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Recognition Criteria in the
Conceptual Framework

Summary

1. This paper has been prepared with a view to making a contribution to the global debate about the recognition criteria in *The Conceptual Framework For Financial Reporting of IFRSs* (the “*Conceptual Framework*”).
2. After the IASB published the Exposure Draft on the Conceptual Framework, there has been extensive debate about whether the ‘probability criterion’ should be prescribed more robustly in the *Conceptual Framework*. Accordingly, this paper explores the following:
 - (a) Whether the probability criterion should be retained in the *Conceptual Framework*;
 - (b) If so, *when* the probability criterion would be necessary; and
 - (c) The ASBJ’s proposal that the IASB may consider in revising the *Conceptual Framework*.
3. As for the needs for the probability criterion in the *Conceptual Framework*, the ASBJ concludes in this paper that a robust description would be necessary, taking into account the role of the *Conceptual Framework* that assists the IASB to develop Standards on consistent concepts.
4. At the same time, however, the ASBJ does not think that the probability criterion is always necessary. Based on its analysis, the ASBJ proposes that:
 - (a) For recognition of an asset or a liability created from a right or an obligation that arises from transactions, the probability criterion is unnecessary.
 - (b) For recognition of an asset or a liability (that is, an item) or a group of assets and/or liabilities (that is, a group of items) created from a right or an obligation (or rights and/or obligations) that arises from ‘other events’, the probability criterion is necessary.
5. The demarcation of the terms ‘events’, ‘transactions’ and ‘other events’ are described as follows:

Events

Transactions

Other events

(Note)

- ◇ Events...Happenings of consequence to an entity
- ◇ Transactions...Transfers of something of value between two or more parties
- ◇ Other events...Events other than transactions

6. The ASBJ hopes that the analysis and proposal in this paper will contribute to the IASB's work on the improvement of the *Conceptual Framework*.

I. Preface

1. This paper has been prepared with a view to making a contribution to the global debate about the recognition criteria in *The Conceptual Framework For Financial Reporting* of IFRSs (the “*Conceptual Framework*”).
2. In May 2015, the IASB published the Exposure Draft *Conceptual Framework for Financial Reporting* (hereinafter referred to as the “ED” or the “*Conceptual Framework ED*”) to improve financial reporting by providing a more complete, clear and updated set of concepts. The ED describes the purpose of the draft *Conceptual Framework* as follows:
 - (a) Assist the IASB to develop Standards that are based on consistent concepts;
 - (b) Assist preparers to develop consistent accounting policies when no Standard applies to a particular transaction or event, or when a Standard allows a choice of accounting policy; and
 - (c) Assist all parties to understand and interpret the Standards.
3. The *Conceptual Framework* is not a Standard and does not override specific Standards. Hence, the proposed changes to the *Conceptual Framework* will not have an immediate effect on the financial statements of most reporting entities. However, taking into account the expected role relating to (a) in the previous paragraph, revisions to the *Conceptual Framework* are expected to have a significant impact on the reporting entities’ financial statements when they implement new or revised Standards based on the revised *Conceptual Framework*. Therefore, the ASBJ has been closely monitoring the IASB’s deliberations on this project, to proactively contribute to the development of the *Conceptual Framework*¹.

¹ In addition to its comment letter to the IASB’s Discussion Paper *A Review of the Conceptual Framework for Financial Reporting*, the ASBJ has published the following papers:

- (a) ASAF meeting paper *Profit or Loss / OCI and Measurement* (December 2013);
- (b) ASBJ Short Paper Series No.1 *Is OCI Unnecessary?* (May 2014);
- (c) ASAF meeting paper *Identification, Description and Classification of Measurement Bases* (March 2015);
and

II. Background

IASB's existing Conceptual Framework

4. The IASB's existing *Conceptual Framework* states that an item that meets the definition of an element should be recognised 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 reliability².
5. Criterion (a) in the previous paragraph is typically referred to as the "probability criterion."

IASB's ED

6. The *Conceptual Framework ED* states that recognition is the process of capturing, for inclusion in the statement of financial position or the statement(s) of financial performance, an item that meets the definition of an element³. In this connection, the ED explains that not all assets and liabilities are recognised because the purpose of financial statements is not to show the value of the entity⁴.
7. As for the recognition criteria, the ED proposes that an entity recognises an asset or a liability (and any related income, expenses or changes in equity) if such recognition provides users of financial statements with⁵:
 - (a) Relevant information about the asset or the liability and about any income, expenses or changes in equity;

(d) ASAF meeting paper *Role of "Nature of an Entity's Business Activities" in Accounting Standard-Setting* (March 2015).

² See paragraph 4.37 of the IASB's *Conceptual Framework*.

³ See paragraph 5.2 of the ED.

⁴ See paragraph 5.7 of the ED.

⁵ See paragraph 5.9 of the ED.

- (b) A faithful representation of the asset or the liability and of any income, expenses or changes in equity; and
 - (c) Information that results in benefits exceeding the cost of providing that information.
8. The ED states that it is impossible to define precisely when recognition of an item that meets the definition of an element will provide useful information to the users of financial statements, because what is useful to users depends on the item and the specific facts and circumstances. Consequently, the ED stresses the importance of the exercise of judgment.
9. With regard to the relevance of information, the ED states that information about assets, liabilities, equity, income and expenses is relevant to users of financial statements, but explains that recognition **may not** provide relevant information if one or more of the following factors applies⁶:
- (a) If it is uncertain whether an asset exists, or is separable from goodwill, or whether a liability exists (commonly referred to as the “existence uncertainty”);
 - (b) If an asset or liability exists, but there is **only a low probability** that an inflow or outflow of economic benefits will result; or
 - (c) If a measurement of an asset or a liability is available, but the level of measurement uncertainty is so high that the resulting information has little relevance and no other relevant measurement is available or can be obtained (commonly referred to as the “measurement uncertainty”).
10. The ED also explains that a combination of factors in the previous paragraph, instead of any single factor, causes information to lack relevance, and other factors may also cause information to lack relevance.

⁶ See paragraphs 5.10 to 5.14 of the ED.

Discussion at the Previous ASAF Meetings

11. In its meetings in July and October 2015, ASAF members discussed the recognition criteria proposed in the Conceptual Framework ED.
12. During the discussions at the July 2015 ASAF meeting, the ASBJ representative suggested that the probability criterion should be retained as part of the recognition criteria, so that elements of financial statements would only be recognised if the probability of inflows or outflows of economic benefits is expected to exceed a certain criterion. The ASBJ representative also stated that this is arguably the most important issue in considering Chapter 5 - *Recognition and derecognition* in the ED, while acknowledging exceptions (for example, assets or liabilities arising from derivative contracts) to the principle. In response to the suggestion, the IASB Staff stated that such an approach is likely to result in frequent departures from the *Conceptual Framework*, and that it would be undesirable to encourage departures that cannot be explained by the material included in the *Conceptual Framework*.
13. The ASBJ understands the IASB Staff's concern. At the same time, however, the ASBJ strongly believes that the *Conceptual Framework* should be designed to help the IASB to develop Standards that are based on consistent concepts. Unless the recognition criteria is robustly prescribed in the *Conceptual Framework*, the ASBJ believes that it would be difficult to determine whether a right or an obligation that meets the definition of an asset or a liability *should not* be recognised when the IASB develops Standards.
14. Indeed, when considering its comment letter on the IASB's Discussion Paper *Reporting the Financial Effects of Rate Regulation*, the ASBJ found it very difficult to conclude that an asset or a liability *should not* be recognised for a combination of rights or obligations arising from rate regulated activities. At the same time, the ASBJ did not believe that this would immediately mean that assets or liabilities *should* be recognised because it felt that the IASB's tentative decisions (leading up to the Conceptual Framework ED) were not precise enough to conclude whether or not such assets or liabilities should (or should

not) be recognised⁷. This may manifest a possible defect of the Conceptual Framework, as the proposed recognition criteria would not be sufficiently helpful for the IASB to develop Standards. If the recognition discussion is left at too high a level in the revised *Conceptual Framework*, the IASB may encounter similar challenges in future standard setting processes.

15. In considering how to strengthen the recognition criteria in the ED, the ASBJ finds that the probability criterion is especially important, because whether to prescribe the ‘probability criterion’ has been the focus of significant debate in past standard setting activities. In addition, a number of stakeholders have expressed their views that not prescribing a clear probability criterion in the *Conceptual Framework* would result in less consistent decisions in standard-setting activities, thereby resulting in less useful financial information in the financial statements prepared in accordance with IFRSs⁸.
16. Taking these considerations into account, the ASBJ believes that the most effective way for us to contribute to the improvement of the recognition criteria is to clarify *why* the probability criterion is so important, and propose a possible idea to determine *when* the probability criterion is necessary, acknowledging that the probability criterion would not be necessary in all the Standards. In the following paragraphs, this paper will further explain the following:
 - (a) Role of the probability criterion in the *Conceptual Framework* (that corresponds to the reason *why* the ASBJ thinks that the probability criterion should remain in the *Conceptual Framework*);
 - (b) *When* the probability criterion would be necessary; and
 - (c) A possible approach that the IASB may consider in revising the *Conceptual Framework*.

⁷ https://www.asb.or.jp/asb/asb_e/international_activities/comments_iasb/20150113_e.pdf

⁸ Responding to such concerns, the IASB discussed at its June 2015 Board meeting the IASB Staff Paper which explained the Staff’s view about how the proposal of the ED may impact IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

III. Role of the Probability Criterion in the *Conceptual Framework*

17. As explained in paragraph 6 of this paper, the ED explains that recognition is the process of capturing, for inclusion in the statement of financial position or the statement(s) of financial performance, an item that meets the definition of an **element**. In other words, the definition of an element together with the recognition criteria works as a ‘filter’ to decide which rights or obligations should be recognised in the financial statements.
18. In Chapter 4 - *The elements of financial statements*, the ED proposes the following definitions of an asset and a liability⁹:
- (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.
19. To supplement the above definitions, the ED explains that an economic resource is a right that has the **potential** to produce economic benefits, and it is only necessary that the economic resource already exists and that there is at least one circumstance in which it would produce economic benefits¹⁰. In combination with the proposed definitions of elements and recognition criteria, the ED essentially leaves windows of opportunities wide open such that the recognition of *any* right or obligation in the financial statements may be possible, as far as there is at least ‘one circumstance’ in which economic benefits would be produced or transferred.
20. Thus, unless the recognition discussion is framed robustly, the recognition filter in the *Conceptual Framework* would be open-ended. The ASBJ agrees with the IASB’s view that judgment is required in the standard setting process (see paragraph 5.10 of the ED) and too prescriptive descriptions in the *Conceptual Framework* may hinder standard setting activities when trying to address emerging economic substance. If the *Conceptual Framework* is too prescriptive, requirements in Standards could experience

⁹ See paragraphs 4.5, 4.6 and 4.24 of the ED.

¹⁰ See paragraph 4.13 of the ED.

frequent departures from the *Conceptual Framework*. In addition, less prescriptive descriptions may better explain the interaction between the concepts explained in the *Conceptual Framework* and the requirements in the existing Standards (for example, recognition of assets and liabilities arising from derivative contracts).

21. However, the ASBJ thinks that leaving the recognition discussion too high a level in the *Conceptual Framework* would not be helpful for the IASB for the following disadvantages:

- (a) It may result in the IASB making inconsistent decisions when developing Standards, considering that the IASB Board members rotate periodically. For example, even if current Board members have the intention to retain the probability criterion in a Standard (for example, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*), future Board members may think differently. Inconsistent decisions regarding recognition requirements in Standards may lower confidence in the IASB's standard-setting activities.
- (b) It would give rise to risks that the IASB could make inappropriate decisions as to whether to prescribe the probability criterion in the Standard (see paragraph 15 of this paper). Inappropriate decisions not to use the probability criterion in Standards (if any) would have a significant impact on the usefulness of financial information and its associated costs. Some expressed fear that not prescribing the probability criterion may result in requiring an unlimited search of rights or obligations in future practice, which would be significantly costly.
- (c) The IASB may find it difficult to explain why there are inconsistencies between existing Standards (for example, IFRS 3 *Business Combinations* and IAS 37), which would hinder stakeholders' ability to properly understand the concepts behind the requirements in IFRSs and the resulting financial information.

22. For these reasons, the ASBJ believes that there is a clear role for the *Conceptual Framework* to robustly prescribe the probability criterion as part of the discussions about the recognition criteria. Some may argue that paragraph 5.13 of the ED already proposes to prescribe the probability criterion, as it describes that '...if one or more of the

following factors applies, **recognition may not provide relevant information**: ... (b) if an asset or a liability exists, but **only a low probability** that an inflow or outflow of economic benefits will result...' (see paragraph 9 of this paper).

23. However, the ASBJ thinks that this description is at best insufficient, because the sentence only indicates the possibility that recognition of an item may (*or may not*) be inappropriate when only a **low probability** that an inflow or outflow of economic benefit will result. In addition, the ASBJ finds it difficult to understand the proposed guidance, because paragraph 5.19 of the ED also suggests that users of financial statements may, in some cases, not find it useful for an entity to recognise assets and liabilities with **very low probabilities** of inflows and outflows of economic benefits. Some wonder why 'a low probability' is referred to in one sentence, while 'very low probability' is referred to in another sentence in the recognition criteria discussion.

IV. When the Probability Criterion would be Necessary

Introduction

24. The previous chapter explained the role of the probability criterion in the *Conceptual Framework* (that is, why the probability criterion should be prescribed therein). At the same time, however, the ASBJ does not believe that the probability criterion is necessary in all Standards (see paragraph 12 of this paper). Hence, challenges arise in relation to how to distinguish between situations where the probability criterion is necessary and other situations where the probability criterion is unnecessary.
25. This chapter will explain the ASBJ's views on when the probability criterion would be necessary in Standards, followed by an explanation thereon. In the explanation, the ASBJ will provide its analysis focusing on the recognition of an 'asset' or a 'liability' which arises as a result of past events, because the Conceptual Framework ED explains that 'income' or 'expenses' are increases in assets or decreases in liabilities except for those relating to contributions from or distributions to holders of equity claims.

26. In addition, in the following paragraphs the ASBJ presumes that an asset or a liability should not be recognised for executory contracts even when a right or an obligation arising from a contract meets the definition of an asset or a liability, primarily because of the reasons explained in paragraphs 4.40 to 4.42 of the ED.
27. Lastly, this paper does not discuss the ASBJ's views as to when an income or an expense should be recognised in profit or loss, although the ASBJ believes that information about an entity's financial performance (especially the information about 'profit or loss') is critically important. The ASBJ's views on recognition of profit or loss has been stated in other papers including the ASBJ's paper titled, *Profit or Loss / OCI and Measurement*¹¹, which was presented at the December 2013 ASAF meeting. The ASBJ will provide its updated views on when to recognise profit or loss in its comment letter to the Conceptual Framework ED.

ASBJ's Proposal

28. With regard to when the probability criterion is necessary, the ASBJ proposes that:
- (a) For recognition of an asset or a liability created from a right or an obligation that arises from 'transactions'¹², the probability criterion is unnecessary.
 - (b) For recognition of an asset or a liability (that is, an item) or a group of assets and/or liabilities (that is, a group of items) created from a right or an obligation (or rights and/or obligations) that arises from 'other events'¹³, the probability criterion is necessary.

Reflecting the Effect of Uncertainty – Classification to 'Transactions' and 'Other Events'

29. In the following paragraphs, the ASBJ will explain the reasons for its suggestion stated in the previous paragraph on the basis of an individual asset or liability.

¹¹ https://www.asb.or.jp/asb/asb_e/asbj/pressrelease/pressrelease_20131227_e.pdf

¹² Please refer to paragraphs 33 and 34 of this paper for the definition of the term 'transactions.'

¹³ In addition to paragraphs 33 and 34, please also refer to paragraph 0 of this paper for the definition of the term 'other events.'

30. Paragraph 5.2 of the Conceptual Framework ED explains that recognition involves depicting the item that meets the definition of an element in words and by a ‘monetary amount.’ Thus, the important feature of financial information contained on the face of the financial statements is that **recognition and measurement occur at one time**. Hence, for financial information recognised in the financial statements to be relevant and faithfully represented, the decision of whether to recognise an asset or a liability should be determined, taking into account the combined effect of recognition and measurement on the usefulness of financial information recognised in the financial statements.
31. When an entity acquires a right or assumes an obligation as a result of the past events and the inflows or outflows of the future cash flows are unconditional and their amounts are virtually certain, there is almost no question as to the recognition and measurement of an asset or a liability as a result of the past events. However, when the amount and timing of the future cash flows of an asset or a liability created from a right or an obligation are uncertain, a question arises as to how to reflect the effect of the uncertainty of future cash flows, including whether and if so when to recognise and measure an asset or a liability in the financial statements, so that the resulting financial information is useful. The ASBJ thinks that broadly there are three ways to reflect the effect of uncertainties; namely, at recognition, at measurement or at both recognition and measurement.
32. In the following paragraphs, this paper will provide the ASBJ’s analysis regarding how to reflect the effect of the uncertainty by classifying ‘past events’¹⁴ into a subset of events meeting the definition of ‘transactions’ and ‘other events’, in line with paragraph 3.5 of the ED stating that financial statements provide information about financial effects of ‘transactions’ and ‘other events’ during a specified period. This is because the ASBJ thinks that how to reflect the effect of the uncertainty should differ depending on whether an entity accounts for ‘transactions’ or ‘other events’.

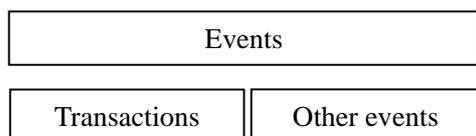
¹⁴ Neither the term ‘event’ nor ‘past event’ is defined under IFRSs, but US GAAP defines the term ‘event’ as ‘a happening of consequences to an entity. The term encompasses both transactions and other events affecting an entity’. In this paper, by reference to the definition in US GAAP, the term ‘events’ is used as a general meaning to denote ‘happenings of consequence to an entity’.

33. Although IFRSs defines neither the term ‘transaction’ nor ‘other event’, the dictionary definition¹⁵ says that ‘transaction’ denotes ‘a piece of business that is done between people, especially an act of buying or selling’. In addition, as a reference, US GAAP¹⁶ defines the term ‘transaction’ as ‘an external event involving transfer of something of value between two (or more) parties.’ Thus, the ASBJ thinks that the term ‘transaction’ in IFRSs is generally understood to have the following two characteristics:

- (a) It involves a transfer of something of value, typically in a form of buying or selling.
- (b) It involves two or more parties.

34. In the following paragraphs, the term ‘transaction’ is used in the meaning noted above. The demarcation between ‘events’, ‘transactions’ and ‘other events’ is shown as follows:

Chart 1: Demarcation of ‘Events’, ‘Transactions’ and ‘Other Events’



(Note)

- ◇ Events...Happenings of consequence to an entity
- ◇ Transactions...Transfers of something of value between two or more parties
- ◇ Other events...Events other than transactions

Recognition of an asset or a liability created from a right or an obligation arising from transactions

35. When an entity acquires a right or assumes an obligation as a result of ‘transactions’, whether to recognise an asset or a liability is not a serious issue in many cases. For example, when an entity purchases a property in exchange for cash, few question if an asset should be recognised. In practice, when the property is purchased and the entity’s right in the property is established, an asset is simply recognised on the face of the statement of financial position, while the cash paid is derecognised from the statement.

¹⁵ Oxford Advanced Learners’ Dictionary 8th Edition

¹⁶ Master Glossary of the FASB Accounting Standards Codification

36. Recognition of an asset acquired or a liability assumed as a result of transactions could also be conceptually justified as follows. In the case of exchange transactions in which cash is received or paid in exchange for an item transferred or received¹⁷, the transaction price is supposed to reflect the scenarios and possibilities of the occurrence of future cash flows presumed by the parties involved in the transaction, and **the effect of the uncertainty of future cash flows (if any) is reflected in the transaction price.** In addition, for other types of transactions including non-exchange transactions¹⁸, although it is necessary to estimate the value of the item transferred or received, **the effect of the uncertainty of future cash flows (if any) is also reflected in the value of the item transferred or received.**
37. Nevertheless, within the context of both cases explained in the preceding paragraph, we believe that the effect of the uncertainty is properly reflected in the measurement of an asset or a liability at initial recognition. As such, information about the value recognised on the face of the financial statements is usually supposed to provide useful information to users of financial statements.
38. Hence, save for situations where a right is consumed as soon as an entity acquires it and an expense is recognised immediately (such as expenditures on cleaning services), in the case of a right or an obligation arising from transactions, recognition of an asset or a liability measured at the value transferred or received is considered to be appropriate. Therefore, in the case of an asset or a liability created from a right or an obligation as a result of transactions, **the probability criterion is unnecessary.**
39. There has been a debate about whether the recognition criteria set forth in the existing *Conceptual Framework* (see paragraph 4 of this paper) is inappropriate. This is because in the case of option contracts, it is not always probable that the future economic benefits associated with the item *will flow to or from the entity* and the criteria seems to exclude the possibility of recognising an asset or a liability arising from option contracts. As

¹⁷ In the case of transactions in which different values are transferred or received between the parties, the difference between the values transferred and received is to be adjusted appropriately.

¹⁸ This typically includes non-exchange transactions in which consideration is transferred or received non-reciprocally (typically, an entity's payment of donation to a third party) as well as transactions in which cash is not transferred or received between the parties (that is typically referred to as barter trades).

such, many have argued that the current recognition criteria in the existing *Conceptual Framework* should be reconsidered, because they consider that information about the asset or liability that arises from option contracts is useful, and consistent with the requirements of the existing Standard, such an asset or a liability should be recognised in the financial statements. Following the ASBJ's analysis explained in paragraphs 36 and 38 of this paper, the conclusion would be that an asset or a liability created from a right or an obligation that arises from option contracts should be recognised in the financial statements, because the effects of the uncertainty of the future cash flows are already factored into their transaction prices and thereby its measurement.

40. In addition, in the case of an entity's derivative contracts *that do not involve* initial investments (for example, interest rate swap transactions), although the value transferred or received at the inception of the transaction is often nil or close to nil, the (nil) value is supposed to reflect virtually all scenarios and possibilities of the occurrence of future cash flows set forth in the terms of the contracts with the counterparties. Thus, although the measurement may be nil or close to nil (and monetary information may not be shown in the financial statements at initial recognition), the conclusion would also be that an asset or a liability created from a right or an obligation that arises from the derivative contracts should be recognised in the financial statements.

Recognition of an asset or a liability created from a right or an obligation arising from other events

Reflecting the Effect of the Uncertainty

41. A challenge of determining whether to recognise an asset or a liability exists when an entity acquires a right or assumes an obligation as a result of 'other events'. The term 'other events' is neither defined under IFRSs nor US GAAP, but in this paper the term is used to denote 'events other than transactions' that includes lawsuits, natural disasters and so forth. Thus, a right or an obligation that arises as a result of other events includes:
 - (a) An entity's obligation to transfer its economic resources to third parties, depending upon the consequence of a pending litigation claims brought by third parties;

- (b) An entity's assurance type product warranty obligation to compensate if a good or service transferred to customers is found to be not in accordance with agreed-upon specifications¹⁹; and
- (c) An entity's right to receive cash, depending upon the consequence of legal proceedings filed by the entity for wrongdoing of others.
42. In the case of a right or an obligation that arises from other events, there is no value transferred or received at inception (such as a transaction price). Therefore, it is necessary to estimate the future cash flows from the right or the obligation if it is to be recognised in the financial statements. Thus, the question is how best to reflect the effect of the uncertainty; namely, whether to reflect the effect at recognition, at measurement or at both recognition and measurement. **In this case, the ASBJ believes that reflecting the effect of the uncertainty at recognition is at least necessary.**
43. This is because the generation of future cash flows resulting from the right or the obligation that arises from other events is often dependent on the occurrence of events outside the control of the entity, and a triggering event that creates the entity's asset or the liability involving future cash inflows or outflows may not necessarily be apparent; thus, it is not always clear whether an entity's asset or liability exists. This notion is sometimes explained as the "existence uncertainty." Paragraph 5.16 of the ED explains the case as follows:

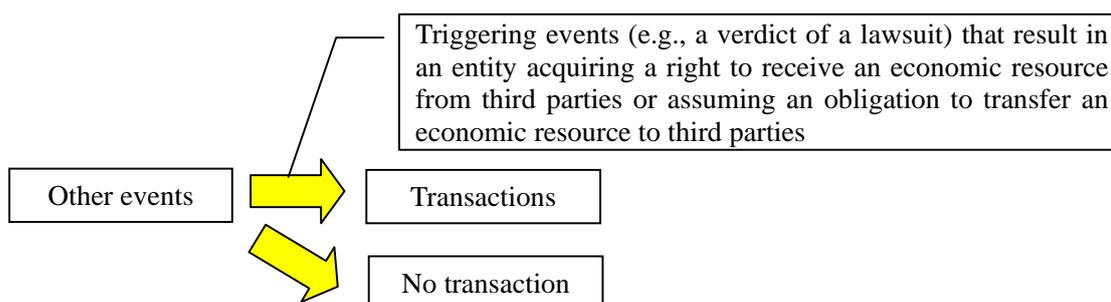
5.16 For some liabilities, it may be unclear whether a past event causing an obligation has occurred. For example, if another party claims that the entity has committed an act of

¹⁹ It is sometimes evident that a right or an obligation transferred or received between parties as a result of a transaction should be recognised separately in the financial statements, but there are other cases in which it is not evident. For example, when an entity incurs a warranty obligation *explicitly* as it is priced or negotiated separately, it is evident that an entity should recognise the obligation as a liability separately in the financial statements as a result of the transaction. On the other hand, when a warranty is provided by an entity to customers *implicitly* (for example, due to the law or its customary business practice), it is not evident if the obligation should be recognised separately in the financial statements when it enters into a transaction. In this paper, the ASBJ presumes that the entity does not incur a warranty obligation that should be recognised separately in the financial statements when it enters into the transaction, because the purpose of the law or customary business practice is to protect the customer against the risk of purchasing a defective product, and such protection usually presumes that the product was defective at the time of sale, if and when a fault (which forms part of 'other events') arises within a specified period.

wrongdoing and should compensate the other party for that act, it may be uncertain whether the act occurred or whether the entity committed it.

44. In addition, the ASBJ notes that ‘other events’ may give rise to ‘transactions’ over time as a consequence of triggering events, which identify an entity’s right to receive economic resource from other(s) or its obligation to transfer an economic resource to other(s). For example, when a third party brings about a lawsuit against an entity, the entity does not have an obligation to pay at that point; thus, there is no transaction between the entity and the third party. However, as the verdict of a lawsuit is handed down by the court, the entity may acquire a right to receive cash from the third party or assume an obligation to transfer cash to the third party in accordance with the verdict.

Chart 2: Transformative Relationship from ‘Other Events’ to ‘Transactions’



45. In addition, in the case of a right or an obligation that arises from other events, an entity usually has no practicable ability to transfer the right or the obligation to third parties²⁰; thus, it is almost impossible for the entity to choose to generate cash flows from the right or the obligation through the transfer of the right or the obligation to third parties. Thus, recognising the right or the obligation in the financial statements and reflecting the effect of the uncertainty solely at measurement using the expected value would result in the amount recognised in the financial statements being less relevant, because the amount would not have a predictive value for the assessment of the prospects of future cash inflows or outflows.

²⁰ In the ASBJ’s view, an entity has no practicable ability to transfer an asset or a liability to third parties, when:

- (a) The entity is unable to find a transferee of the right or the obligation, because (i) it does not have the access to the market in which it can realise cash flows from items by transferring them to third parties, or (ii) the scenarios and possibilities of occurrence of future cash flows are not reasonably known to an entity and third parties; and
- (b) The entity is restricted from transferring an asset or a liability either legally or substantively.

Consequences of not Specifying the 'Probability Criterion' in the Standards

46. Presuming that it is appropriate to reflect the effect of uncertainty at recognition for a right or an obligation that arises from other events, the next question is how it should be reflected at recognition. In this regard, the ASBJ believes that the use of the probability criterion is appropriate. This is because if an entity recognises the asset or liability with low likelihood of occurrence of future cash flows and measure it based on the expected value (using virtually every possible cash flow scenario predicted by the entity), the entity would need to report on the consequences of non-occurrence of cash flows in future periods by recognising gains or losses for the difference between the future cash flow amount and the amount having been recognised in the financial statements. Such gains or losses recognised in future periods to reverse the previously recognised gains or losses are essentially considered to be a 'noise' for users of financial statements when assessing the amount, timing and uncertainty of future cash inflows to an entity, as there is no predictive value in themselves.
47. In addition, if an entity recognises an asset or a liability and measures it based on a particular cash flow scenario (for example, the most-likely scenario) or scenarios, even for an asset or a liability with a low likelihood of the occurrence of future cash flows, financial statements would become difficult to understand. By doing so, items with a higher possibility of occurrence and those with a lower possibility of occurrence would be added as if there have similar possibilities of future cash flows occurring. If related incomes or expenses are recognised by reference to the measurement of the asset or liability, an entity's financial performance may be distorted.
48. Accordingly, unlike a right or an obligation that arises from transactions, the ASBJ believes that **the probability criterion²¹ is necessary when considering the recognition of a right acquired or an obligation assumed that arises from other events.** By doing so, the effect of the uncertainty of the future cash flows is reflected at recognition.

²¹ Under IFRSs, the existing *Conceptual Framework* does not define the term 'probable.' However, the term is explained as the meaning equivalent to 'more likely than not' in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* and IAS 37.

Consideration of a Group of Items

49. In paragraphs 41 to 48 of this paper, the ASBJ stated its views on *when* the probability criterion is necessary on the basis of an individual asset or a liability (i.e., individual item), in the case where an entity acquires a right or assumes an obligation as a result of ‘other events’. However, the ASBJ believes that consideration should be given to whether a different approach is necessary when an entity has a large number of items with similar characteristics, because in such situations the economic phenomenon would be more properly identified if the items are considered on an aggregated basis.
50. Even if the future net cash flows from an individual asset or a liability is unlikely to occur, an entity should still recognise the item ***when it has a large number of items with similar characteristics such that the items as a group are likely to contribute to future net cash inflows to the entity***²².
51. For example, it would be appropriate to conclude that an assurance type product warranty liability should be recognised in the financial statements even when the possibility of the occurrence of future cash flows may not be considered probable individually, because an entity normally incurs future cash outflows from the product warranty obligations when obligations are considered for its products as a whole.

V. Other Consideration

Application of Asymmetrical Prudence

52. The ASBJ also thinks that it may be appropriate for the IASB to consider whether a higher hurdle is more appropriate for the recognition of an asset (and related income) than that of a liability (and related expenses), considering the notion of ‘asymmetrical prudence’ explained in BC2.11 to BC2.15 of the ED. For example, IAS 37 requires recognition of a provision when an outflow of resources embodying economic benefits

²² Due to the similarity of characteristics of items, typically, the shape of the distribution regarding the amounts and probabilities of future cash flows generated from each item would be similar with each other.

has become *probable*, whereas it requires recognition of an asset when the realisation of income is *virtually certain*²³.

53. Considering the explanations given in paragraphs BC2.11 to BC2.15 of the ED, the ASBJ thinks that it would be helpful for the IASB if the *Conceptual Framework* acknowledges the notion of ‘asymmetrical prudence’ within the discussion of the recognition criteria, because making that explicit in the *Conceptual Framework* would help the IASB to develop accounting requirements asymmetrically between assets (and related income) and liabilities (and related expenses).
54. In addition, the ASBJ thinks that the notion of asymmetrical prudence may also be applicable at measurement. For example, in some cases, it may be possible for the IASB to require the use of different sets of cash flow scenarios for the measurement of an asset or a liability.

When the Measurement Uncertainty Is Extremely High

55. When the probability criterion is met, an asset or a liability or a group of assets and/or liabilities can be usually measured reliably. However, the ASBJ thinks that, *in extremely rare circumstances*, even when an entity determines that the prospects of generating future cash inflows or outflows from its right(s) or obligation(s) meet the probability criterion, it might be possible for the entity to conclude that an asset or a liability created from a right acquired or an obligation assumed (or a group of assets and/or liabilities) as a result of other events should *not* be recognised, and instead conclude that disclosure of relevant information would provide more useful information. This is when extremely significant challenges exist for the entity to estimate future cash flows due to the unavailability of reliable information²⁴, such that any single amount of measurement cannot provide useful information of the asset or the liability (or a group of assets and/or liabilities) to users of financial statements.

²³ See paragraphs 30 and 33 of IAS 37.

²⁴ See paragraph 2.21 of the ED. In the ASBJ’s view, reliable information might be unavailable, for example, when the number of possible future cash flow scenarios is significantly large and amounts of possible future cash flows are significantly widespread.

VI. Concluding Remarks

56. In this paper, the ASBJ proposes that the probability criterion is necessary for a set of situations, while in other situations the probability criteria is irrelevant. The ASBJ thinks that it is neither necessary nor appropriate for the *Conceptual Framework* to discuss situations where the probability of inflows or outflows of economic benefits is greater than low but less than probable, when considering whether to recognise an asset or a liability, or a group of assets and/or liabilities.
57. The ASBJ hopes that the analysis and the proposal in this paper will contribute to the IASB's work on the improvement of the *Conceptual Framework*.