December 4, 2020

Technical Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
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File Reference No. 2020-500

Dear Ms. Salo:

FinREC welcomes the opportunity to comment on the Financial Accounting Standards Board's (FASB's or Board's) July 16, 2020, Exposure Draft—Concepts Statement No. 8, *Conceptual Framework for Financial Reporting—Chapter 4: Elements of Financial Statements* (Concepts Statement No. 8, or CON 8). While we support the Board's effort to reduce unnecessary complexity in the definitions of the elements in financial statements, it is unclear whether the proposed elemental definitions would achieve that objective. It is also questionable whether these proposed changes to the definitions would assist stakeholders in practical application of this guidance. Nevertheless, FinREC believes the Board should continue its work on this project; however, it may face significant challenges in meeting the objectives of the Exposure Draft in its current form. Therefore, we offer the following general comments for your consideration:

- The proposed chapter seems to indicate that the Board's intent was to clarify the existing elemental definitions and not to substantially change the nature and population of items that would currently meet those definitions. For example, the Questions to Respondents 1 and 5 about the proposed asset and liability definitions include a statement that that the Board expects most items that met the Concepts Statement No. 6 (CON 6) asset and liability definitions will continue to meet the proposed definitions of each. However, it is not clear whether items that did not meet the CON 6 definitions are expected to continue not to meet the proposed definitions. In addition, the nature and extent of the proposed changes suggests that substantive changes may result from the revised definitions. We recommend that the Board clarify their intention regarding the significance of the changes to the existing definitions.

- Recognizing that guidance in Concepts Statements is not authoritative, it is unclear whether elemental definitions have primacy over any other content in the proposed chapter. Specifically, there may be confusion regarding the primacy of statements made in the formal definitions, the paragraphs that follow, and the Basis for Conclusions. For example, specific items are removed from the existing formal definitions of assets and liabilities in the proposed chapter (such as "control", "probable", "past transaction or event"), but the multiple paragraphs that follow the proposed definitions and the Basis for Conclusions include statements that indicate that these excluded items continue to be essential to the definitions of assets and liabilities. We suggest that the Board clearly indicate what information should be given primacy over other information presented in the proposed chapter.

- We suggest that the Board clarify whether an enforceable contract (for example, a licensing agreement that has been initiated but not yet commenced) creates a present right. In addition, a definitive statement that indicates if a present right can exist before the counterparty's completion of performance would be helpful. Although paragraph E29 indicates that "a benefit that is expected only because of anticipation of the action or performance of either a counterparty or the entity is not a present right," the discussion in paragraph E41 may result in a conflicting conclusion as it indicates that a binding performance requirement creates an obligation (and presumably a present right to an economic benefit on the other side of the transaction). A binding performance requirement implies that future performance is still needed.
- We recommend retaining the notion of control in the definition of an asset. The elimination of "control" from the proposed definition of the assets may result in expansion of the population of assets. Furthermore, the concept of control is used extensively in existing GAAP, such as FASB ASC Topics 606 and 842. The elements as currently defined in Concepts Statement No. 6 seem better aligned to the definitions used in FASB ASC Topics 606 and 842, whereas the proposed Concepts Statement No. 8 Chapter 4 elements may not be as closely aligned. We recommend continued convergence between the Concepts Statements and the authoritative guidance whenever possible, particularly those standards that have been recently issued and are not likely to be substantively amended in the foreseeable future.
- The inclusion of a present right coupled with the exclusion of "past transactions and events," may, like the exclusion of "control," also change the existing population of assets, including internally generated intangible assets and assets that represent a present right to receive or obtain a stand-ready service. Please see our response to Question 2 for examples.
- There are significant differences between revenues and gains and between expenses and losses, and we do not support the notion that distinguishing them is simply a matter of presentation. For example, users of financial statements may be interested in sources of revenues of an entity when making their investment decisions or analyzing cash flows. Therefore, we believe retaining the existing elemental definitions of revenues, expenses, gains and losses, including the notion of central or core operations in the elemental definitions of revenues and expenses and transactions of a peripheral or incidental nature in the elemental definitions of gains and losses, is critically important.
- There may be divergence not only from authoritative US GAAP but also from the IFRS conceptual framework. The current IFRS conceptual framework project summary includes common components of an asset (present right to future economic benefits) but also explicitly includes "control" in the asset definition. Aside from our preference for retaining control explicitly in the proposed asset definition, we believe conceptual convergence is also preferable in the long run.

We provide more detailed responses to specific questions in Appendix A.

Angela J. Newell
Chair
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Appendix

Responses to Questions

<u>Question 1</u>: **The Board expects that most assets that met the definition of an asset in FASB Concepts Statement No. 6, *Elements of Financial Statements*, will continue to qualify as assets under the definition of an asset in this proposed chapter. Do you agree that the definition of an asset in this proposed chapter is consistent with the Board's assertion? If not, please provide examples.**

We generally agree that most assets meeting the definition of an asset under FASB Concepts Statement No. 6, *Elements of Financial Statements* (CON 6), will continue to meet that definition under the proposed chapter. However, we believe that additional clarity regarding the Board's intent with respect to changes from CON 6 and how the definitions relate to the supplemental guidance is needed before we can adequately assess whether the asset population would change.

Examples include items removed from but still characterized as part of the definition in the supplemental guidance and how to evaluate present contractual rights. Paragraph BC4.10 states, in part: "The term probable in the definitions in Concepts Statement 6 has been misunderstood as implying that a future economic benefit or a future sacrifice of economic benefit must be probable to a certain threshold before the definition of an asset or liability is met. In other words, if the probability of future economic benefit is low, the asset definition is not met under this interpretation. A similar interpretation could be made for liabilities." Absent that threshold, the population of assets (and liabilities) could increase.

Paragraph BC4.13 indicates: "For assets, the considerations in this chapter do not alter the population of items that were included under the previous definition of an asset in Concepts Statement 6." Yet, the text of the proposed chapter may imply that the population of assets under the new definition may change. For example, if the notion of control is removed from the definition of an asset, the population of what is considered an asset may expand. Enforceable rights created under stand-ready service contracts may represent a present right and, therefore, be recognized as an asset under the proposed definition. In addition, although executory contracts create rights, they may not be considered assets under the revised definition and this may in fact be the FASB's intention. However, if that is the case, how should assets related to variable consideration under ASC 606 be treated? Are they contingent assets or not assets at all because there is no present right until a condition is satisfied?

<u>Question 2:</u> **In particular, respondents are asked to focus on internally generated intangible assets. Is the definition of an asset in this proposed chapter helpful in resolving issues of identifying intangible assets?**

It is unclear how the proposed revised guidance would help to answer this question. We recommend that the FASB provide more clarity in order to determine if internally generated intangibles would meet the new definition of an asset.

We believe that paragraph E35 does not explain whether a right to a future economic benefit exists for internally generated intangible assets. If there is no intent to add internally generated intangible assets, such as research and development costs, to the balance sheet, the final CON 8 should make that clear.

For example, employee training might be considered a future benefit, and perhaps, give rise to an asset under the proposed new definition. When an entity invests in employee training, it expects that its investment will result in increased productivity and efficiency. Nonetheless, it is unclear if the entity has a present right resulting from past training because the employee may generally sever their employment at his or her discretion.

In addition, if the proposed asset definition simply requires that a present right to future economic benefits exists and excludes control and the need for a past transaction or event, certain assets, such as proprietary processes or unique formula development, may meet the definition of an asset. This is similar to internally generated software development costs that are capitalized.

<u>Question 3:</u> The Board's definition of an asset in this proposed chapter does not include the term *control*. However, this proposed chapter explains why and how control is interrelated to the definition of an asset. Is this discussion sufficient or is the term *control* necessary to include in the definition of an asset? If the term *control* is necessary to include, please explain how its inclusion would change the population of items that would meet the definition of an asset in this proposed chapter.

While we appreciate the Board's effort to define the elements in a more concise manner, we believe that shortening the definitions would not result in making them simpler to apply, especially when it is not clear how the definitions relate to the information in the supplemental paragraphs and in the Basis for Conclusions. It seems inconsistent and perhaps vague to exclude the notion of control from the definition but then include the requirement that access to the asset is restricted by the holder in explanatory paragraphs that follow the new definition. Rather than stating that "the ability to restrict others' access is a component of an asset of an entity because the ability to restrict creates an advantage in the form of privileged access and control of economic benefits", we recommend definition of an asset includes "control." In addition, as previously noted, the term "control" is widely used in practice, including FASB ASC Topic 606 for revenue recognition and FASB ASC Topic 860 as one of the criteria for derecognition of financial assets, and we believe it is important that the concepts statements are consistent with existing standards.

<u>Question 4:</u> The Board decided that an obligation to transfer either assets or, in certain limited circumstances, an entity's own shares would meet the definition of a liability. Is the discussion in this proposed chapter of the limited circumstances in which the entity's own shares would

meet the definition of a liability sufficiently clear?

We believe that in very limited situations, a transfer of shares as defined in paragraph E58 would meet the definition of a liability. We understand that obligation to issue a variable number of shares meets the proposed definition of a liability, yet we encourage the Board to explain why issuing a fixed number of shares does not meet the proposed definition.

<u>Question 5:</u> **Other than as described in Question 4, to allow certain share-settled instruments to be liabilities, the Board expects the liabilities that met the definition of a liability in Concepts Statement 6 will continue to qualify as liabilities under the definition of a liability in this proposed chapter. Do you agree that the definition of a liability in this proposed chapter is consistent with the Board's assertion? If not, please provide examples.**

We agree that liabilities under Concepts Statement No. 6 will likely continue to qualify as liabilities under the definition in the proposed chapter. Similar to our response to Question 1, we believe that additional clarity regarding the Board's intent about changes from CON 6, how the definitions relate to the supplemental guidance, the impact of the removal of "probable" from the definition, and whether certain executory contracts would create liabilities under the proposed definition, is needed before we can adequately assess how the liability population would change. For example, consider a take or pay agreement where the contract conveys an enforceable obligation to supply a specific asset coupled with a disincentive for nonperformance. Does this constitute a liability?

In addition, as previously noted, we believe it is important to retain the notion of "probable" in the definition, rather than only referring to the concept in the following explanatory paragraphs and the Basis for Conclusions, for the same reasons that it is important to maintain the notion of "control" in the definition of an asset. We also believe that the definition of "probable" should be aligned with its technical definition, or a different term used if the intent was not to align with the technical definition.

Please also refer to our response to Question 6 that follows.

<u>Question 6:</u> **In practice, the more challenging applications of the definition of a liability in Concepts Statement 6 were related to business risks, constructive obligations, and stand-ready obligations. Is the discussion of those three areas in this proposed chapter adequate to understand and apply the definition of a liability?**

Generally, we do not believe that the discussion in the proposed chapter is adequate to determine whether certain items meet the definition of a liability. Specifically, we are unclear whether certain executory contracts would represent liabilities under the proposed definition and recommend that the Board clearly articulate how to apply the proposed definition to those types of contracts.

If the Board's intent is that some types of executory contracts would give rise to contractual assets and liabilities, we recommend that the Board also consider addressing whether the presentation of such assets and liabilities should be on a gross or a net basis in the presentation chapter.

<u>Question 7:</u> The Board suggested that integration with presentation principles would be helpful in distinguishing between the components of comprehensive income. To facilitate this distinction, paragraph E92 of this proposed chapter references presentation principles. Is distinguishing revenues from gains and expenses from losses essential as a matter of elements, or should those distinctions be exclusively a matter for presentation concepts? Please explain.

Displaying revenues separately from gains and expenses separately from losses in financial statements makes information about the sources of comprehensive income more useful to the users of financial statements. However, the distinction between revenues and gains and expenses and losses is a fundamental difference that should not be reduced to a simple matter of presentation. This distinction is important in enabling users of financial statements to properly assess the amount, timing and uncertainty of the related cash flows of the entity, thereby meeting the objective of financial reporting.

Although revenues and gains both increase comprehensive income while expenses and losses both reduce comprehensive income, revenues and expenses result from delivering goods and services or other activities (rent, royalties, fees, interest, etc.) while gains and losses have a significantly different character. Therefore, we think it is important that the final definition of revenues and expenses retain reference to "the entity's ongoing major or central operations" from CON 6 and the final definition of gains and losses retain reference to "from peripheral or incidental transactions of an entity" from CON 6. Please also see our general comments in the beginning of the comment letter.

<u>Question 8:</u> As described in Question 7, this proposed chapter seeks to distinguish between revenues, expenses, gains, and losses. Do the definitions of and other explanatory language related to revenues, expenses, gains, and losses make the distinction between these elements sufficiently clear?

We believe the significant changes to the definitions of these items, principally the elimination of the references to "ongoing major or central operations" and "from peripheral or incidental transactions", suggests a meaningful change to what would meet these definitions. However, those significant changes seem to conflict with the Board's implied intent with respect to changes in element populations from CON 6 and the discussion in paragraph E90. As noted in our response to the prior question, we recommend retaining the notion of "ongoing major or central operations" in the definitions of revenues and expenses, and "from incidental or peripheral transactions" in the definitions of gains and losses.
More broadly, a residual approach should not be used to distinguish revenues from gains and expenses from losses in a Concepts Statement. A residual approach is insufficient to properly identify the sources of comprehensive income as it makes the information less useful. Although "other activities" are defined in paragraph E88, the definition appears too broad and can lead to

confusion regarding proper income statement presentation.

<u>Question 9:</u> **The Board has concluded that, other than when exceptions are specifically noted in this proposed chapter, the elements described in this proposed chapter would apply to not-for-profit organizations. Do you agree with this conclusion?**

We generally agree that the elements in this proposed chapter would apply to not-for-profit (NFP) organizations.

We believe that the more broadly structured definition of assets may modify the population of assets held by NFP entities. For example, the broad definition strengthens the recognition of pledges receivable because the “result of past transaction or events” wording has been removed. Beneficial interests in trusts are now considered assets because of the existence of a present “right” not due to “control.” Conversely, funds or financial assets held by a fiduciary may no longer be considered an asset under the new definition because the fiduciary entity doesn’t have an economic benefit.

An NFP entity holding a significant amount of investment assets would benefit from clear definitions of revenues and expenses (gains and losses) in order to prevent, for example, potential misclassification of investment gains as revenues.

Finally, regarding investments from and distributions to owners, NFP entities that are related parties (for example, a controlled group) may engage in equity transfers on a regular basis. In many cases the related parties are consolidated for financial statement purposes, and thus, the transactions are eliminated. However, if one of the consolidated entities is preparing stand-alone financial statements, FASB ASU No. 2016-14, *Presentation of Financial Statements of Not-for-Profit Entities*, specifically requires that equity transfers are presented separately within changes in net assets. We note that while equity transfers are defined as similar to the ownership transactions, they do not appear to fit the definition of investments from and distributions to owners described in the proposed chapter. We recommend that the FASB clearly determine whether and how equity transfers fit within the conceptual element framework to reduce any diversity in practice.

<u>Question 10:</u> **This proposed chapter was developed on the basis of Concepts Statement 6, though several paragraphs have been removed or adapted. Are any of the paragraphs from Concepts Statement 6 that have been removed in drafting this proposed chapter necessary to keep? If so, why?**

We do not have any other comments in addition to those made throughout our response.

<u>Question 11:</u> **“Appendix A: Accrual Accounting and Related Concepts,” includes discussion of several concepts that are used in this proposed chapter and in other chapters of the Conceptual Framework. Is this material helpful in a chapter discussing the elements of financial statements?**

We agree this material is helpful in discussing the elements of financial statements and beneficial to the reader in supporting the conclusions reached in this chapter. However, it is unclear how this material impacts what meets the elemental definitions in the proposed chapter. To increase usefulness, we suggest that the Board clearly indicate how the accrual accounting and related concepts assist stakeholders in understanding and applying the proposed elemental definitions. The Board could also provide examples on how the information in this Appendix A influences the determination of what meets an elemental definition.