising a mismatched remeasurement in profit or loss would diminish the understandability and predictive value of the amounts included in profit or loss.
- 8.63 For example, IFRS requires most derivatives to be measured at fair value. When a derivative is used to hedge a forecast transaction, changes in the fair value of the derivative may arise in a reporting period or periods before the income or expense resulting from the forecast transaction. It can be argued that, until the impact of the derivative and the hedged item can be presented together, any gains or losses resulting from the remeasurement of the derivative may not provide the most relevant information about the return that the entity has made on its resources during the period. To the extent that the hedge is effective and qualifies for hedge accounting, in accordance with IFRS, an entity reports in OCI the gains or losses on the derivative, and subsequently recycles those gains or losses into profit or loss when the forecast transaction affects profit or loss. That enables users of financial statements to see the results of the hedging relationship.
- 8.64 Another example of a mismatched remeasurement is exchange gains or losses resulting when an entity translates an investment in a foreign operation into its presentation currency. This is because that remeasurement provides only an incomplete depiction of how the change in exchange rates affected the value of the investment in the foreign operation. It does not capture its effect on the value of unrecognised assets, particularly goodwill and intangible assets. In addition, it does not capture how changes in exchange rates affect the value, expressed in the foreign currency, of non-monetary assets or liabilities that are measured using a cost-based measurement. However, some have suggested that foreign exchange remeasurements maintain the capital of a foreign operation and hence may be viewed as capital maintenance adjustments. Those with this view think that these exchange gains and losses should not be recognised at all in the statement(s) of profit or loss and OCI (see Section 9 for more detail on capital maintenance).

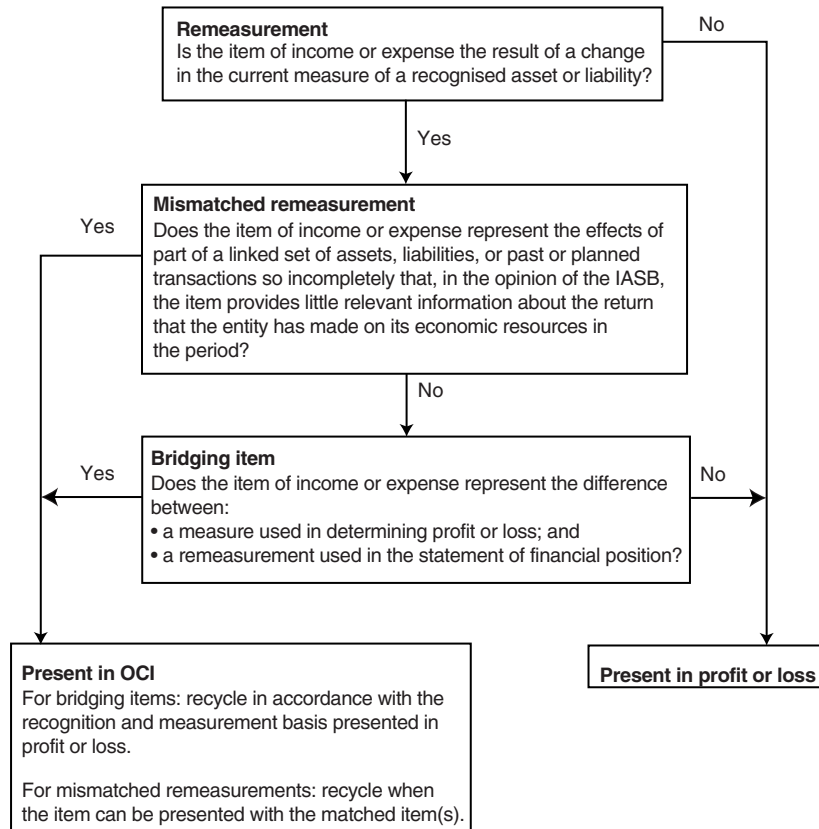
*Recycling mismatched remeasurements*

- 8.65 Amounts in OCI that are related to mismatched remeasurements would be recycled into profit or loss when they can be presented with the transactions with which they are linked. For example, in an effective cash flow hedge of a forecast sale of inventories that will be produced, and sold, in the future, the cumulative gain or loss on the hedging instrument previously recognised in OCI would be recycled to profit or loss when the entity recognises the revenue arising from the sale of the inventories.
- 8.66 Likewise, the cumulative amount of exchange gains or loss arising from the translation of a foreign operation would be recycled into profit or loss on disposal of the operation. This is on the basis that the cumulative amount at the date of disposal provides relevant information about the cumulative impact of the entity's exposure to foreign currency arising from its foreign activities. The recycled amount would appear in profit or loss together with the profit or loss on disposal of the operation, which would implicitly incorporate an amount for the appreciation (or depreciation) of all the foreign operation's assets and liabilities, including those that are non-monetary and cost-based or that were previously unrecognised.
- 8.67 However, some are of the view that because it can be difficult to determine when a foreign operation has been disposed of, for example, when the activities of the operation have been abandoned, identifying any particular period as the period of disposal can be arbitrary. Those with this view would argue that recycling of cumulative exchange differences may not necessarily provide relevant information in the period of disposal, particularly if that period is many years after the exchange differences were accumulated, such as in the case of foreign operations that have been gradually wound down.
- 8.68 Others are of the view that recycling exchange differences will produce relevant information in the period of disposal because it reflects the impact of the entity's long-term exposure resulting from a net investment. Those with this view argue that an entity has long-term foreign currency exposure to a net investment in a foreign operation rather than short-term exposure to the operation's net monetary assets. Disposal of that net investment marks the end of that long-term investment (and foreign currency exposure) and hence recycling of the cumulative exchange gain or loss provides information about both that cumulative exposure and the fact that the exposure has come to an end.

### Illustrating the concepts in Approach 2A

8.69 Flowchart 8.1 describes how the concepts of bridging items and mismatched remeasurements could be applied.

**Flowchart 8.1: Approach 2A—applying the concepts of bridging items and mismatched remeasurements**



### Applying Approach 2A to current (and proposed) OCI items

8.70 Table 8.2 sets out how the concepts of ‘bridging items’ and ‘mismatched remeasurements’ would apply to current and proposed treatments of OCI items.<sup>70</sup> As Table 8.2 shows, some items currently recognised in OCI, or currently proposed to be recognised in OCI, would not fit easily into either the bridging or mismatched remeasurement concepts without modification. This is because current IFRS requirements for these items:

- (a) do not permit recycling; or

<sup>70</sup> The analysis for financial instruments is based on IFRS 9 *Financial Instruments* and the IFRS 9 2010 ED (hedge accounting) and the IFRS 9 2012 ED (classification and measurement). It does not deal with IAS 39 *Financial Instruments: Recognition and Measurement*.

- (b) result in an amount recognised in profit or loss that would not result from a meaningful, understandable and clearly describable measure of the asset or the liability.

8.71 Table 8.2 does not include the treatment of OCI items arising from equity method investments in IAS 28 *Investments in Associates and Joint Ventures*. Table 8.2 does not include them because they are the investor's share of the investee's items of OCI.

Table 8.2: applying the concepts of 'bridging items' and 'mismatched remeasurements' to current and proposed OCI items							
IFRS or proposed IFRS	Recognised asset or liability	OCI item	Bridging item	Mismatched remeasurement	Inconsistencies of current IFRS treatment with bridging items or mismatched remeasurements		
IFRS 9 2012 ED	Financial assets measured at fair value through OCI	Change in the discount rate	Yes	No			
Insurance Contracts 2013 ED	Insurance contracts	Changes in the discount rate	Yes	No			
IAS 16, IAS 38, IFRS 6	Property, plant and equipment, intangibles, exploration and evaluation assets	Revaluation gain or reversals	?	No	Could be a bridging item. Revalued amount represents the amount that the entity may receive on disposal of the asset, and depreciated cost represents the use or consumption.  Potential amendments needed to meet bridging item criteria: (i) depreciation/amortisation would need to be based on the original cost; (ii) recycling on derecognition and impairment. See discussion in paragraph 8.75.		
IAS 19	Pensions—net defined benefit assets or liabilities	Remeasurement	?	No	See discussion in paragraph 8.73		
IAS 21	Net investment in foreign operations (and hedges)	Exchange differences	No	Yes			
IFRS 9 2010 ED	Cash flow hedging instruments	Effective portion of change in fair value	No	Yes			

continued...



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Table 8.2: applying the concepts of 'bridging items' and 'mismatched remeasurements' to current and proposed OCI items						
IFRS or proposed IFRS	Recognised asset or liability	OCI item	Bridging item	Mismatched remeasurement	Inconsistencies of current IFRS treatment with bridging items or mismatched remeasurements	
IFRS 9	Financial liabilities designated at fair value through profit or loss	Change in fair value attributable to issuer's own credit risk	No	?	<p>Could be a mismatched remeasurement.<sup>(a)</sup> Changes in fair value due to an entity's own credit risk are linked to changes in its goodwill. Because its credit risk increases, the value of goodwill decreases. Because internally generated goodwill is not recognised, changes in the value of goodwill are not recognised at the same time as related effects on own credit.</p> <p>Potential amendment needed to become mismatched remeasurement: amounts previously recognised in OCI would be recycled if the liability is transferred prior to maturity.</p>	
IFRS 9	Designated investments in equity instruments	Change in fair value	No	No	<p>Unlikely to meet either the bridging or mismatched remeasurement concept unless an operational impairment model can be developed. In addition, fair value is generally regarded as the most relevant measure of performance for equity instruments, except, arguably, for some strategic investments.</p> <p>(a) Changes in the fair value of a liability attributable to an issuer's own credit risk could also be viewed as a potential bridging item. The measure recognised in profit or loss reflects the change in fair value of the liability using a credit spread fixed at initial recognition. Cumulative amounts recognised in OCI would reverse over the life of the liability, or would need to be recycled on derecognition prior to maturity.</p>	

*Pensions*

- 8.72 Net defined benefit assets or liabilities are generally long term, which means that small changes in volatile market-based inputs, such as interest rates, can have a significant effect on remeasurements recognised in the current period. Some argue that because these effects could reverse or significantly change over the long holding period, information about financial performance can be better communicated if these remeasurements are presented in OCI.
- 8.73 However, in applying Approach 2A, a remeasurement of a net defined benefit pension asset or liability in accordance with IAS 19 *Employee Benefits* would not be recognised in OCI because it is:
- (a) not a mismatched remeasurement because there is no linked item that is not recognised, or is not remeasured; and
  - (b) not a bridging item. The cumulative amount recognised in profit or loss would not be consistent with any meaningful, understandable and clearly describable measure of the liability or the asset, because:
    - (i) the amounts recognised in profit or loss are determined using discount rates that are reset at the start of each period. An accumulation of these amounts could be described only by its history, not as a meaningful, understandable and clearly describable measure. In principle, this could be overcome by using a single discount rate for recognition in profit or loss through the life of an obligation, but this would require considerable tracking and operational complexity or highly arbitrary simplifications; it is not obvious that the resulting information would be relevant to users of financial statements.
    - (ii) differences between actual cash flows and previous estimates are accumulated in OCI without recycling. Any basis for recycling these differences would be arbitrary or highly complex.
- 8.74 The different ways of dealing with the remeasurement of net defined benefit assets and liabilities include the following:
- (a) if possible, address the operational and discount rate issues discussed in paragraph 8.73(b) so that the remeasurements of net defined benefit assets or liabilities could be treated as bridging items.
  - (b) accept that remeasurements of a net defined benefit pension asset or liability do not fit the concept of a bridging item or mismatched remeasurement, but require the use of OCI regardless. This would be a decision made by the IASB when developing or revising particular Standards.
  - (c) recognise and present the remeasurement of the net defined benefit pension asset or liability as a separate line item within profit or loss.

*Revaluations of property, plant and equipment*

- 8.75 As noted in Table 8.2, the revaluation of property, plant and equipment and intangible assets as currently required under IFRS does not seem to meet the

definition of a bridging item because, in accordance with IAS 16 and IAS 38 *Intangible Assets*, depreciation amounts recognised in profit or loss are determined using revalued carrying amounts. Consequently, cost less accumulated depreciation would not be a meaningful, understandable and clearly describable measure. In addition, these Standards do not permit recycling.

- 8.76 Some are of the view that revaluations in accordance with IAS 16 and IAS 38 were originally intended to be physical capital maintenance adjustments resulting from a current cost measurement. Section 9 discusses the concept of physical capital maintenance and how it relates to revaluations of property, plant and equipment and intangible assets.

***Impact of limiting OCI to bridging items and mismatched remeasurements***

- 8.77 Limiting OCI items conceptually to bridging items and mismatched remeasurements could mean that some items currently in OCI would conceptually not qualify for recognition in OCI. Conversely, some items currently recognised in profit or loss would qualify conceptually for recognition in OCI. This is not surprising, because the current approach to what should be recognised in OCI has developed without explicit concepts to guide consistent decisions.

- 8.78 Any decision to amend the existing use of OCI and profit or loss in particular Standards would require the IASB to go through its normal due process for adding a project to its agenda, and for developing an Exposure Draft and then an amendment to the relevant Standard. The IASB has no current plans to do so.

**Approach 2B: broad approach to OCI**

- 8.79 Some are of the view that Approach 2A narrows the use of OCI too far. Those with this view are concerned that:
- (a) some items currently recognised in OCI would not be eligible to be recognised in OCI under Approach 2A; and
  - (b) recycling all types of items recognised in OCI will not always provide useful information.

- 8.80 To reflect those views, Approach 2B would permit more items to be recognised in OCI than Approach 2A. Approach 2B allows the IASB greater discretion than Approach 2A when developing or revising particular Standards to determine whether an item of income or expense should be recognised in OCI and whether the item should subsequently be recycled.

**Principles to distinguish profit or loss from OCI items**

- 8.81 Approach 2B uses broadly the same principles as does Approach 2A, but interprets Principles 1 and 2 more broadly and amends Principle 3. Principles 1 and 2 are the same, namely:
- (a) Principle 1: items of income and expense presented in profit or loss provide the primary source of information about the return an entity has made on its economic resources in a period.

- (b) Principle 2: all items of income and expense should be recognised in profit or loss unless recognising an item in OCI enhances the relevance of profit or loss in that period.

8.82 However, in applying Principles 1 and 2, Approach 2B would take a broader view about the nature of the measure that is recognised in profit or loss. Approach 2A takes the view that splitting an item of income or expense into a component in profit or loss and a component in OCI will result in relevant information in profit or loss only if the component in profit or loss arises from a meaningful, understandable and clearly describable measure of the related asset or liability. Approach 2B takes a broader view about what information is relevant and understandable. That is, under Approach 2B, an item of income or expense can be disaggregated between profit or loss and OCI if the component recognised in profit or loss provides relevant information, ie enhances the predictive value and understandability of profit or loss. It would not need to arise from a clearly describable measure of the related asset or liability.

8.83 In addition, Principle 3 has been amended to give greater discretion to the IASB to determine whether items of income or expense recognised in OCI should be recycled. Principle 3 in Approach 2B reads as follows [emphasis added]:

Principle 3: an item that has previously been recognised in OCI should be reclassified (recycled) to profit or loss **when, and only when**, the reclassification results in relevant information.

8.84 The difference from Principle 3 in Approach 2A is that:

- (a) under Approach 2B only, an item may be recognised in OCI even if it would not subsequently qualify for recycling; and, accordingly,
- (b) a broader range of items of income and expense could be recognised in OCI under Approach 2B than under Approach 2A.

8.85 This treatment of recycling is based on the following arguments:

- (a) recycling some OCI items, such as the remeasurement of a defined benefit pension asset or liability, will not provide sufficiently relevant information (would not enhance the predictive value of profit or loss) to warrant recycling; and
- (b) recycling only when it provides relevant information protects the integrity of profit or loss as the primary group of items to provide information about the return that the entity has made on its economic resources.

### **Approach 2B—applying the principles**

8.86 In addition to the concepts in Approach 2A (bridging items and mismatched remeasurements), Approach 2B introduces an additional category of OCI item. This additional category is based on the view that remeasurements of some long-term assets or liabilities are best reflected outside profit or loss. Those with this view think that the long-term nature of those items and the resulting sensitivity of measures to small changes in inputs, such as discount rates, result

in remeasurements that are less predictive of future returns, or that may, in some cases, obscure or otherwise make it difficult to understand the information in profit or loss.

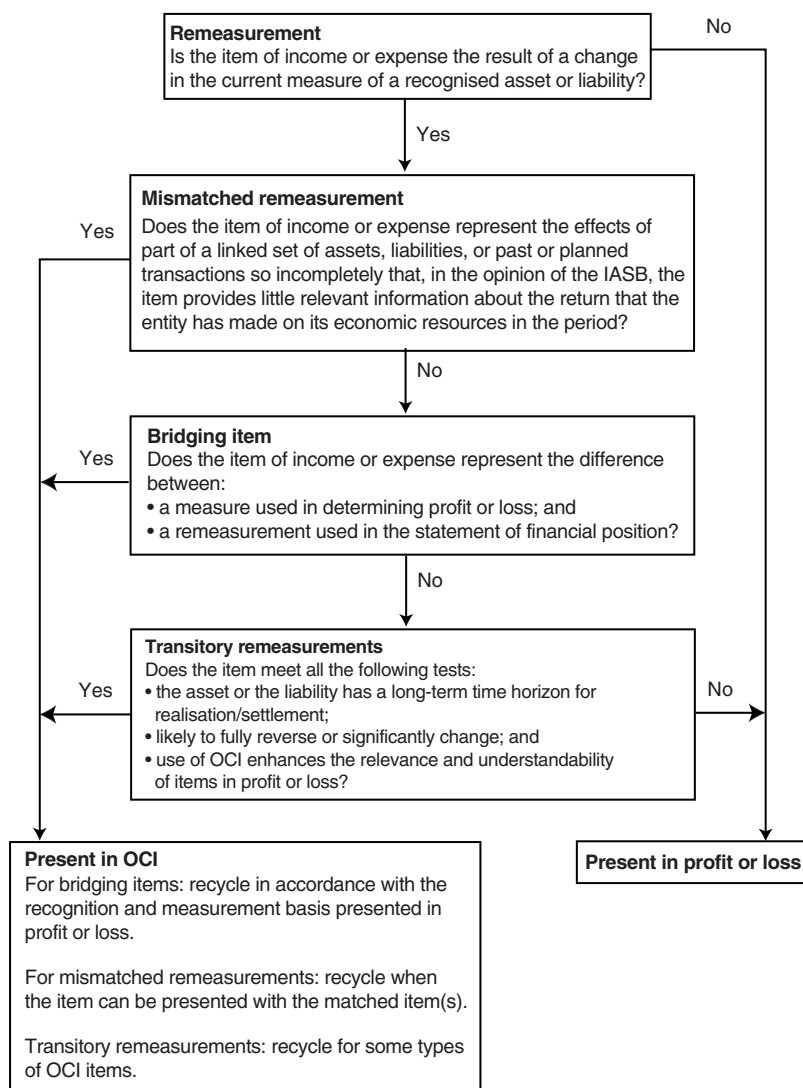
- 8.87 Presentation of a remeasurement, or more generally a disaggregated component of a remeasurement, in OCI in these circumstances may provide more transparent information about how the asset is likely to contribute to future cash flows or how the liability is likely to be settled.
- 8.88 On the basis of this view, Approach 2B proposes that, in addition to using the concepts of mismatched remeasurements and bridging items, the IASB should consider recognising items of income and expense in OCI if they have all of the following characteristics:
- (a) the asset will be realised, or the liability will be settled, over the long-term;
  - (b) the current period remeasurement is likely to reverse fully, or significantly change (in either direction), over the holding period of the asset or the liability; and
  - (c) recognising the current period remeasurement fully or partly in OCI enhances the relevance and understandability of profit or loss as the primary indicator of the return that the entity has made on its economic resources.
- 8.89 In this Discussion Paper, items of income or expense that have all the characteristics listed in paragraph 8.88 and that the IASB decides should be recognised in OCI are collectively referred to as 'transitory remeasurements'.
- 8.90 An example of a transitory remeasurement would be the remeasurement of a net defined benefit pension liability or asset. The individual obligations will be settled as employees leave employment and eventually die. The time horizon for this type of settlement is generally viewed as long term, ie the lives of the employees. Because of this time horizon and the nature of the risks, actuarial gains and losses arising from defined benefit obligations and plan assets are expected to change significantly over many reporting periods. The remeasurement provides information about the uncertainty and risks of future cash flows and reflects those uncertainties and risks in the statement of financial position. However, the remeasurement provides less information about the likely amount and timing of those cash flows. Consequently, recognising the remeasurement in OCI makes the difference in the predictive value of those items transparent and differentiates them from items in profit or loss that have more predictive value, making profit or loss more understandable.
- 8.91 Transitory remeasurements are recycled only if the recycling adjustment provides sufficiently relevant information to justify the cost and complexity that recycling adds to financial reporting. Consequently, the IASB would determine in the Standard dealing with each particular type of transitory remeasurement included in OCI whether it should be recycled, and when.
- 8.92 For example, because for remeasurements of net defined benefit liabilities it is difficult to identify a suitable basis for recycling that is both operational and provides relevant information (see paragraph 8.73(b)), the IASB could determine

that those transitory remeasurements should not be recycled. As in Approach 2A, recycling would always be used for bridging items and mismatched remeasurements.

**Illustrating the concepts in Approach 2B**

8.93 Flowchart 8.2 describes how the concepts of bridging items, mismatched remeasurements and transitory remeasurements could be applied.

**Flowchart 8.2: Approach 2B—applying the concepts of bridging items, mismatched remeasurements and transitory remeasurements**



8.94 Table 8.3 sets out how Approach 2B would apply to current and proposed treatments of OCI items.<sup>71</sup>

**Table 8.3: applying Approach 2B to current and proposed OCI items**

IFRS or proposed IFRS	Recognised asset or liability	OCI item	OCI item using Approach 2B?	Basis for OCI treatment (based on current/ proposed IFRS)
IFRS 9 2012 ED	Financial assets measured at fair value through OCI	Changes in discount rate	Yes	Bridging item
Insurance Contracts 2013 ED	Insurance contracts	Changes in the discount rate	Yes	Bridging item
IAS 16, IAS 38, IFRS 6	Property, plant and equipment, intangible assets and exploration and evaluation assets	Revaluation gain or reversals	Yes	Transitory remeasurement
IAS 19	Pensions—net defined benefit assets or liabilities	Remeasurement	Yes	Transitory remeasurement
IAS 21	Net investment in foreign operations (and hedges)	Exchange differences	Yes	Mismatched remeasurement
IFRS 9 2010 ED	Cash flow hedging instruments	Effective portion of change in fair value	Yes	Mismatched remeasurement
IFRS 9	Financial liabilities designated at fair value through profit or loss	Change in fair value due to issuer's own credit risk	Yes	Transitory remeasurement
IFRS 9	Designated investments in equity instruments	Change in fair value	Yes	Transitory remeasurement

<sup>71</sup> The analysis for financial instruments is based on IFRS 9 *Financial Instruments*, the Exposure Draft *Hedge Accounting* (published in 2010) and the IFRS 9 2012 ED (classification and measurement). The analysis does not deal with IAS 39. OCI items arising within equity method investments follow the analysis of the individual items presented.

**Impact of Approaches 2A and 2B on items currently reported in profit or loss**

- 8.95 Other remeasurements in existing IFRSs currently recognised in profit or loss could potentially qualify conceptually as bridging items or transitory remeasurements (see Table 8.4). However, this does not necessarily mean that the IASB would choose to treat these items as bridging items or transitory remeasurements. Doing so would be a decision that the IASB might make if it develops or revises a Standard on these areas.
- 8.96 The IASB has not identified any mismatched remeasurements that are not currently recognised in OCI.



**Table 8.4: applying the concepts of ‘bridging items’ and ‘transitory remeasurements’ to items currently recognised in profit or loss**

IFRS	Recognised asset or liability	Current profit or loss item	Characteristics that may make item qualify as a bridging item or transitory remeasurement
IAS 37	Long-term provisions (includes decommissioning, restoration and similar liabilities)	Remeasurement	Transitory remeasurement: Provisions can be long-term in nature, which means that small changes in market-based inputs, such as discount rates, can have a significant effect on remeasurements recognised in the current period. Aspects of these remeasurements, for example, the effect of changes in discount rates are likely to significantly change or reverse over the life of the provision. Separate recognition of these effects in OCI may help to make other components of the remeasurement, for example, increased costs, more understandable. However, it might be inconsistent to treat losses recognised on initial recognition differently from subsequent remeasurements.
IAS 40	Investment property	Remeasurement	Bridging item: Business model may be both: (a) to collect cash flows from renting the property; and (b) to sell the property.
IAS 41	Biological asset before point of harvest	Change in fair value less costs to sell	Transitory remeasurement: Biological assets may be long term, which means that small changes in market-based inputs, such as commodity prices and discount rates, may have significant effect on remeasurements that are recognised during the period, but are likely to significantly change over time. Separate recognition of some components in OCI may make information about other components of the remeasurement recognised in profit or loss more understandable, for example, change in value due to growth recognised in profit or loss. <sup>(a)</sup>

(a) The proposed limited-scope improvement to IAS 41 *Agriculture* may treat some bearer biological assets in the same way as property, plant and equipment. This would make the IAS 16 revaluation model available for these assets.

## Comparison of approaches

8.97 Table 8.5 sets out arguments for and against the three approaches discussed in this Discussion Paper. As discussed in paragraph 8.26, the IASB's preliminary view is that the *Conceptual Framework* should require a profit or loss total or subtotal that also results, or could result, in some items of income or expense being recycled. Approach 1 is not compatible with this preliminary view.

**Table 8.5: arguments for and against each approach to profit or loss**

Approach	Arguments in support	Arguments against
Approach 1	<p>Eliminating recycling reduces complexity, for example, recycling may obscure the income and expenses relating to the period.</p> <p>Because all items of income and expense are recognised in the statement of comprehensive income only once, the financial statements may be more understandable.</p> <p>Reclassification adjustments may not meet the definition of income or expense.</p> <p>Profit or loss would be less susceptible to earnings management.</p>	<p>Does not address what should be presented in profit or loss and OCI (with no recycling).</p> <p>Gives the IASB too much discretion when developing or revising Standards to determine how it would distinguish profit or loss from OCI.</p> <p>Because some gains and losses might never be recognised in profit or loss, prohibiting recycling impairs the depiction of profit or loss as the return that the entity has made on its economic resources.</p>
Approach 2A	<p>Clear framework for determining what is recognised in OCI, and therefore more likely to result in consistent use of OCI in IFRSs.</p> <p>Consistent treatment of recycling helps to reduce the complexity of financial statements.</p> <p>Because all items of income and expense will ultimately be recognised in profit or loss, it supports profit or loss as the primary depiction of the return that the entity has made on its economic resources.</p> <p>Cumulative OCI has an inherent meaning for each item.</p>	<p>Some items currently recognised in OCI would not meet the criteria for bridging items or mismatched remeasurements. Some think that these items should be recognised in OCI and therefore question the usefulness of the concepts of bridging items and mismatched remeasurements.</p> <p>Provides little flexibility for the IASB to use OCI as IFRSs develop in the future.</p> <p>Always recycling items may result in items of income and expense in profit or loss that provide little additional relevant information for that period.</p> <p>Recycling defers items of income and expense that, arguably, do not meet the definition of income or expense in the period when they recycle.</p>

*continued...*

...continued

Approach	Arguments in support	Arguments against
Approach 2B	<p>Provides a framework for use of OCI, but still gives the IASB some discretion when developing or revising Standards to adapt the use of OCI as IFRS develops.</p> <p>Measurement of some items is so sensitive to small changes in inputs that recognising the measurement change in profit or loss may drown the underlying signals from other items in profit or loss. This approach enables the IASB to consider separate presentation in OCI for these items.</p> <p>This approach would more closely reflect items that are currently recognised in OCI.</p> <p>Recycling does not always provide sufficiently relevant information about a transaction or other event in a subsequent period. This approach gives the IASB discretion to determine when this may be the case.</p>	<p>Discretion by the IASB when developing or revising Standards may result in less consistent treatment of OCI in IFRS.</p> <p>Results in less consistent treatment of recycling. Consequently, it is more complex than 'no recycling' or 'all recycling' options.</p> <p>Recycling of only some OCI items reduces the 'primacy' of profit or loss. Non-recycling of some items may result in relevant transactions or other events never being reflected in profit or loss.</p> <p>Cumulative OCI may have no meaning for some items.</p>

## Questions for respondents

### Question 19

The IASB's preliminary view that the *Conceptual Framework* should require a total or subtotal for profit or loss is discussed in paragraphs 8.19–8.22.

Do you agree? Why or why not?

If you do not agree do you think that the IASB should still be able to require a total or subtotal profit or loss when developing or revising particular Standards?

### Question 20

The IASB's preliminary view that the *Conceptual Framework* should permit or require at least some items of income and expense previously recognised in OCI to be recognised subsequently in profit or loss, ie recycled, is discussed in paragraphs 8.23–8.26.

Do you agree? Why or why not? If you agree, do you think that all items of income and expense presented in OCI should be recycled into profit or loss? Why or why not?

If you do not agree, how would you address cash flow hedge accounting?

### Question 21

In this Discussion Paper, two approaches are explored that describe which items could be included in OCI: a narrow approach (Approach 2A described in paragraphs 8.40–8.78) and a broad approach (Approach 2B described in paragraphs 8.79–8.94).

Which of these approaches do you support, and why?

If you support a different approach, please describe that approach and explain why you believe it is preferable to the approaches described in this Discussion Paper.

## Section 9—Other issues

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- 9.1 The following issues are discussed in this section:
- (a) the IASB's proposed approach to Chapters 1 and 3 of the existing *Conceptual Framework* (see paragraphs 9.2–9.22);
  - (b) the use of the business model concept in financial reporting (see paragraphs 9.23–9.34);
  - (c) unit of account (see paragraphs 9.35–9.41);
  - (d) going concern (see paragraphs 9.42–9.44); and
  - (e) capital maintenance (see paragraphs 9.45–9.54).

### **Chapter 1 and Chapter 3 of the existing *Conceptual Framework***

- 9.2 When the IASB restarted work on the *Conceptual Framework* project in 2012, it decided not to undertake a fundamental reconsideration of the chapters of the *Conceptual Framework* that it published in 2010 (Chapter 1 *The Objective of General Purpose Financial Reporting* and Chapter 3 *Qualitative Characteristics of Useful Financial Information* ('Chapters 1 and 3')) because:
- (a) these chapters have been through extensive due process and, in the IASB's opinion, provide a sound foundation for the rest of the *Conceptual Framework*; and
  - (b) the IASB has no reason to think that a fundamental reconsideration of Chapters 1 and 3 would lead to significant changes, or that any resulting changes would significantly affect the remaining chapters. A fundamental reconsideration of these chapters would be time consuming and might lead to unnecessary delays in the finalisation of the revised *Conceptual Framework*.
- 9.3 Although the IASB does not intend to fundamentally reconsider the content of these chapters, the IASB will make changes if work on the rest of the *Conceptual Framework* highlights areas that need clarifying or amending. Appendix A reproduces the text of these two chapters.
- 9.4 Some have expressed concerns about the IASB's decision not to reconsider fundamentally Chapters 1 and 3 of the existing *Conceptual Framework*. In particular, they have expressed concerns about the following aspects of these chapters:
- (a) the treatment of 'stewardship' in Chapter 1 (see paragraphs 9.5–9.9);
  - (b) the decision to replace the fundamental characteristic of 'reliability' with that of faithful representation (see paragraphs 9.10–9.14); and
  - (c) the decision to remove any reference to the concept of 'prudence' from the *Conceptual Framework* (see paragraphs 9.15–9.22).

## Stewardship

- 9.5 Before the publication of Chapter 1, the *Conceptual Framework* made explicit reference to stewardship:

Financial statements also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it. Those users who wish to assess the stewardship or accountability of management do so in order that they may make economic decisions; these decisions may include, for example, whether to hold or sell their investment in the entity or whether to reappoint or replace the management.<sup>72</sup>

- 9.6 In describing the objective of general purpose financial reporting, Chapter 1 does not use the word 'stewardship'. Some have interpreted this as meaning that the *Conceptual Framework* no longer treats information about stewardship as part of what is needed to meet the objective of financial reporting. Those with this view believe that, as a result, financial reporting may come to focus more on the needs of short-term investors, who may be viewed as likely to sell their holdings if the performance of an entity is poor, rather than on the needs of longer-term investors, who may be viewed as more likely to work with management to improve an entity's performance, or who may wish to change management.

- 9.7 Although Chapter 1 does not use the phrase stewardship, it was not the intention of the IASB to remove the concept of stewardship from the objective of financial reporting. Chapter 1 states that users of financial statements need information about how effectively and efficiently the entity's management and governing body have discharged their responsibilities:

To assess an entity's prospects for future net cash inflows, existing and potential investors, lenders and other creditors need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources. Examples of such responsibilities include protecting the entity's resources from unfavourable effects of economic factors such as price and technological changes and ensuring that the entity complies with applicable laws, regulations and contractual provisions. Information about management's discharge of its responsibilities is also useful for decisions by existing investors, lenders and other creditors who have the right to vote on or otherwise influence management's actions.<sup>73</sup>

- 9.8 Paragraph BC1.27 of Chapter 1 states that information that can be used to assess future cash flow prospects and information about stewardship are both important for making decisions about providing resources to an entity. In addition, information about stewardship is important for resource providers who have the ability to vote on, or otherwise influence, management's actions.

- 9.9 The Basis for Conclusions goes on to explain that the IASB decided to describe what is meant by the term stewardship rather than using the term itself because there would be difficulties translating the term 'stewardship' into other languages.

<sup>72</sup> See paragraph 14 of the pre-2010 *Conceptual Framework*.

<sup>73</sup> See paragraph OB4 of the existing *Conceptual Framework*.

## Reliability

- 9.10 Before Chapter 3 was published in 2010, the *Conceptual Framework* stated that one of the qualitative characteristics of useful financial information was reliability. In 2010, Chapter 3 replaced reliability with the qualitative characteristic of faithful representation—information is useful if it faithfully represents what it purports to represent.<sup>74</sup>
- 9.11 Paragraphs BC3.20–BC3.25 of Chapter 3 explain why the IASB replaced the term ‘reliability’ with the term ‘faithful representation’. The main reason for the change was a lack of a common understanding of the term reliability. In particular, many seemed to equate reliability with information being verifiable or free from material error.<sup>75</sup>
- 9.12 Some have objected to the replacement of the term ‘reliability’ with the term ‘faithful representation’ stating that:
- (a) the idea that users can rely on the financial statements is a key concept;
  - (b) the concept of reliability is better understood and easier to explain than the concept of faithful representation; and
  - (c) the concept of reliability is more likely to result in the use of measurements that are more verifiable and more likely to be free from error.
- 9.13 The term ‘reliability’ was in fact intended to describe more than just verifiability and freedom from material error. Table 9.1 compares the description of reliability in the pre-2010 *Conceptual Framework* and the description of faithful representation in Chapter 3.

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<sup>74</sup> See paragraph QC12 of the existing *Conceptual Framework*.

<sup>75</sup> ‘Verifiability’ is described in Chapter 3 as an enhancing qualitative characteristic of useful financial information.

**Table 9.1: description of reliability in the pre-2010 *Conceptual Framework* and the description of faithful representation in Chapter 3**

<b>Pre-2010 <i>Conceptual Framework</i></b>	<b>Chapter 3</b>
<p>To be useful, information must be reliable. Information is reliable when it:</p> <ul style="list-style-type: none"> <li>• is free from material error and bias; and</li> <li>• can be depended upon by users of financial statements to represent faithfully what it purports to represent.</li> </ul> <p>Other aspects of reliability:</p> <ul style="list-style-type: none"> <li>• substance over form;</li> <li>• neutrality;</li> <li>• prudence; and</li> <li>• completeness.</li> </ul>	<p>To be useful, information must faithfully represent what it purports to represent. A perfectly faithful representation would be:</p> <ul style="list-style-type: none"> <li>• complete;</li> <li>• neutral; and</li> <li>• free from error.</li> </ul>

- 9.14 As can be seen from Table 9.1, the concepts of reliability and faithful representation have much in common. Both concepts require neutrality, completeness and freedom from error. Faithful representation is described in the pre-2010 *Conceptual Framework* as an aspect of reliability (that is, information is reliable if it can be depended upon to represent faithfully what it purports to represent). The main difference between the two concepts is that Chapter 3 does not refer to prudence or substance over form. The concept of prudence is discussed in paragraphs 9.15–9.22. Paragraph BC3.26 of Chapter 3 explains that substance over form is not considered a separate component of faithful representation because it would be redundant. Accounting for something in accordance with its legal form rather than its economic substance could not result in a faithful representation.

### **Prudence**

- 9.15 Both paragraph QC12 of Chapter 3 and paragraph 36 of the pre-2010 *Conceptual Framework* state that financial statements should be neutral, that is, free from bias. However, the pre-2010 *Conceptual Framework* went on to describe the concept of prudence. Chapter 3 does not include any reference to prudence.
- 9.16 Paragraph 37 of the pre-2010 *Conceptual Framework* describes prudence as follows:
- Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and therefore, not have the quality of reliability.



- 9.17 Hence, the pre-2010 *Conceptual Framework* expressed the view that the exercise of prudence need not be inconsistent with neutrality.
- 9.18 In developing Chapter 3 of the *Conceptual Framework*, the IASB removed reference to the concept of prudence. The Basis for Conclusions on Chapter 3 explains that prudence was not included as an aspect of faithful representation because:
- (a) including a reference to prudence would be inconsistent with neutrality. Even with the prohibitions against deliberate misstatement that appear in the pre-2010 *Conceptual Framework*, a requirement to be prudent would lead to bias in the preparation of financial statements.
  - (b) deliberately understating assets or overstating liabilities in one period often leads to overstating financial performance in later periods.<sup>76</sup>
- 9.19 Many continue to object to the removal of the reference to prudence from the *Conceptual Framework*, stating that:
- (a) deliberately reflecting conservative estimates in the financial statements may be desirable to counteract the effect of over-optimistic management estimates.
  - (b) such a removal could result in the recognition of assets and gains whose existence is uncertain and the non-recognition of some possible liabilities and possible losses. The IASB's proposed approach to situations where the existence of an asset or a liability is uncertain is discussed in Section 2.
  - (c) such a removal may increase the use of current value measurements (including fair value), which some view as inherently unverifiable and prone to error.
- 9.20 Few would disagree with the idea expressed in the pre-2010 *Conceptual Framework* that a preparer should exercise caution when making estimates and judgements under conditions of uncertainty. This idea is reflected in many of the decisions that the IASB makes when setting Standards.
- 9.21 However, it is unclear whether some who call for the reintroduction of references to prudence would agree with the description of prudence as the exercise of caution when making estimates and judgements under conditions of uncertainty. Some would prefer financial statements to show a bias towards conservatism and reject the notion of neutrality.
- 9.22 As noted in paragraph 9.19, some have expressed a fear that removing prudence will lead to a much more widespread use of current value measurements than at present. Section 6 on measurement indicates the factors that the IASB believes it will need to consider when determining which measurement to adopt when developing or revising particular Standards. It is not clear that including prudence as an additional factor to consider would result in a significantly different outcome.

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<sup>76</sup> See paragraphs BC3.27–BC3.29 of the existing *Conceptual Framework*.

## **The use of the business model concept in financial reporting**

- 9.23 Some have argued that the business model concept should play a significant role in standard-setting. The following paragraphs:
- (a) describe how the business model concept is used in existing IFRSs (see paragraphs 9.24–9.28);
  - (b) discuss how others have described the business model concept (see paragraph 9.29);
  - (c) discuss the advantages and disadvantages of using a business model concept in financial reporting (see paragraphs 9.30–9.31); and
  - (d) describe how ideas similar to a business model concept have been used in this Discussion Paper (see paragraphs 9.32–9.34).

### **How the business model concept is used in existing IFRSs**

- 9.24 The IASB first used the term ‘business model’ in IFRS 9 *Financial Instruments*, which stated that classification and measurement of financial assets depend on an entity’s business model for managing those assets.
- 9.25 IFRS 9 does not define an entity’s business model but notes the following:
- (a) the entity’s key management personnel (as defined in IAS 24 *Related Party Disclosures*) are responsible for determining the objective of the business model;
  - (b) an entity’s business model is not a choice but is instead a matter of fact that can be observed by the way an entity is managed and information is provided to its management;
  - (c) a single entity may have more than one business model for managing its financial instruments; and
  - (d) a business model is different from ‘management’s intentions’, which can relate to a single financial instrument.
- 9.26 More recently, the IASB required investment entities not to consolidate some of their subsidiaries (see paragraph BC226 of IFRS 10 *Consolidated Financial Statements*). This is because investment entities have a unique business model that makes reporting subsidiaries at fair value more appropriate than consolidation.
- 9.27 Although other IFRSs do not explicitly refer to a business model, the way in which an entity uses its assets has previously been used in IFRSs, particularly in classifying and measuring different types of non-financial assets:
- (a) inventories are assets that are held for sale in the ordinary course of business, in the process of production for such sales or in the form of materials or supplies to be consumed in the production process or in the rendering of services (see IAS 2 *Inventories*).

- (b) inventories held by commodity broker-traders are measured differently from other inventories because they are acquired with the purpose of selling in the near future and generating a profit from fluctuations in price or broker-traders' margin (see paragraph 5 of IAS 2).
- (c) investment properties are held to earn rentals or for capital appreciation or both, rather than for:
  - (i) use in the production or supply of goods or services or for administrative purposes; or
  - (ii) sale in the ordinary course of business (see IAS 40 *Investment Property*).
- (d) property, plant and equipment are held for use in the production or supply of goods or services or for administrative purposes (see IAS 16 *Property, Plant and Equipment*).
- (e) non-current assets that will no longer be used by the entity (assets that are held for sale or are discontinued) are measured differently from other non-current assets (see IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*).

9.28 An entity's business model also affects how it reports operating segments in accordance with IFRS 8 *Operating Segments*. The management approach to segment reporting requires the disclosure of information about operating segments that is based on how the entity's chief operating decision maker decides about the resources to be allocated and assesses the performance of each segment. Respondents to the Exposure Draft on IFRS 8 noted that this approach would allow users to review an entity's operations from the same perspective as management.<sup>77</sup>

#### **How others have described the term 'business model'**

9.29 Although some existing IFRSs reflect the way in which a reporting entity conducts its business activities, the IASB has not defined the term 'business model'. However, other organisations have described the business model concept as follows:

- (a) the International Integrated Reporting Council's Consultation Draft of the International <IR> Framework suggested the following definition for a business model: "the chosen system of inputs, business activities, outputs and outcomes that aims to create value over the short, medium and long term."
- (b) some think that a business model would reflect:
  - (i) the configuration of the business;
  - (ii) activities of the business;
  - (iii) how the business adds value including the generation of its cash flows; and
  - (iv) customers of the products or services.

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<sup>77</sup> See paragraph BC10 of IFRS 8.

- (c) some think that the business model refers to management's use or disposition of assets and holding or transferring/settling obligations, with the understanding that these actions are undertaken with a profit motive. They are of the view that there is no difference between management's intention and a business model approach.

#### **Advantages and disadvantages of using an entity's business model in financial reporting**

- 9.30 Some have argued that the business model concept should play a significant role in standard-setting. They think that applying the business model concept when developing IFRSs provides relevant information because it provides insights into how the entity's business activities are managed. Consequently, it helps users of financial statements to assess the resources of the entity, claims against the entity, and how the entity's management and governing board have discharged their responsibilities to use the entity's resources.
- 9.31 Others think that the business model should not be used in standard-setting because:
  - (a) they think it reduces comparability:
    - (i) having a business model approach could result in different classification, measurement or disclosure of the same economic phenomenon or transaction. For example, identical financial assets could be accounted for differently depending on whether the entity will hold the asset for collection or for sale.
    - (ii) some believe that the business model approach to financial reporting provides entities with a choice about how to report the same economic phenomenon or transaction.
  - (b) they think it could encourage less neutral reporting because it could encourage preparers to present the most favourable outcome.
  - (c) they believe that the business model concept is difficult to define and apply on a consistent basis.

#### **How this Discussion Paper has used ideas that are similar to a business model concept**

- 9.32 This Discussion Paper does not define the business model concept. However, the IASB's preliminary view is that financial statements can be made more relevant if the IASB considers, when it develops or revises particular Standards, how an entity conducts its business activities.
- 9.33 The way in which an entity conducts its business activities is considered in the following sections:
  - (a) Section 6—Measurement: the IASB should consider how an asset contributes to future cash flows and how a liability will be settled or fulfilled when deciding on an appropriate measurement method.

- (b) Section 7—Presentation and disclosure: in determining the level of aggregation or disaggregation in the primary financial statements, the IASB or an entity will need to consider how the item is used in the entity's business.
  - (c) Section 8—Presentation in the statement(s) of profit or loss and other comprehensive income: in deciding whether to present different measurements in profit or loss and the statement of financial position (ie a bridging item), the IASB should consider (among other things) how the entity will use that item in its business.
- 9.34 The IASB has not identified any other significant implications of the business model concept for the *Conceptual Framework*.

### **Unit of account**

- 9.35 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 resources, or other rights, and obligations. The level of aggregation required is usually referred to as the 'unit of account'.
- 9.36 For example, as discussed in Section 3, 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 any other rights conferred by legal title to the asset). Although, in principle, each of these rights is capable of being a separate asset, combining them 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 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.
- 9.37 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 a single share in that equity investment is measured and multiplied by the number of shares held; 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.
  - (c) if assets or liabilities are measured by reference to the most likely outcome of uncertain future cash flows, that outcome may differ depending on whether it is determined for each asset or liability individually, or for a group of assets or liabilities.

- 9.38 The IASB's preliminary view is that deciding which unit of account will provide the most useful information to existing and potential investors, lenders and other creditors will normally be a decision for projects to develop or revise particular Standards, rather than a decision that can be resolved conceptually for a broad range of Standards. In making that decision, the IASB will consider the qualitative characteristics of useful financial 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, the subject of separate transactions or if they would expire in different patterns.
  - (b) faithfully represent what it purports to represent. Grouping unrelated assets or liabilities together, in order to measure them, may not faithfully represent an entity's financial position or performance.
- 9.39 In addition, the costs associated with the selected unit of account must not exceed the benefits. In general, the costs associated with recognising and measuring items will be greater for a smaller unit of account.
- 9.40 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.
- 9.41 The unit of account for recognition and measurement will normally be the same. However, in some situations the IASB may decide that different units of account should be used for recognition and/or measurement.

### Going concern

- 9.42 In paragraph 4.1 of the existing *Conceptual Framework*, the going concern assumption is discussed:
- The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations; if such an intention or need exists, the financial statements may have to be prepared on a different basis and, if so, the basis used is disclosed.
- 9.43 This Discussion Paper identifies the following situations in which the going concern assumption is relevant:
- (a) Section 3 on additional guidance to support the asset and liability definitions states that requirements to make payments that would arise only on liquidation do not meet the definition of a present obligation.
  - (b) Section 6 on measurement notes that a change in an entity's ability to continue as a going concern may affect how its:
    - (i) assets will contribute to future cash flows; and

- (ii) liabilities will be settled.

In addition, whether an entity is or is not a going concern could affect the disclosures that are made by that entity.

- 9.44 The IASB has not identified any other situations in which the going concern assumption affects an entity's financial statements.

### **Capital maintenance**

- 9.45 Concepts of capital maintenance are important, because only income earned in excess of amounts needed to maintain capital can be regarded as profit. Paragraph 4.59 of the existing *Conceptual Framework* describes the following concepts of capital maintenance:

- (a) *financial capital maintenance*: under this concept a profit is earned only if the financial (or money) amount of the net assets at the end of the period exceeds the financial (or money) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.
- (b) *physical capital maintenance*: under this concept a profit is earned only if the physical productive capacity (or operating capacity) of the entity (or the resources or funds needed to achieve that capacity) at the end of the period exceeds the physical productive capacity at the beginning of the period, after excluding any distributions to, and contributions from, owners during the period.

- 9.46 Most entities adopt a financial concept of capital maintenance. However, the existing *Conceptual Framework* does not prescribe a particular model of capital maintenance. The existing *Conceptual Framework* notes that management of an entity should exercise judgement and select the concept of capital maintenance that provides the most useful information to users of financial statements.

- 9.47 Increases and decreases in equity arising from capital maintenance adjustments would normally be reported directly in equity rather than in the statement of comprehensive income.

- 9.48 The concepts of capital maintenance are used in IAS 29 *Financial Reporting in Hyperinflationary Economies*.

### **Proposed approach to capital maintenance**

- 9.49 The IASB notes that the concepts of capital maintenance are probably most relevant for entities operating in high inflation economies. The IASB plans to undertake research to determine whether to revise IAS 29. Consequently, the IASB believes that the issues associated with capital maintenance are best dealt with at the same time as a possible project on accounting for high inflation rather than as part of the *Conceptual Framework* project. As part of this work, the IASB may consider whether capital maintenance adjustments should continue to be presented in equity or whether they should be included in a separate category of OCI that is not recycled.

- 9.50 The IASB plans to include the existing descriptions and discussion of the concepts of capital maintenance in the revised *Conceptual Framework* largely unchanged until such time as any project on accounting for high inflation indicates a need for change.

### **Revaluations of property, plant and equipment**

- 9.51 IAS 16 permits entities to revalue property, plant and equipment.<sup>78</sup> If an entity elects to use the revaluation model, it accounts for its revalued items as follows:
- (a) the item of property, plant and equipment is carried at its revalued amount less any subsequent accumulated depreciation and subsequent accumulated impairment losses;
  - (b) depreciation is based on the revalued carrying amount of the asset;
  - (c) revaluation gains are recognised in OCI and are accumulated in equity as a revaluation surplus (unless they reverse a revaluation decrease that was previously recognised in profit or loss);
  - (d) revaluation losses are recognised in profit or loss (unless a credit balance exists on the revaluation surplus for that asset, in which case the loss is recognised in OCI); and
  - (e) revaluation surpluses are not recycled to profit or loss on derecognition of the associated asset. However, an entity may transfer the revaluation surplus directly to another component of equity.
- 9.52 As noted in Section 8, presenting revaluations of property, plant and equipment in OCI may be inconsistent with some of the possible approaches to deciding what should be presented in OCI (in particular with the bridging concept described in Section 8). This is because the amounts reported in profit or loss are not the same as would be presented if the item were to be measured on a cost basis (depreciation reported in profit or loss is based on the revalued amount and revaluation surpluses are not recycled).
- 9.53 It could be argued that the revaluation model in IAS 16 was intended to be a form of capital maintenance adjustment. This would explain why depreciation reported in profit or loss is based on the revalued amount rather than cost and why revaluation surpluses are not recycled. However, reporting revaluation gains and losses in OCI is inconsistent with this view, because capital maintenance adjustments would normally be reported directly in equity. Indeed, prior to the introduction of OCI, revaluation gains and losses were reported directly in equity.
- 9.54 Given these factors, the IASB may at some point wish to consider whether to amend the revaluation model in IAS 16 (and IAS 38 *Intangible Assets*) to make it consistent with either the bridging concept or the capital maintenance concept. In developing this Discussion Paper, the IASB has not considered whether such changes would be appropriate.

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<sup>78</sup> IAS 38 *Intangible Assets* includes a similar revaluation model.



## Questions for respondents

### Question 22

*Chapters 1 and 3 of the existing Conceptual Framework*

Paragraphs 9.2–9.22 address the chapters of the existing *Conceptual Framework* that were published in 2010 and how those chapters treat the concepts of stewardship, reliability and prudence. The IASB will make changes to those chapters if work on the rest of the *Conceptual Framework* highlights areas that need clarifying or amending. However, the IASB does not intend to fundamentally reconsider the content of those chapters.

Do you agree with this approach? Please explain your reasons.

If you believe that the IASB should consider changes to those chapters (including how those chapters treat the concepts of stewardship, reliability and prudence), please explain those changes and the reasons for them, and please explain as precisely as possible how they would affect the rest of the *Conceptual Framework*.

### Question 23

*Business model*

The business model concept is discussed in paragraphs 9.23–9.34. This Discussion Paper does not define the business model concept. However, the IASB's preliminary view is that financial statements can be made more relevant if the IASB considers, when developing or revising particular Standards, how an entity conducts its business activities.

Do you think that the IASB should use the business model concept when it develops or revises particular Standards? Why or why not?

If you agree, in which areas do you think that the business model concept would be helpful?

Should the IASB define 'business model'? Why or why not?

If you think that 'business model' should be defined, how would you define it?

### Question 24

*Unit of account*

The unit of account is discussed in paragraphs 9.35–9.41. The IASB's preliminary view is that the unit of account will normally be decided when the IASB develops or revises particular Standards and that, in selecting a unit of account, the IASB should consider the qualitative characteristics of useful financial information.

Do you agree? Why or why not?

**Question 25**

*Going concern*

Going concern is discussed in paragraphs 9.42–9.44. The IASB has identified three situations in which the going concern assumption is relevant (when measuring assets and liabilities, when identifying liabilities and when disclosing information about the entity).

Are there any other situations where the going concern assumption might be relevant?

**Question 26**

*Capital maintenance*

Capital maintenance is discussed in paragraphs 9.45–9.54. The IASB plans to include the existing descriptions and the discussion of capital maintenance concepts in the revised *Conceptual Framework* largely unchanged until such time as a new or revised Standard on accounting for high inflation indicates a need for change.

Do you agree? Why or why not? Please explain your reasons.

## Appendix A

### Text of Chapters 1 and 3 of the existing *Conceptual Framework*

This appendix reproduces the text of Chapter 1 *The Objective of General Purpose Financial Reporting* and Chapter 3 *Qualitative Characteristics of Useful Financial Information* of the existing *Conceptual Framework*. The Bases for Conclusions on these chapters is not included.

#### Chapter 1: *The objective of general purpose financial reporting*

##### Introduction

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OB1 The objective of general purpose financial reporting forms the foundation of the *Conceptual Framework*. Other aspects of the *Conceptual Framework*—a reporting entity concept, the qualitative characteristics of, and the constraint on, useful financial information, elements of financial statements, recognition, measurement, presentation and disclosure—flow logically from the objective.

##### Objective, usefulness and limitations of general purpose financial reporting

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OB2 The objective of general purpose financial reporting<sup>79</sup> 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. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.

OB3 Decisions by existing and potential investors about buying, selling or holding equity and debt instruments depend on the returns that they expect from an investment in those instruments, for example dividends, principal and interest payments or market price increases. Similarly, decisions by existing and potential lenders and other creditors about providing or settling loans and other forms of credit depend on the principal and interest payments or other returns that they expect. Investors', lenders' and other creditors' expectations about returns depend on their assessment of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity. Consequently, existing and potential investors, lenders and other creditors need information to help them assess the prospects for future net cash inflows to an entity.

OB4 To assess an entity's prospects for future net cash inflows, existing and potential investors, lenders and other creditors need information about the resources of the entity, claims against the entity, and how efficiently and effectively the entity's management and governing board<sup>80</sup> have discharged their responsibilities to use the entity's resources. Examples of such responsibilities include protecting the entity's resources from unfavourable effects of economic

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79 Throughout this *Conceptual Framework*, the terms *financial reports* and *financial reporting* refer to *general purpose financial reports* and *general purpose financial reporting* unless specifically indicated otherwise.

80 Throughout this *Conceptual Framework*, the term *management* refers to *management and the governing board of an entity* unless specifically indicated otherwise.

factors such as price and technological changes and ensuring that the entity complies with applicable laws, regulations and contractual provisions. Information about management's discharge of its responsibilities is also useful for decisions by existing investors, lenders and other creditors who have the right to vote on or otherwise influence management's actions.

- OB5 Many existing and potential investors, lenders and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial reports for much of the financial information they need. Consequently, they are the primary users to whom general purpose financial reports are directed.
- OB6 However, general purpose financial reports do not and cannot provide all of the information that existing and potential investors, lenders and other creditors need. Those users need to consider pertinent information from other sources, for example, general economic conditions and expectations, political events and political climate, and industry and company outlooks.
- OB7 General purpose financial reports are not designed to show the value of a reporting entity; but they provide information to help existing and potential investors, lenders and other creditors to estimate the value of the reporting entity.
- OB8 Individual primary users have different, and possibly conflicting, information needs and desires. The Board, in developing financial reporting standards, will seek to provide the information set that will meet the needs of the maximum number of primary users. However, focusing on common information needs does not prevent the reporting entity from including additional information that is most useful to a particular subset of primary users.
- OB9 The management of a reporting entity is also interested in financial information about the entity. However, management need not rely on general purpose financial reports because it is able to obtain the financial information it needs internally.
- OB10 Other parties, such as regulators and members of the public other than investors, lenders and other creditors, may also find general purpose financial reports useful. However, those reports are not primarily directed to these other groups.
- OB11 To a large extent, financial reports are based on estimates, judgements and models rather than exact depictions. The *Conceptual Framework* establishes the concepts that underlie those estimates, judgements and models. The concepts are the goal towards which the Board and preparers of financial reports strive. As with most goals, the *Conceptual Framework's* vision of ideal financial reporting is unlikely to be achieved in full, at least not in the short term, because it takes time to understand, accept and implement new ways of analysing transactions and other events. Nevertheless, establishing a goal towards which to strive is essential if financial reporting is to evolve so as to improve its usefulness.

## **Information about a reporting entity's economic resources, claims against the entity and changes in resources and claims**

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OB12 General purpose financial reports provide information about the financial position of a reporting entity, which is information about the entity's economic resources and the claims against the reporting entity. Financial reports also provide information about the effects of transactions and other events that change a reporting entity's economic resources and claims. Both types of information provide useful input for decisions about providing resources to an entity.

### **Economic resources and claims**

OB13 Information about the nature and amounts of a reporting entity's economic resources and claims can help users to identify the reporting entity's financial strengths and weaknesses. That information can help users to assess the reporting entity's liquidity and solvency, its needs for additional financing and how successful it is likely to be in obtaining that financing. Information about priorities and payment requirements of existing claims helps users to predict how future cash flows will be distributed among those with a claim against the reporting entity.

OB14 Different types of economic resources affect a user's assessment of the reporting entity's prospects for future cash flows differently. Some future cash flows result directly from existing economic resources, such as accounts receivable. Other cash flows result from using several resources in combination to produce and market goods or services to customers. Although those cash flows cannot be identified with individual economic resources (or claims), users of financial reports need to know the nature and amount of the resources available for use in a reporting entity's operations.

### **Changes in economic resources and claims**

OB15 Changes in a reporting entity's economic resources and claims result from that entity's financial performance (see paragraphs OB17–OB20) and from other events or transactions such as issuing debt or equity instruments (see paragraph OB21). To properly assess the prospects for future cash flows from the reporting entity, users need to be able to distinguish between both of these changes.

OB16 Information about a reporting entity's financial performance helps users to understand the return that the entity has produced on its economic resources. Information about the return the entity has produced provides an indication of how well management has discharged its responsibilities to make efficient and effective use of the reporting entity's resources. Information about the variability and components of that return is also important, especially in assessing the uncertainty of future cash flows. Information about a reporting entity's past financial performance and how its management discharged its responsibilities is usually helpful in predicting the entity's future returns on its economic resources.

### **Financial performance reflected by accrual accounting**

- OB17 Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period. This is important because information about a reporting entity's economic resources and claims and changes in its economic resources and claims during a period provides a better basis for assessing the entity's past and future performance than information solely about cash receipts and payments during that period.
- OB18 Information about a reporting entity's financial performance during a period, reflected by changes in its economic resources and claims other than by obtaining additional resources directly from investors and creditors (see paragraph OB21), is useful in assessing the entity's past and future ability to generate net cash inflows. That information indicates the extent to which the reporting entity has increased its available economic resources, and thus its capacity for generating net cash inflows through its operations rather than by obtaining additional resources directly from investors and creditors.
- OB19 Information about a reporting entity's financial performance during a period may also indicate the extent to which events such as changes in market prices or interest rates have increased or decreased the entity's economic resources and claims, thereby affecting the entity's ability to generate net cash inflows.

### **Financial performance reflected by past cash flows**

- OB20 Information about a reporting entity's cash flows during a period also helps users to assess the entity's ability to generate future net cash inflows. It indicates how the reporting entity obtains and spends cash, including information about its borrowing and repayment of debt, cash dividends or other cash distributions to investors, and other factors that may affect the entity's liquidity or solvency. Information about cash flows helps users understand a reporting entity's operations, evaluate its financing and investing activities, assess its liquidity or solvency and interpret other information about financial performance.

### **Changes in economic resources and claims not resulting from financial performance**

- OB21 A reporting entity's economic resources and claims may also change for reasons other than financial performance, such as issuing additional ownership shares. Information about this type of change is necessary to give users a complete understanding of why the reporting entity's economic resources and claims changed and the implications of those changes for its future financial performance.

## Chapter 3: *Qualitative characteristics of useful financial information*

### Introduction

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- QC1 The qualitative characteristics of useful financial information discussed in this chapter identify the types of information that are likely to be most useful to the existing and potential investors, lenders and other creditors for making decisions about the reporting entity on the basis of information in its financial report (financial information).
- QC2 Financial reports provide information about the reporting entity's economic resources, claims against the reporting entity and the effects of transactions and other events and conditions that change those resources and claims. (This information is referred to in the *Conceptual Framework* as information about the economic phenomena.) Some financial reports also include explanatory material about management's expectations and strategies for the reporting entity, and other types of forward-looking information.
- QC3 The qualitative characteristics of useful financial information<sup>81</sup> apply to financial information provided in financial statements, as well as to financial information provided in other ways. Cost, which is a pervasive constraint on the reporting entity's ability to provide useful financial information, applies similarly. However, the considerations in applying the qualitative characteristics and the cost constraint may be different for different types of information. For example, applying them to forward-looking information may be different from applying them to information about existing economic resources and claims and to changes in those resources and claims.

### Qualitative characteristics of useful financial information

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- QC4 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.

#### Fundamental qualitative characteristics

- QC5 The fundamental qualitative characteristics are *relevance* and *faithful representation*.

#### Relevance

- QC6 Relevant financial information is capable of making a difference in the decisions made by users. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it or are already aware of it from other sources.
- QC7 Financial information is capable of making a difference in decisions if it has predictive value, confirmatory value or both.

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<sup>81</sup> Throughout this *Conceptual Framework*, the terms *qualitative characteristics* and *constraint* refer to the qualitative characteristics of, and the constraint on, useful financial information.

- QC8 Financial information has predictive value if it can be used as an input to processes employed by users to predict future outcomes. Financial information need not be a prediction or forecast to have predictive value. Financial information with predictive value is employed by users in making their own predictions.
- QC9 Financial information has confirmatory value if it provides feedback about (confirms or changes) previous evaluations.
- QC10 The predictive value and confirmatory value of financial information are interrelated. Information that has predictive value often also has confirmatory value. For example, revenue information for the current year, which can be used as the basis for predicting revenues in future years, can also be compared with revenue predictions for the current year that were made in past years. The results of those comparisons can help a user to correct and improve the processes that were used to make those previous predictions.

### *Materiality*

- QC11 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 based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report. Consequently, the Board cannot specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

### **Faithful representation**

- QC12 Financial reports represent economic phenomena in words and numbers. To be useful, financial information must not only represent relevant phenomena, but it must also faithfully represent the phenomena that it purports to represent. To be a perfectly faithful representation, a depiction would have three characteristics. It would be *complete*, *neutral* and *free from error*. Of course, perfection is seldom, if ever, achievable. The Board's objective is to maximise those qualities to the extent possible.
- QC13 A complete depiction includes all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations. For example, a complete depiction of a group of assets would include, at a minimum, a description of the nature of the assets in the group, a numerical depiction of all of the assets in the group, and a description of what the numerical depiction represents (for example, original cost, adjusted cost or fair value). For some items, a complete depiction may also entail explanations of significant facts about the quality and nature of the items, factors and circumstances that might affect their quality and nature, and the process used to determine the numerical depiction.
- QC14 A neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users. Neutral information does not mean information with no purpose or no



influence on behaviour. On the contrary, relevant financial information is, by definition, capable of making a difference in users' decisions.

QC15 Faithful representation does not mean accurate in all respects. Free from error means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. In this context, free from error does not mean perfectly accurate in all respects. For example, an estimate of an unobservable price or value cannot be determined to be accurate or inaccurate. However, a representation of that estimate can be faithful if the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate.

QC16 A faithful representation, by itself, does not necessarily result in useful information. For example, a reporting entity may receive property, plant and equipment through a government grant. Obviously, reporting that an entity acquired an asset at no cost would faithfully represent its cost, but that information would probably not be very useful. A slightly more subtle example is an estimate of the amount by which an asset's carrying amount should be adjusted to reflect an impairment in the asset's value. That estimate can be a faithful representation if the reporting entity has properly applied an appropriate process, properly described the estimate and explained any uncertainties that significantly affect the estimate. However, if the level of uncertainty in such an estimate is sufficiently large, that estimate will not be particularly useful. In other words, the relevance of the asset being faithfully represented is questionable. If there is no alternative representation that is more faithful, that estimate may provide the best available information.

### **Applying the fundamental qualitative characteristics**

QC17 Information must be both relevant and faithfully represented if it is to be useful. Neither a faithful representation of an irrelevant phenomenon nor an unfaithful representation of a relevant phenomenon helps users make good decisions.

QC18 The most efficient and effective process for applying the fundamental qualitative characteristics would usually be as follows (subject to the effects of enhancing characteristics and the cost constraint, which are not considered in this example). First, identify an economic phenomenon that has the potential to be useful to users of the reporting entity's financial information. Second, identify the type of information about that phenomenon that would be most relevant if it is available and can be faithfully represented. Third, determine whether that information is available and can be faithfully represented. If so, the process of satisfying the fundamental qualitative characteristics ends at that point. If not, the process is repeated with the next most relevant type of information.

### **Enhancing qualitative characteristics**

QC19 *Comparability, verifiability, timeliness* and *understandability* are qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented. The enhancing qualitative characteristics may also help

determine which of two ways should be used to depict a phenomenon if both are considered equally relevant and faithfully represented.

### **Comparability**

- QC20 Users' decisions involve choosing between alternatives, for example, selling or holding an investment, or investing in one reporting entity or another. Consequently, information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date.
- QC21 Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items. Unlike the other qualitative characteristics, comparability does not relate to a single item. A comparison requires at least two items.
- QC22 Consistency, although related to comparability, is not the same. Consistency refers to the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities. Comparability is the goal; consistency helps to achieve that goal.
- QC23 Comparability is not uniformity. For information to be comparable, like things must look alike and different things must look different. Comparability of financial information is not enhanced by making unlike things look alike any more than it is enhanced by making like things look different.
- QC24 Some degree of comparability is likely to be attained by satisfying the fundamental qualitative characteristics. A faithful representation of a relevant economic phenomenon should naturally possess some degree of comparability with a faithful representation of a similar relevant economic phenomenon by another reporting entity.
- QC25 Although a single economic phenomenon can be faithfully represented in multiple ways, permitting alternative accounting methods for the same economic phenomenon diminishes comparability.

### **Verifiability**

- QC26 Verifiability helps assure users that information faithfully represents the economic phenomena it purports to represent. Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. Quantified information need not be a single point estimate to be verifiable. A range of possible amounts and the related probabilities can also be verified.
- QC27 Verification can be direct or indirect. Direct verification means verifying an amount or other representation through direct observation, for example, by counting cash. Indirect verification means checking the inputs to a model, formula or other technique and recalculating the outputs using the same methodology. An example is verifying the carrying amount of inventory by checking the inputs (quantities and costs) and recalculating the ending inventory using the same cost flow assumption (for example, using the first-in, first-out method).

- QC28 It may not be possible to verify some explanations and forward-looking financial information until a future period, if at all. To help users decide whether they want to use that information, it would normally be necessary to disclose the underlying assumptions, the methods of compiling the information and other factors and circumstances that support the information.

### **Timeliness**

- QC29 Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. Generally, the older the information is the less useful it is. However, some information may continue to be timely long after the end of a reporting period because, for example, some users may need to identify and assess trends.

### **Understandability**

- QC30 Classifying, characterising and presenting information clearly and concisely makes it *understandable*.
- QC31 Some phenomena are inherently complex and cannot be made easy to understand. Excluding information about those phenomena from financial reports might make the information in those financial reports easier to understand. However, those reports would be incomplete and therefore potentially misleading.
- QC32 Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently. At times, even well-informed and diligent users may need to seek the aid of an adviser to understand information about complex economic phenomena.

### **Applying the enhancing qualitative characteristics**

- QC33 Enhancing qualitative characteristics should be maximised to the extent possible. However, the enhancing qualitative characteristics, either individually or as a group, cannot make information useful if that information is irrelevant or not faithfully represented.
- QC34 Applying the enhancing qualitative characteristics is an iterative process that does not follow a prescribed order. Sometimes, one enhancing qualitative characteristic may have to be diminished to maximise another qualitative characteristic. For example, a temporary reduction in comparability as a result of prospectively applying a new financial reporting standard may be worthwhile to improve relevance or faithful representation in the longer term. Appropriate disclosures may partially compensate for non-comparability.

## **The cost constraint on useful financial reporting**

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- QC35 Cost is a pervasive constraint on the information that can be provided by financial reporting. Reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information. There are several types of costs and benefits to consider.

- QC36 Providers of financial information expend most of the effort involved in collecting, processing, verifying and disseminating financial information, but users ultimately bear those costs in the form of reduced returns. Users of financial information also incur costs of analysing and interpreting the information provided. If needed information is not provided, users incur additional costs to obtain that information elsewhere or to estimate it.
- QC37 Reporting financial information that is relevant and faithfully represents what it purports to represent helps users to make decisions with more confidence. This results in more efficient functioning of capital markets and a lower cost of capital for the economy as a whole. An individual investor, lender or other creditor also receives benefits by making more informed decisions. However, it is not possible for general purpose financial reports to provide all the information that every user finds relevant.
- QC38 In applying the cost constraint, the Board assesses whether the benefits of reporting particular information are likely to justify the costs incurred to provide and use that information. When applying the cost constraint in developing a proposed financial reporting standard, the Board seeks information from providers of financial information, users, auditors, academics and others about the expected nature and quantity of the benefits and costs of that standard. In most situations, assessments are based on a combination of quantitative and qualitative information.
- QC39 Because of the inherent subjectivity, different individuals' assessments of the costs and benefits of reporting particular items of financial information will vary. Therefore, the Board seeks to consider costs and benefits in relation to financial reporting generally, and not just in relation to individual reporting entities. That does not mean that assessments of costs and benefits always justify the same reporting requirements for all entities. Differences may be appropriate because of different sizes of entities, different ways of raising capital (publicly or privately), different users' needs or other factors.

## Appendix B Reporting entity

- B1 In May 2008, the IASB issued *Preliminary Views on an Improved Conceptual Framework for Financial Reporting—The Reporting Entity*, which was a joint Discussion Paper ('the Reporting Entity DP') with the US Financial Accounting Standards Board (FASB). That Discussion Paper set out the preliminary views of the IASB and the FASB (the 'boards') on the reporting entity concept.
- B2 The boards considered comments received on this Discussion Paper as they developed the Exposure Draft *Conceptual Framework for Financial Reporting—The Reporting Entity* (the 'Reporting Entity ED') issued in March 2010. The comment period for the Exposure Draft closed in July 2010 and a comment letter summary was presented to the boards in October 2010. Work on the *Conceptual Framework* was suspended in November 2010. Consequently, the Reporting Entity chapter was not finalised.
- B3 Because a Discussion Paper and an Exposure Draft have already been issued on the reporting entity, the IASB believes that it is unnecessary to include a discussion of the issues associated with the reporting entity in this Discussion Paper. Instead, the IASB intends to review the reporting entity proposals, including comments received on the Reporting Entity ED, as it develops an Exposure Draft on a revised *Conceptual Framework*. As noted in Section 1, the *Conceptual Framework* project (including work on the reporting entity) is no longer being conducted jointly with the FASB.
- B4 This appendix summarises the proposals in the Reporting Entity ED and the comments received.

### Summary of the Reporting Entity ED

- B5 The following was discussed in the Reporting Entity ED:
- (a) description of a reporting entity;
  - (b) consolidated financial statements; and
  - (c) other types of financial statements.

### Description

- B6 The Reporting Entity ED:
- (a) described a reporting entity as:
    - ... a circumscribed area of economic activities whose financial information has the potential to be useful to existing and potential equity investors, lenders and other creditors who cannot directly obtain the information they need in making decisions about providing resources to the entity and in assessing whether management and the governing board of that entity have made efficient and effective use of the resources provided.

- (b) explained that most, if not all, single legal entities have the potential to be reporting entities. However, a legal entity may not qualify as a reporting entity if, for example, there is no basis for objectively distinguishing its economic activities from those of another entity.
- (c) stated that a portion of an entity could qualify as a reporting entity:
  - (i) if the economic activities of that portion can be distinguished objectively from the rest of the entity; and
  - (ii) financial information about the portion of the entity has the potential to be useful in making decisions about providing resources to that portion of the entity.

### **Consolidated financial statements**

- B7 The Reporting Entity ED described 'control of another entity' as the power to direct the activities of that other entity to generate benefits for the controlling entity. In addition, the Reporting Entity ED stated that:
- (a) if an entity controls one or more entities and prepares financial statements, it should present consolidated financial statements because consolidated financial statements are most likely to provide useful information to the greatest number of users of financial statements.
  - (b) if two or more entities share the power to direct the activities of another entity, none of the entities individually controls the other entity. Accordingly, none of those entities would present information about itself and the other entity on a consolidated basis.
  - (c) if one entity has significant influence over another entity it does not control that other entity.

### **Other types of financial statements**

- B8 The Reporting Entity ED explained that 'parent-only' financial statements (ie financial statements that include controlled entities as investments rather than consolidating those entities) might provide useful information if they are presented together with consolidated financial statements.
- B9 In addition, the Reporting Entity ED stated that combined financial statements (that is, financial statements that combine rather than consolidate the results of two or more entities) might provide useful information about entities under common control.

### **Summary of comments received on the Reporting Entity ED**

- B10 The following is a high-level summary of comments received on the Reporting Entity ED. A more detailed comment letter summary was presented to the IASB at its October 2010 meeting and can be obtained from the IASB's website.<sup>82</sup>

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<sup>82</sup> <http://go.ifrs.org/2010-Reporting-Entity-ED-comment-letter-summary>

### **Purpose of the chapter**

- B11 Respondents commented that the Reporting Entity ED did not clearly state the purpose of the reporting entity chapter of the *Conceptual Framework*. In particular, they stated that it was unclear whether the ED was proposing who **must**, **should** or **could** prepare general purpose financial reports. Those respondents asked the IASB to clarify the purpose of the reporting entity chapter.

### **Entity perspective and proprietary perspective**

- B12 The Reporting Entity DP included a discussion of the entity perspective and the proprietary perspective and proposed that the entity perspective should be adopted. However, this discussion was not carried forward to the Reporting Entity ED. Many respondents requested that the reporting entity chapter should include a discussion of the perspective from which financial statements are presented. Some respondents expressed support for the entity perspective while others expressed support for the proprietary perspective.

### **Description of a reporting entity**

- B13 Most respondents to the Reporting Entity ED generally agreed with the proposed description of a reporting entity. However, the following alternatives were suggested:

- (a) use the existing *Conceptual Framework*'s description of a reporting entity;
- (b) describe a reporting entity as a legal entity; or
- (c) leave the description of a reporting entity to governments and regulators.

- B14 Many respondents stated that all legal entities that are required to report should qualify as a reporting entity and some respondents stated that all legal entities should be reporting entities, regardless of whether they are required to report.

- B15 Most respondents agreed that a portion of an entity could qualify as a reporting entity if the economic activities of the portion can be objectively distinguished from the rest of the entity and the financial information about that portion has the potential to be useful to users of financial statements.

- B16 In addition, respondents suggested a number of clarifications and amendments to the proposed description of a reporting entity.

### **Consolidated financial statements**

- B17 Most respondents agreed with the proposed description of 'control of an entity'.<sup>83</sup> However, many stated that the concept of control is a pervasive notion and, therefore, should not be defined in the reporting entity chapter. Instead, control should be defined at a higher, more general level in the *Conceptual Framework*.<sup>84</sup>

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83 Control of an investee has since been defined in IFRS 10 *Consolidated Financial Statements*.

84 Section 3 includes a discussion of the control concept.

- B18 Most respondents agreed that an entity that controls one or more other entities should present consolidated financial statements. However, several respondents stated that it is not the responsibility of the IASB to decide which entities have to prepare consolidated financial statements because such responsibility lies solely with governments and regulators.

### **Other types of financial statements**

#### *Parent-only financial statements*

- B19 Several respondents disagreed with the statement in the Reporting Entity ED that parent- financial statements provide useful information only if they are presented together with consolidated financial statements. Those respondents disagreed because:
- (a) they believe that entities should be permitted to present parent-only financial statements on a different date, or in a different document, from their consolidated financial statements;
  - (b) they believe that parent-only financial statements are useful on their own; and
  - (c) some governments and regulators require the presentation of parent-only financial statements without the accompanying consolidated financial statements.

#### *Combined financial statements*

- B20 Many respondents to the Reporting Entity ED disagreed with the proposal that combined financial statements should be restricted to the combination of entities under common control. They suggested examples of other situations in which combined financial statements may be useful, including:
- (a) entities under common management; and
  - (b) groups of mutual banks.

#### *Dual listed companies*

- B21 A few respondents to the Reporting Entity ED noted that it is unclear how to apply the reporting entity concept to dual listed companies, stapled entities and similar entities.



## Appendix C

### Distinction between liabilities and equity instruments

C1 In Section 5 two approaches to distinguishing liabilities from equity instruments are discussed: a narrow equity approach and a strict obligation approach. This appendix illustrates how those approaches, as well as the existing approach in IAS 32 *Financial Instruments: Presentation*, would apply to two examples:

- (a) Example C1: written put option, settlement net in cash.
- (b) Example C2: written put option, settlement net in shares.

#### Example C1: written put option, settlement net in cash

C2 This example illustrates how the approaches described in this paper would treat a written put option that must be settled net in cash. For such an option, if the strike price exceeds the share price at expiry, the issuer must pay cash equal to that excess.

#### Fact pattern

C3 An entity issues a written put option on 1,000 of its own shares on 1 February 20X2. The issuer receives a premium of CU5,000 for the option.<sup>85</sup> The option is exercisable only on 31 January 20X3, in exchange for paying a strike price of CU98 per share (CU98,000 in total). The option will be settled net in cash. In other words, if the holder exercises the option, it will receive the fair value of 1,000 shares on the exercise date (31 January 20X3), less the total strike price of CU98,000.

C4 Further data:

	1 Feb 20X2	31 Dec 20X2	31 Jan 20X3
Fair value per share	CU100	CU95	CU95
Fair value of option	CU5,000	CU4,000	CU3,000

C5 On 31 January 20X3, the holder exercises the option, receiving cash of CU3,000 (ie CU98,000 – CU95,000).

#### IAS 32 approach, narrow equity approach and strict obligation approach

C6 The same treatment would apply under IAS 32, the narrow equity approach and the strict obligation approach. The issuer treats the contract as a derivative financial liability because the issuer has a present obligation that will require the issuer to deliver an economic resource (cash) if the holder exercises the option. The issuer would present the following information:

<sup>85</sup> In this Discussion Paper, currency amounts are denominated in 'currency units' (CU).

**Statement of financial position**

	1 Feb 20X2	31 Dec 20X2	31 Jan 20X3
Cash	5,000	5,000	2,000
Derivative liability	(5,000)	(4,000)	—
Net assets	—	1,000	2,000
Share capital	—	—	—
Retained earnings	—	1,000	2,000
Total equity	—	1,000	2,000

**Statement(s) of profit or loss and OCI**

	31 Dec 20X2	31 Jan 20X3
Change in fair value of derivatives	1,000	1,000
Profit/comprehensive income	1,000	1,000

**Statement of changes in equity**

	Share capital	Retained earnings	Total existing shareholders
Opening 1 February 20X2	—	—	—
Profit/comprehensive income for 20X2	—	1,000	1,000
31 December 20X2	—	1,000	1,000
Profit/comprehensive income for January 20X3	—	1,000	1,000
31 January 20X3	—	2,000	2,000

C7 In the statement of changes in equity, the right-hand column is labelled 'total existing shareholders' for ease of comparison with Example C2.

**Example C2: written put option, settlement net in shares****Fact pattern**

C8 The facts are as in Example C1, except that the option will be settled net in shares. In other words, if the holder exercises the option, the issuer will issue shares whose total fair value equals the amount of cash that would be paid in Example C1. Neither party pays cash when the option is exercised or expires.

C9 On 31 January 20X3, the holder exercises the option. The issuer issues 31.6 shares with an aggregate fair value of CU3,000 (CU95 each) to settle its obligation to issue shares.<sup>86</sup>

**IAS 32 approach**

C10 Under IAS 32, the issuer treats the obligation to deliver a variable number of shares as a liability (because the issuer is, in effect, using its own shares as currency). The issuer accounts for the transactions as shown below. The

<sup>86</sup> In these examples, fractional shares are assumed possible.

accounting at 1 February 20X2 and 31 December 20X2 is the same as in Example C1. The accounting differs at 31 January 20X3 because the issuer must settle by issuing shares, not by paying cash.

**Statement of financial position**

	1 Feb 20X2	31 Dec 20X2	31 Jan 20X3
Cash	5,000	5,000	5,000
Derivative liability	(5,000)	(4,000)	—
Net assets	—	1,000	5,000
Share capital	—	—	3,000
Retained earnings	—	1,000	2,000
Total equity	—	1,000	5,000

**Statement(s) of profit or loss and OCI**

	31 Dec 20X2	31 Jan 20X3
Change in fair value of derivatives	1,000	1,000
Profit/comprehensive income	1,000	1,000

**Statement of changes in equity**

	Share capital	Retained earnings	Total existing shareholders
Opening 1 February 20X2	—	—	—
Profit/comprehensive income for 20X2	—	1,000	1,000
31 December 20X2	—	1,000	1,000
Profit/comprehensive income for January 20X3	—	1,000	1,000
Shares issued	3,000	—	3,000
31 January 20X3	3,000	2,000	5,000

**Narrow equity approach**

C11 In this example the narrow equity approach would lead to the same results as IAS 32.

**Strict obligation approach**

C12 The obligation to issue shares is not an obligation to transfer economic resources. Consequently, applying the strict obligation approach, that obligation is an equity claim, not a liability.

C13 At inception (1 February 20X2), the issuer recognises:

- (a) cash of CU5,000; and

- (b) within equity, an equity claim of CU5,000. That equity claim consists of a present obligation that will require the issuer to issue its own shares if the holder exercises its option.

C14 At 31 December 20X2, the issuer remeasures the equity claim. For illustration purposes, this example assumes that the remeasurement is to fair value (see paragraphs 5.18–5.20 for a discussion of how to measure equity claims). At this date, the fair value of the equity claim is CU4,000, and the issuer recognises in the statement of changes in equity a wealth transfer of CU1,000 from the column labelled ‘Obligation to issue shares’ (which depicts the interest of option holders) to the section for existing shareholders. For illustration purposes, the example shows that wealth transfer as a transfer to retained earnings, but other classifications would be possible, provided that the statement of changes in equity identifies clearly which class of equity holder benefits from the transfer.<sup>87</sup>

C15 At 31 January 20X3:

- (a) the issuer remeasures the equity claim to its new fair value of CU3,000, recognising in the statement of changes in equity a further wealth transfer of CU1,000 from the option holders to shareholders.
- (b) the issuer issues 31.6 shares with an aggregate fair value of CU3,000 (CU95 each) to settle its obligation to issue shares. At this point, the issuer transfers CU3,000 from the column labelled ‘Obligation to issue shares’ to the section for existing shareholders. For illustration purposes, this example assumes that the entire amount of CU3,000 is transferred to share capital rather than to some other category attributable to existing shareholders.
- (c) if the option expires unissued, the issuer transfers any remaining balance from the column labelled ‘Obligation to issue shares’ to some category within the section for existing shareholders.

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<sup>87</sup> IFRSs do not in general prescribe which categories of equity an entity should present separately, because determining which categories are most relevant to users of financial statements may depend on local legislation and on the reporting entity’s governing constitution. IAS 1 *Presentation of Financial Statements* requires an entity to disclose a description of the nature and purpose of each reserve within equity.

C16 The issuer would present the amounts shown below:

**Statement of financial position**

	<b>1 Feb 20X2</b>	<b>31 Dec 20X2</b>	<b>31 Jan 20X3</b>
Cash	5,000	5,000	5,000
Net assets	5,000	5,000	5,000
Share capital	–	–	3,000
Retained earnings	–	1,000	2,000
Total existing shareholders	–	1,000	5,000
Obligation to issue shares	5,000	4,000	–
Total equity	5,000	5,000	5,000

**Statement(s) of profit or loss and OCI**

	<b>31 Dec 20X2</b>	<b>31 Jan 20X3</b>
Income	–	–
Expense	–	–
Profit/comprehensive income	–	–

**Statement of changes in equity**

	Share capital	Retained earnings	Total existing shareholders	Obligation to issue shares	Total
Opening 1 February 20X2	–	–	–	–	–
Profit/comprehensive income for 20X2	–	–	–	–	–
Change in fair value of option	–	1,000	1,000	(1,000)	–
Change in net assets	–	1,000	1,000	(1,000)	–
Written option issued	–	–	–	5,000	5,000
31 December 20X2	–	1,000	1,000	4,000	5,000
Profit/comprehensive income for January 20X3	–	–	–	–	–
Change in fair value of option	–	1,000	1,000	(1,000)	–
Change in net assets	–	1,000	1,000	(1,000)	–
New shares issued	3,000	–	3,000	(3,000)	–
31 January 20X3	3,000	2,000	5,000	–	5,000

- C17 In the statement of changes in equity in Example C2:
- (a) the column 'Total existing shareholders' shows the sum of share capital and retained earnings. In this example, these are entirely attributable to existing shareholders.
  - (b) the column 'Obligation to issue shares' shows the portion of total equity attributed to option holders. In this example, it is measured as the fair value of the written option.
  - (c) the row 'Change in fair value of option' show the wealth transfers between existing shareholders and option holders. In this example, it is measured as the change in fair value of the obligation to issue shares.
  - (d) the row 'Change in net assets' shows the subtotal of profit/comprehensive income and change in fair value of option.

### Comparison of Examples C1 and C2

- C18 The following comments can be made about Examples C1 and C2:
- (a) the treatments under IAS 32 and under the narrow equity approach at 1 February 20X2 and 31 December 20X2 do not depict, in a faithful and understandable manner, the fact that these two examples will cause different effects on the economic resources of the issuer. In Example C1, the issuer suffers a cash outflow of CU3,000. In Example C2, no cash outflow can occur. In contrast, the strict obligation approach does depict that difference.
  - (b) all three approaches depict the fact that both examples cause the same degree of dilution to those remaining shareholders (ie the shareholders who do not hold the put options):
    - (i) IAS 32 and the narrow equity approach depict this similarity by generating the same profit or loss in both examples.
    - (ii) the strict obligation approach depicts this similarity in the statement of changes in equity in the line labelled 'Change in net assets', in the column labelled 'Total existing shareholders'. For example, in both Examples C1 and C2, the 'change in net assets' for existing shareholders in 20X2 is an increase of CU1,000, because the obligation is remeasured to fair value in both cases. (In Example C1, the only component of that change in net assets is the comprehensive income for 20X2.)

## Appendix D

### Effect of strict obligation approach on different classes of instrument

- D1 In Section 5 two approaches to distinguishing liabilities from equity instruments are discussed: a narrow equity approach and a strict obligation approach. Table D.1 compares the current treatment of various instruments under IAS 32 *Financial Instruments: Presentation* with how they would be treated under the strict obligation approach.
- D2 In several cases, the treatment depends on whether the instrument would be settled by delivering a fixed number of the issuer's own equity instruments for a fixed amount of cash, or whether it would be settled in some other way. Table D.1 identifies those cases by the legend 'If not only fixed for fixed, then derivative'. For instruments labelled in this way, if they do not meet the 'fixed for fixed' criterion they are treated as derivatives and hence are classified as financial liabilities (or financial assets) measured at fair value through profit or loss.
- D3 In paragraphs 5.18–5.20, the way to measure equity claims is discussed, but no specific proposals are provided. In Table D.1, it is assumed that equity claims are measured in the same way as otherwise comparable financial liabilities, unless otherwise stated in Table D.1.

**Table D.1: comparison of the current treatment of various instruments under IAS 32 and the strict obligation approach**

<b>Instrument</b>	<b>Current treatment under IAS 32</b>	<b>Effect of strict obligation approach</b>
Obligation to deliver a variable number of shares, whose total fair value equals a fixed amount.  The entity will receive no further cash in exchange for that obligation.	Liability, measured at amortised cost, with interest expense reported in profit or loss.	Equity claim, measured as if it were a financial liability: most likely at amortised cost, with interest expense reported in the statement of changes in equity (SCE) as a wealth transfer to the future shareholders from existing shareholders.
Obligation to deliver a variable number of shares, whose total fair value equals a specified amount indexed to the gold price.  The entity will receive no further cash in exchange for that obligation.	Liability, measured at fair value (under the fair value option) or at amortised cost with separate measurement of an embedded derivative at fair value through profit or loss.	Equity claim, measured as if it were a financial liability that requires the issuer to pay the specified amount (ie measured at fair value).  Changes in carrying amount reported in the SCE.
Forward contract to repurchase own shares, settled gross.	Liability at present value of gross redemption amount.  Subsequent changes in that amount in profit or loss.	Liability at present value of gross redemption amount.  To be determined: whether to recognise subsequent changes in that amount in profit or loss, or in SCE (see paragraphs F4–F5).
Written put option on own shares, settled gross.	Liability at present value of gross redemption amount.  Subsequent changes in that amount in profit or loss.	Liability.  To be determined: measurement and treatment of subsequent changes in carrying amount (see paragraphs F2–F10).

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Instrument	Current treatment under IAS 32	Effect of strict obligation approach
Written put option on non-controlling interest (NCI put), settled gross for a cash payment equal to the fair value of the underlying non-controlling interest (NCI).	Liability at present value of the gross redemption amount (ie fair value of the underlying NCI).  Subsequent changes in that amount in profit or loss. <sup>(a)</sup>	Liability.  To be determined: measurement and treatment of subsequent changes in carrying amount (see paragraphs F2-F10).
Purchased call option to repurchase own shares, settled gross.	No asset or liability.  Recognise in equity, initial measurement net at premium paid.  No remeasurement.  If not only fixed for fixed, then derivative.	No asset or liability.  Equity claim: right to receive shares on request by electing to pay the strike price, initial measurement net at premium paid.  Subsequent remeasurement (net) to fair value through SCE.
Forward sale of own shares, settled gross.	Do not recognise until settlement.  If not only fixed for fixed, then derivative.	Asset at present value of gross sale proceeds.  Subsequent measurement: same basis as for a financial asset that entitles the entity to receive the specified amount.  To be determined: whether interest expense (and impairment loss on asset, if applicable) in profit or loss or in SCE.  No liability.  Equity claim: obligation to deliver own shares.
Purchased put on own shares, settled gross.	No asset or liability.  Recognised in equity, initial measurement net at premium paid.  No remeasurement.  If not only fixed for fixed, then derivative.	Asset, initial measurement net at premium paid.  Subsequent remeasurement (net) to fair value through SCE to show wealth transfers between different equity claimants.

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<b>Instrument</b>	<b>Current treatment under IAS 32</b>	<b>Effect of strict obligation approach</b>
Written call on own shares, settled gross.	Equity claim, initial measurement net at proceeds received. No remeasurement. If not only fixed for fixed, then derivative.	Equity claim, initial measurement net at proceeds received. Subsequent remeasurement (net) to fair value through SCE.
All net cash-settled derivatives on own shares.	Derivative asset or liability measured net: fair value through profit or loss.	Derivative asset or liability measured net: fair value through profit or loss.
All derivatives on own shares if they must be settled by net delivery or net receipt of shares with no cash payment (net share settlement).	Derivative asset or liability: fair value through profit or loss. On settlement or expiry, derecognise the derivative asset or liability, with a corresponding decrease or increase in equity.	Equity claim measured net: fair value, remeasured through SCE.
Derivative obligation that permits the holder to elect whether the issuer will settle in cash or in shares.	Financial liability. Measure in accordance with IFRS 9 <i>Financial Instruments</i> .	Financial liability. Measure in accordance with IFRS 9.
Derivative obligation that permits the issuer to elect whether to settle in cash or in shares.	Financial liability. Measure in accordance with IFRS 9.	Equity claim (because the issuer is not obliged to deliver economic resources). <sup>(b)</sup> Measured as if it were a financial liability, with changes in the carrying amount reported in the SCE.
Cash-settled share-based payment.	Recognise as an expense and a liability. Remeasure the liability through profit or loss.	Recognise as an expense and a liability. Remeasure the liability through profit or loss.

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Instrument	Current treatment under IAS 32	Effect of strict obligation approach
Equity-settled share-based payment.	Recognise as an expense and as an equity claim. Do not remeasure.	Recognise as an expense and as an equity claim. Remeasure the equity claim through SCE.
<p>(a) See draft IFRIC Interpretation <i>Put Options Written on Non-controlling Interests</i> and further discussion in paragraphs F6–F10.</p> <p>(b) As discussed in Section 3, if the entity's option to settle in shares has no commercial substance, the entity might have a financial liability.</p>		

## Appendix E

### Rights and obligations arising under options and forwards on an entity's own shares

Table E.1 analyses the rights and obligations that arise under options and forwards on an entity's own shares. Table E.1 applies the definitions discussed in Section 2 and the related guidance in Section 3 to assess whether those rights and obligations are assets, liabilities or equity claims. In all cases, it is assumed in Table E.1 that the entity ultimately settles the instruments by delivering or receiving the entity's own shares in exchange for receiving or paying cash.

**Table E.1: analysis of the rights and obligations that arise under options and forwards on an entity's own shares**

Type of option	Right of the entity	Obligation of the entity
Purchased call option.	To receive shares on request, by electing to pay the strike price.  (An equity claim on the writer of the option, not an economic resource.)	None.  (An obligation to pay the strike price will arise subsequently if the entity exercises the option.)
Written call option.	None.  (A right to receive the strike price will arise subsequently if the holder exercises the option.)	To stand ready to issue shares, at the request of the holder, in exchange for the strike price.  (An equity claim, not an obligation to transfer economic resources.)
Purchased put option.	To receive the strike price on request, by electing to issue or deliver shares.  (An asset.)	None.  (An obligation to issue or to deliver the shares will arise subsequently if the entity exercises the option. That obligation will be an equity claim, not a liability.)
Written put option.	None.  (A right to receive the shares will arise subsequently if the holder exercises the option. That right will be an equity claim, not an asset.)	To stand ready to pay the strike price at the request of the holder.  (An obligation to transfer economic resources, and hence a liability.)

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<b>Type of option</b>	<b>Right of the entity</b>	<b>Obligation of the entity</b>
Forward purchase for cash.	To receive shares. (An equity claim.)	To pay cash. (A liability.)
Forward sale for cash.	To receive cash. (An asset.)	To issue or deliver shares. (An equity claim.)

## Appendix F

### Written put options on own equity and on non-controlling interests

F1 Paragraph 5.54 identifies some questions that the IASB might need to address if it undertakes a project to amend its Standards on how to distinguish liabilities from equity instruments. This appendix provides background information on three of those questions:

- (a) how to measure the rights and obligations that arise under a written put option on an entity's own shares (see paragraphs F2–F3);
- (b) whether changes in liabilities arising under a written put option result in income or expense, or in a distribution of equity or contribution to equity (see paragraphs F4–F5); and
- (c) how to measure the rights and obligations that arise under a written put option on non-controlling interests (NCI), and where to present changes in those rights and obligations (see paragraphs F6–F10).

#### Written put options on own shares

F2 Possible approaches for how an entity should measure written put options on its own shares are:

- (a) the present value of the redemption amount, the existing requirement as set out in paragraph 23 of IAS 32 *Financial Instruments: Presentation*. This measure is simple, and conveys information about the possible outflow of economic resources, but it has the following disadvantages:
  - (i) it conveys no information about the likelihood of the transfer. It depicts the liability as if its exercise were certain, regardless of how certain or uncertain the exercise is.
  - (ii) if the strike price for the option is the fair value of the underlying shares, the liability is measured at fair value. Changes in its fair value are recognised in profit or loss, even if the fair value of such an option is minimal, and regardless of the likelihood of exercise.
- (b) the fair value of the entire instrument. This would be consistent with the treatment of most other derivatives. On the other hand, it would appear inconsistent to measure an obligation to transfer an economic resource by factoring in both the resource that will be transferred and the underlying shares to be received, which are not a resource of the entity itself.
- (c) the present value of the redemption amount, probability-weighted to reflect the estimated likelihood of the exercise. This would depict more faithfully whether the exercise is likely, however:
  - (i) until close to expiry, when the exercise becomes either highly likely or highly unlikely, that measure is likely to differ from the ultimate cash outflow. It is also likely to change over time.

- (ii) this measure would require estimates of the probabilities, which would require subjective estimates or models, perhaps using the probabilities that are implied in a fair value measurement of the entire option. This approach has some similarities with the revised expected outcomes approach (the 'REO approach') described in paragraph 5.50. As noted in paragraph 5.52, the IASB and FASB rejected the REO approach, partly because they viewed it as too complex.
  - (d) an approach that measures the option at the present value of the strike price if some threshold is passed, and at zero if the threshold is not passed. This would be simpler than the expected value approach described in F2(c), but it would ignore the time value of the option (ie the possibility that the threshold might be passed in the future). The threshold might be, for example:
    - (i) when the option comes into the money. With this threshold, the measure of the option would equal its intrinsic value (ie zero if the option is out of the money, and the present value of the strike price if the option is in the money).
    - (ii) when the entity concludes that exercise is likely.
- F3 This Discussion Paper does not conclude on how an entity should measure the obligation that arises under a written put option on its own shares.

### **Changes in the carrying amount of written put options on own shares**

- F4 There are two views on how to treat changes in the carrying amount of obligations arising under written put options on an entity's own shares:
- (a) View A: those changes relate to a financial liability and should therefore be recognised in profit or loss.
  - (b) View B: the settlement of the obligation relates to a distribution of equity. Consequently, increases in the carrying amount of that obligation are distributions of equity and decreases in that carrying amount are contributions to equity.
- F5 Arguably, deciding which view to adopt in particular cases is a matter for projects on particular Standards, not for the *Conceptual Framework*. Consequently, this Discussion Paper does not investigate this issue further. One topical case where this issue is relevant is for NCI puts, as discussed in paragraphs F6–F10.

### **Implications for NCI puts**

- F6 IAS 32 requires that the issuer of a written put on its own shares should recognise a liability for the present value of the redemption amount. One instrument subject to that requirement is a written put option that obliges a parent to purchase shares of its subsidiary that are held by an NCI shareholder on request by that shareholder (an NCI put). In May 2012 the IFRS Interpretations Committee (the 'Interpretations Committee') addressed NCI puts in a draft Interpretation *Put Options Written on Non-controlling Interests* (the 'draft Interpretation').

- F7 Under the draft Interpretation, changes in the measurement of NCI puts would, in the parent's consolidated financial statements, be recognised in profit or loss. The Interpretations Committee reasoned that changes in the measurement of NCI puts do not change the relative interests of the parent and the NCI shareholder and are therefore not equity transactions (ie they are not transactions with owners in their capacity as owners). Moreover, the NCI put is a financial liability, and thus sits within the scope of IFRS 9 *Financial Instruments*. It follows that the gains and losses would be recognised in profit or loss. In other words, the Interpretations Committee adopted View A identified in paragraph F4. In addition, that conclusion ensures consistency with the treatment of written put options embedded in an equity instrument (ie redeemable equity instruments), for which changes in the carrying amount are also recognised in profit or loss.
- F8 To some, the approach in IAS 32 seems particularly problematic for written put options on the issuer's own shares (and NCI puts) with a strike price equal to fair value (fair value puts). For these instruments, the requirement in IAS 32 means that:
- (a) the strike price would be recognised as a liability and measured at fair value.
  - (b) changes in the fair value of the liability would be recognised in profit or loss. Part of those changes arises from changes in the value of unrecognised assets, such as goodwill. Some believe that this does not result in relevant or understandable information for users of financial statements.
  - (c) measurement of the liability is equal to the strike price, as if the exercise were certain to occur, even if the exercise is highly unlikely.
- F9 In March 2013 the IASB discussed the feedback it had received on the draft Interpretation, and the Interpretations Committee's reactions to that feedback. The IASB decided to reconsider the requirements in IAS 32, including whether all or particular put options and forward contracts written on an entity's own equity should be measured on a net basis at fair value, consistently with derivatives that are within the scope of IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9. The IASB will continue to discuss this issue.
- F10 This paper does not conclude on whether changes in the carrying amount of NCI puts should be recognised in profit or loss or in equity.



## Appendix G Overview of topics for the revised *Conceptual Framework*

Table G.1 gives a high-level overview of the topics to be covered in the revised *Conceptual Framework*.

**Table G.1: overview of topics for the *Conceptual Framework***

Topic	Section	Preliminary view in this Discussion Paper	Paragraphs in the existing <i>Conceptual Framework</i>
Purpose and status of the <i>Conceptual Framework</i> .	Section 1	Focus the purpose and status of the <i>Conceptual Framework</i> .	The introduction includes the purpose and status and scope of the <i>Conceptual Framework</i> .
The objective of general purpose financial reporting.	Section 1 Appendix A	No fundamental reconsideration.	Paragraphs OB1–OB21.
Qualitative characteristics of useful financial information.	Section 1 Appendix A	No fundamental reconsideration.	Paragraphs QC1–QC39.
Reporting entity.	Appendix B	No further discussion—will be addressed in the <i>Conceptual Framework</i> Exposure Draft.	To be based on the 2010 Reporting Entity ED and responses. Result was intended to become Chapter 2.
Elements.	Sections 2, 3 and 5	Refine the definitions of assets and liabilities and supporting guidance. Clarify approach to probability. Use the liability definition to distinguish between liabilities and equity instruments. Update the measurement of different classes of equity claim.	Paragraphs 4.2–4.36.

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<b>Topic</b>	<b>Section</b>	<b>Preliminary view in this Discussion Paper</b>	<b>Paragraphs in the existing <i>Conceptual Framework</i></b>
Recognition.	Section 4	Amend.	Paragraphs 4.37–4.53.
Derecognition.	Section 4	New section.	No guidance.
Measurement.	Section 6	Largely a new section.	Paragraphs 4.54–4.56.
Unit of account.	Section 9	Decide when developing or revising particular Standards.	No guidance.
Capital maintenance.	Section 9	Retain the existing guidance until future work, if any, on high inflation.	Paragraphs 4.57–4.65.
Presentation.	Section 7 Section 8	New section.	No guidance.
Disclosure.	Section 7	New section.	No guidance.
Going concern.	Section 9	Identifies two areas in which the going concern assumption could affect financial reporting.	Paragraph 4.1.
Business model.	Section 9	Business model, or similar notion, likely to play some role.  No specific definition proposed.	No guidance.

## Appendix H Summary of questions for respondents

### Section 1 Introduction

#### Question 1

Paragraphs 1.25–1.33 set out the proposed purpose and status of the *Conceptual Framework*. The IASB's preliminary views are that:

- (a) the primary purpose of the revised *Conceptual Framework* is to assist the IASB by identifying concepts that it will use consistently when developing and revising IFRSs; and
- (b) in rare cases, in order to meet the overall objective of financial reporting, the IASB may decide to issue a new or revised Standard that conflicts with an aspect of the *Conceptual Framework*. If this happens the IASB would describe the departure from the *Conceptual Framework*, and the reasons for that departure, in the Basis for Conclusions on that Standard.

Do you agree with these preliminary views? Why or why not?

### Section 2 Elements of financial statements

#### Question 2

The definitions of an asset and a liability are discussed in paragraphs 2.6–2.16. The IASB proposes the following definitions:

- (a) an asset is a present economic resource controlled by the entity as a result of past events.
- (b) a liability is a present obligation of the entity to transfer an economic resource as a result of past events.
- (c) an economic resource is a right, or other source of value, that is capable of producing economic benefits.

Do you agree with these definitions? Why or why not? If you do not agree, what changes do you suggest, and why?

**Question 3**

Whether uncertainty should play any role in the definitions of an asset and a liability, and in the recognition criteria for assets and liabilities, is discussed in paragraphs 2.17–2.36. The IASB’s preliminary views are that:

- (a) the definitions of assets and liabilities should not retain the notion that an inflow or outflow is ‘expected’. An asset must be capable of producing economic benefits. A liability must be capable of resulting in a transfer of economic resources.
- (b) the *Conceptual Framework* should not set a probability threshold for the rare cases in which it is uncertain whether an asset or a liability exists. If there could be significant uncertainty about whether a particular type of asset or liability exists, the IASB would decide how to deal with that uncertainty when it develops or revises a Standard on that type of asset or liability.
- (c) the recognition criteria should not retain the existing reference to probability.

Do you agree? Why or why not? If you do not agree, what do you suggest, and why?

**Question 4**

Elements for the statement(s) of profit or loss and OCI (income and expense), statement of cash flows (cash receipts and cash payments) and statement of changes in equity (contributions to equity, distributions of equity and transfers between classes of equity) are briefly discussed in paragraphs 2.37–2.52.

Do you have any comments on these items? Would it be helpful for the *Conceptual Framework* to identify them as elements of financial statements?

### Section 3 Additional guidance to support the asset and liability definitions

**Question 5**

Constructive obligations are discussed in paragraphs 3.39–3.62. The discussion considers the possibility of narrowing the definition of a liability to include only obligations that are enforceable by legal or equivalent means. However, the IASB tentatively favours retaining the existing definition, which encompasses both legal and constructive obligations—and adding more guidance to help distinguish constructive obligations from economic compulsion. The guidance would clarify the matters listed in paragraph 3.50.

Do you agree with this preliminary view? Why or why not?

**Question 6**

The meaning of ‘present’ in the definition of a liability is discussed in paragraphs 3.63–3.97. A present obligation arises from past events. An obligation can be viewed as having arisen from past events if the amount of the liability will be determined by reference to benefits received, or activities conducted, by the entity before the end of the reporting period. However, it is unclear whether such past events are sufficient to create a present obligation if any requirement to transfer an economic resource remains conditional on the entity’s future actions. Three different views on which the IASB could develop guidance for the *Conceptual Framework* are put forward:

- (a) View 1: a present obligation must have arisen from past events and be strictly unconditional. An entity does not have a present obligation if it could, at least in theory, avoid the transfer through its future actions.
- (b) View 2: a present obligation must have arisen from past events and be practically unconditional. An obligation is practically unconditional if the entity does not have the practical ability to avoid the transfer through its future actions.
- (c) View 3: a present obligation must have arisen from past events, but may be conditional on the entity’s future actions.

The IASB has tentatively rejected View 1. However, it has not reached a preliminary view in favour of View 2 or View 3.

Which of these views (or any other view on when a present obligation comes into existence) do you support? Please give reasons.

**Question 7**

Do you have comments on any of the other guidance proposed in this section to support the asset and liability definitions?

**Section 4 Recognition and derecognition**

**Question 8**

Paragraphs 4.1–4.27 discuss recognition criteria. In the IASB’s preliminary view, an entity should recognise all its assets and liabilities, unless the IASB decides when developing or revising a particular Standard that an entity need not, or should not, recognise an asset or a liability because:

- (a) recognising the asset (or the liability) would provide users of financial statements with information that is not relevant, or is not sufficiently relevant to justify the cost; or
- (b) no measure of the asset (or the liability) would result in a faithful representation of both the asset (or the liability) and the changes in the asset (or the liability), even if all necessary descriptions and explanations are disclosed.

Do you agree? Why or why not? If you do not agree, what changes do you suggest, and why?

**Question 9**

In the IASB's preliminary view, as set out in paragraphs 4.28–4.51, an entity should derecognise an asset or a liability when it no longer meets the recognition criteria. (This is the control approach described in paragraph 4.36(a)). However, if the entity retains a component of an asset or a liability, the IASB should determine when developing or revising particular Standards how the entity would best portray the changes that resulted from the transaction. Possible approaches include:

- (a) enhanced disclosure;
- (b) presenting any rights or obligations retained on a line item different from the line item that was used for the original rights or obligations, to highlight the greater concentration of risk; or
- (c) continuing to recognise the original asset or liability and treating the proceeds received or paid for the transfer as a loan received or granted.

Do you agree? Why or why not? If you do not agree, what changes do you suggest, and why?

## Section 5 Definition of equity and distinction between liabilities and equity instruments

### Question 10

The definition of equity, the measurement and presentation of different classes of equity, and how to distinguish liabilities from equity instruments are discussed in paragraphs 5.1–5.59. In the IASB’s preliminary view:

- (a) the *Conceptual Framework* should retain the existing definition of equity as the residual interest in the assets of the entity after deducting all its liabilities.
- (b) the *Conceptual Framework* should state that the IASB should use the definition of a liability to distinguish liabilities from equity instruments. Two consequences of this are:
  - (i) obligations to issue equity instruments are not liabilities; and
  - (ii) obligations that will arise only on liquidation of the reporting entity are not liabilities (see paragraph 3.89(a)).
- (c) an entity should:
  - (i) at the end of each reporting period update the measure of each class of equity claim. The IASB would determine when developing or revising particular Standards whether that measure would be a direct measure, or an allocation of total equity.
  - (ii) recognise updates to those measures in the statement of changes in equity as a transfer of wealth between classes of equity claim.
- (d) if an entity has issued no equity instruments, it may be appropriate to treat the most subordinated class of instruments as if it were an equity claim, with suitable disclosure. Identifying whether to use such an approach, and if so, when, would still be a decision for the IASB to take in developing or revising particular Standards.

Do you agree? Why or why not? If you do not agree, what changes do you suggest, and why?

## Section 6 Measurement

### Question 11

How the objective of financial reporting and the qualitative characteristics of useful financial information affect measurement is discussed in paragraphs 6.6–6.35. The IASB's preliminary views are that:

- (a) the objective of measurement is to contribute to the faithful representation of relevant information about:
  - (i) the resources of the entity, claims against the entity and changes in resources and claims; and
  - (ii) how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.
- (b) a single measurement basis for all assets and liabilities may not provide the most relevant information for users of financial statements;
- (c) when selecting the measurement to use for a particular item, the IASB should consider what information that measurement will produce in both the statement of financial position and the statement(s) of profit or loss and OCI;
- (d) the relevance of a particular measurement will depend on how investors, creditors and other lenders are likely to assess how an asset or a liability of that type will contribute to future cash flows. Consequently, the selection of a measurement:
  - (i) for a particular asset should depend on how that asset contributes to future cash flows; and
  - (ii) for a particular liability should depend on how the entity will settle or fulfil that liability.
- (e) the number of different measurements used should be the smallest number necessary to provide relevant information. Unnecessary measurement changes should be avoided and necessary measurement changes should be explained; and
- (f) the benefits of a particular measurement to users of financial statements need to be sufficient to justify the cost.

Do you agree with these preliminary views? Why or why not? If you disagree, what alternative approach to deciding how to measure an asset or a liability would you support?



**Question 12**

The IASB's preliminary views set out in Question 11 have implications for the subsequent measurement of assets, as discussed in paragraphs 6.73–6.96. The IASB's preliminary views are that:

- (a) if assets contribute indirectly to future cash flows through use or are used in combination with other assets to generate cash flows, cost-based measurements normally provide information that is more relevant and understandable than current market prices.
- (b) if assets contribute directly to future cash flows by being sold, a current exit price is likely to be relevant.
- (c) if financial assets have insignificant variability in contractual cash flows, and are held for collection, a cost-based measurement is likely to provide relevant information.
- (d) if an entity charges for the use of assets, the relevance of a particular measure of those assets will depend on the significance of the individual asset to the entity.

Do you agree with these preliminary views and the proposed guidance in these paragraphs? Why or why not? If you disagree, please describe what alternative approach you would support.

**Question 13**

The implications of the IASB's preliminary views for the subsequent measurement of liabilities are discussed in paragraphs 6.97–6.109. The IASB's preliminary views are that:

- (a) cash-flow-based measurements are likely to be the only viable measurement for liabilities without stated terms.
- (b) a cost-based measurement will normally provide the most relevant information about:
  - (i) liabilities that will be settled according to their terms; and
  - (ii) contractual obligations for services (performance obligations).
- (c) current market prices are likely to provide the most relevant information about liabilities that will be transferred.

Do you agree with these preliminary views and the proposed guidance in these paragraphs? Why or why not? If you disagree, please describe what alternative approach you would support.

**Question 14**

Paragraph 6.19 states the IASB's preliminary view that for some financial assets and financial liabilities (for example, derivatives), basing measurement on the way in which the asset contributes to future cash flows, or the way in which the liability is settled or fulfilled, may not provide information that is useful when assessing prospects for future cash flows. For example, cost-based information about financial assets that are held for collection or financial liabilities that are settled according to their terms may not provide information that is useful when assessing prospects for future cash flows:

- (a) if the ultimate cash flows are not closely linked to the original cost;
- (b) if, because of significant variability in contractual cash flows, cost-based measurement techniques may not work because they would be unable to simply allocate interest payments over the life of such financial assets or financial liabilities; or
- (c) if changes in market factors have a disproportionate effect on the value of the asset or the liability (ie the asset or the liability is highly leveraged).

Do you agree with this preliminary view? Why or why not?

**Question 15**

Do you have any further comments on the discussion of measurement in this section?

## Section 7 Presentation and disclosure

### Question 16

This section sets out the IASB's preliminary views about the scope and content of presentation and disclosure guidance that should be included in the *Conceptual Framework*. In developing its preliminary views, the IASB has been influenced by two main factors:

- (a) the primary purpose of the *Conceptual Framework*, which is to assist the IASB in developing and revising Standards (see Section 1); and
- (b) other work that the IASB intends to undertake in the area of disclosure (see paragraphs 7.6–7.8), including:
  - (i) a research project involving IAS 1, IAS 7 and IAS 8, as well as a review of feedback received on the Financial Statement Presentation project;
  - (ii) amendments to IAS 1; and
  - (iii) additional guidance or education material on materiality.

Within this context, do you agree with the IASB's preliminary views about the scope and content of guidance that should be included in the *Conceptual Framework* on:

- (a) presentation in the primary financial statements, including:
  - (i) what the primary financial statements are;
  - (ii) the objective of primary financial statements;
  - (iii) classification and aggregation;
  - (iv) offsetting; and
  - (v) the relationship between primary financial statements.
- (b) disclosure in the notes to the financial statements, including:
  - (i) the objective of the notes to the financial statements; and
  - (ii) the scope of the notes to the financial statements, including the types of information and disclosures that are relevant to meet the objective of the notes to the financial statements, forward-looking information and comparative information.

Why or why not? If you think additional guidance is needed, please specify what additional guidance on presentation and disclosure should be included in the *Conceptual Framework*.

**Question 17**

Paragraph 7.45 describes the IASB's preliminary view that the concept of materiality is clearly described in the existing *Conceptual Framework*. Consequently, the IASB does not propose to amend, or add to, the guidance in the *Conceptual Framework* on materiality. However, the IASB is considering developing additional guidance or education material on materiality outside of the *Conceptual Framework* project.

Do you agree with this approach? Why or why not?

**Question 18**

The form of disclosure requirements, including the IASB's preliminary view that it should consider the communication principles in paragraph 7.50 when it develops or amends disclosure guidance in IFRSs, is discussed in paragraphs 7.48–7.52.

Do you agree that communication principles should be part of the *Conceptual Framework*? Why or why not?

If you agree they should be included, do you agree with the communication principles proposed? Why or why not?

**Section 8 Presentation in the statement of comprehensive income—profit or loss and other comprehensive income**

**Question 19**

The IASB's preliminary view that the *Conceptual Framework* should require a total or subtotal for profit or loss is discussed in paragraphs 8.19–8.22.

Do you agree? Why or why not?

If you do not agree do you think that the IASB should still be able to require a total or subtotal profit or loss when developing or amending Standards?

**Question 20**

The IASB's preliminary view that the *Conceptual Framework* should permit or require at least some items of income and expense previously recognised in OCI to be recognised subsequently in profit or loss, ie recycled, is discussed in paragraphs 8.23–8.26.

Do you agree? Why or why not? If you agree, do you think that all items of income and expense presented in OCI should be recycled into profit or loss? Why or why not?

If you do not agree, how would you address cash flow hedge accounting?

**Question 21**

In this Discussion Paper, two approaches are explored that describe which items could be included in OCI: a narrow approach (Approach 2A described in paragraphs 8.40–8.78) and a broad approach (Approach 2B described in paragraphs 8.79–8.94).

Which of these approaches do you support, and why?

If you support a different approach, please describe that approach and explain why you believe it is preferable to the approaches described in this Discussion Paper.

**Section 9 Other issues**

**Question 22**

*Chapters 1 and 3 of the existing Conceptual Framework*

Paragraphs 9.2–9.22 address the chapters of the existing *Conceptual Framework* that were published in 2010 and how those chapters treat the concepts of stewardship, reliability and prudence. The IASB will make changes to those chapters if work on the rest of the *Conceptual Framework* highlights areas that need clarifying or amending. However, the IASB does not intend to fundamentally reconsider the content of those chapters.

Do you agree with this approach? Please explain your reasons.

If you believe that the IASB should consider changes to those chapters (including how those chapters treat the concepts of stewardship, reliability and prudence), please explain those changes and the reasons for them, and please explain as precisely as possible how they would affect the rest of the *Conceptual Framework*.

**Question 23**

*Business model*

The business model concept is discussed in paragraphs 9.23–9.34. This Discussion Paper does not define the business model concept. However, the IASB's preliminary view is that financial statements can be made more relevant if the IASB considers, when developing or revising particular Standards, how an entity conducts its business activities.

Do you think that the IASB should use the business model concept when it develops or revises particular Standards? Why or why not?

If you agree, in which areas do you think that the business model concept would be helpful?

Should the IASB define 'business model'? Why or why not?

If you think that 'business model' should be defined, how would you define it?

**Question 24**

*Unit of account*

The unit of account is discussed in paragraphs 9.35–9.41. The IASB’s preliminary view is that the unit of account will normally be decided when the IASB develops or revises particular Standards and that, in selecting a unit of account, the IASB should consider the qualitative characteristics of useful financial information.

Do you agree? Why or why not?

**Question 25**

*Going concern*

Going concern is discussed in paragraphs 9.42–9.44. The IASB has identified three situations in which the going concern assumption is relevant (when measuring assets and liabilities, when identifying liabilities and when disclosing information about the entity).

Are there any other situations where the going concern assumption might be relevant?

**Question 26**

*Capital maintenance*

Capital maintenance is discussed in paragraphs 9.45–9.54. The IASB plans to include the existing descriptions and the discussion of capital maintenance concepts in the revised *Conceptual Framework* largely unchanged until such time as a new or revised Standard on accounting for high inflation indicates a need for change.

Do you agree? Why or why not? Please explain your reasons.