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Project	**Conceptual Framework**		
Paper topic	Draft discussion paper: guidance to support the definition of a liability		

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This paper is a very early draft of part of the Conceptual Framework discussion paper. It has been prepared by the staff for discussion by the IASB. Issues discussed and conclusions reached will be subject to change.

Guidance to support the definition of a liability

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What does this section cover?

This section covers additional guidance to support the definition of a liability.

Why is this section important? What problems will this section help address?

Aspects of the existing definition of a liability are unclear and the principles underlying different IFRSs can appear inconsistent. As a result, the Board, the IFRS Interpretations Committee and others have had difficulty reaching conclusions on whether and when some transactions give rise to liabilities.

When this section of the discussion paper is complete, it will discuss several problems that arise frequently in practice and suggest alternative ways in which each problem could be resolved.

The draft for discussion at this meeting considers the first of the problems: whether an entity has a 'present' obligation if a future transfer of resources is conditional on the occurrence or non-occurrence of future events. The staff outline three different approaches for identifying present obligations and illustrate the consequences of each approach for a range of topical examples, including levies and emissions trading schemes.

What are the questions for the Board?

Board members are asked:

(a) which of the approaches they think should be included in the discussion paper; and

(b) whether they have a preliminary view as to which approach should form the basis of guidance in the Conceptual Framework.

Next steps

Other problems that the staff envisage covering in this section of the discussion paper are outlined very briefly in the appendix to this paper. These problems will be discussed at a future meeting. They are:

(a) the distinction between a constructive obligation (which can result in a liability) and economic compulsion (which cannot, by itself, result in a liability);

(b) problems specific to contractual obligations;

(c) whether obligations to stand aside or forgo potential inflows of resources are liabilities; and

(d) other sundry matters on which further guidance might be useful.

‘Present’ obligation—the impact of future events

1. As discussed in Agenda Paper 3B, the staff recommend that the Conceptual Framework should define a liability as a present obligation to transfer an economic resource. A present obligation is one that exists at the reporting date. The economic resource to be transferred need not exist at that date, nor need it already be controlled at that date. In many cases, an entity has a present obligation and will fulfil that obligation with economic resources that it will acquire in the future.

2. To identify a liability it is necessary to distinguish between present obligations and possible future obligations. Difficulties are often encountered in practice because it is unclear whether an entity has a present obligation while any requirement to transfer resources remains conditional on the occurrence of uncertain future events. This question has arisen both for the Board in developing new standards, and for the IFRS Interpretations Committee and others in 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. Future events can be of two types:

   (a) those whose occurrence is outside the control of the entity; and

   (b) those whose occurrence depends on the entity’s future actions.

Future events outside the control of the entity

4. In some situations, the outcome of an obligation depends on the occurrence or non-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) the obligation of an entity that has purchased plant or equipment to make an additional payment to the vendor if the plant or equipment meets specified performance levels at a future date.

5. 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 Board has concluded that these unconditional obligations are present obligations that meet the definition of a liability. The requirements of several recent and forthcoming IFRSs—such as the forthcoming IFRSs for revenue recognition and insurance contracts—reflect this conclusion. However, the existing Conceptual Framework does not articulate the conclusion in general terms.

Future events that depend on the entity’s future actions

6. There has been more debate about whether a liability exists if the eventual need to transfer economic resources depends on the entity’s own future actions. The existing Conceptual Framework does not address this question and the principles underlying individual standards can appear to be inconsistent.

7. There are numerous transactions for which this question arises. Several examples are considered below. The subsequent analysis considers whether a present obligation exists in each case. Some of the transactions might also give rise to an asset for the entity. However, any discussion of those assets is beyond the scope of this section of the discussion paper.

Example 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. The entity has a right to terminate an employment contract before the end of the vesting period (i.e. before the five years’ service is complete) and in that event, the entity would not be required to pay any bonus to the employee. However, it is highly likely that most of the employees will complete the five years' service and hence that their bonuses will vest.

Example 2: Rail levy with 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% of revenue earned in the year in excess of CU500 million. A train operator 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[1] for the calendar year.

Example 3: Electricity supplier levy

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 entity with a reporting period ending on 31 December 20X0 earned revenue of CU100 million during 20X0. It will be charged a levy only if it is still supplying electricity to the specified market on 1 April 20X1.

Example 4: Bank levy

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 month from January-June and 0.2% 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.

1 (CU900 million – CU500 million) × 1%

Example 5: Waste disposal levy

Legislation is enacted in 20X3. It will require manufacturers of electronic equipment to contribute at a future date to the costs of disposing of 'historical waste', i.e. equipment that was manufactured before the legislation came into force. Each manufacturer will be charged an amount proportional to its share of the market in 20X4. An electronic equipment manufacturer prepares financial statements as at 31 December 20X3. Before the financial statements are finalised, it is clear that the entity has sold equipment in the market in 20X4.

Example 6: Emissions trading scheme

A power generating entity participates in an emissions trading scheme. At the start of each compliance period, the entity receives an allocation of tradable emissions allowances from the scheme administrator. At the end of that compliance period, the entity must deliver back to the scheme administrator one allowance for every tonne of carbon dioxide that it has emitted during the period. The entity prepares financial statements immediately after receiving its allocation of allowances and before it starts emitting.

Example 7: Variable lease payments

A lease agreement for a retail unit in a shopping mall requires a lessee to pay a variable rental of 1% of its monthly sales. The lease commences on the last day of the entity's reporting period. The first variable payment will be calculated by reference to sales in the first month of the next reporting period.

Example 8: 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 earnings targets will be met.

Is there a present obligation in these examples

8. The staff outline below three different approaches that could be developed further to form the basis of guidance on future events.

Approach 1: Apply a principle that obligations must be unconditional

9. One approach could be to state that an obligation must be unconditional. 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. Following this approach, there would not be a present obligation in any of the examples set out above. In each case, there remains a condition that must be satisfied before the entity is unconditionally obliged to transfer resources and, applying approach 1, the obligation will not be a present obligation until that condition has been satisfied.

Table 1: Applying approach 1 to examples

	Example	Present obligation?	Reason
1	Employee bonus with vesting conditions	✗	Employer could terminate employment contracts before end of vesting period.
2	Rail levy with threshold	✗	Rail operator, electricity supplier, bank and electronic equipment manufacturer could stop operating in relevant market before date/period on which a levy would become payable.
3	Electricity supplier levy	✗	
4	Bank levy	✗	
5	Waste disposal levy	✗	
6	Emissions trading scheme	✗	Power generating company could install new equipment to avoid emissions or cease production entirely.
7	Variable lease payments	✗	Lessee could avoid making sales from leased retail unit.
8	Contingent consideration	✗	Acquirer could conduct operations of acquired business so that it fails to meet specified earnings targets.

Approach 2: Modify the principle that a liability must be unconditional

10. It is often argued that limiting liabilities to unconditional obligations would impair the usefulness of financial statements. If an obligation accumulates over time or as goods and services are received, and if an entity will almost certainly have to transfer economic resources in a future period as a direct result of the amounts that have accumulated in the current period, the financial statements provide more relevant information if the entity recognises an obligation in the current period. There may be a theoretical possibility of the entity avoiding the future transfer. But, if there is no realistic possibility, the entity has a present obligation.

11. The Conceptual Framework could reflect this view by modifying the principle that an obligation must be unconditional, stating that a present obligation also exists if:

    (a) an obligation that accumulates over time or as the entity receives goods or services has already started to accumulate; and

    (b) although there is a theoretical possibility that a final condition will not be met, that possibility is not a realistic one.

12. Such an approach could lead to present obligations being identified in Examples 1-4 above because an obligation has started to accumulate and cannot realistically be avoided. In some situations, it might be difficult to judge whether there is a realistic possibility of the entity avoiding the final condition. For example, it might be difficult for an employer to judge whether and for how long it will continue to employ staff with unvested bonus rights. The judgement might depend on the proportion of the workforce affected and the nature of their employment.

13. In Examples 5-8, no liability would be identified because the obligation has not yet started to accumulate.

Table 2: Applying approach 2 to examples

	Example	Present obligation?	Reason
1	Employee bonus with vesting conditions	✓	Employees have started to provide services that contribute to the threshold being met. No realistic possibility of avoiding paying some bonuses.
2	Rail levy with threshold	✓	Rail operator has started to earn revenue that contributes to the threshold above which a levy will become chargeable. No realistic possibility of avoiding future levy.
3	Electricity supplier levy	✓	Electricity supplier has earned revenues on which a future charge will be payable. No realistic possibility of avoiding future levy.
4	Bank levy	✓	Bank has operated in period over which levy accumulates. No realistic possibility of avoiding future levy.
5	Waste disposal levy	✗	Manufacturer has not yet started to sell electronic equipment in the assessment period.
6	Emissions trading scheme	✗	Power generator has not yet started to emit carbon dioxide in compliance period.
7	Variable lease payments	✗	Lessee has not yet started to earn revenue from leased retail unit. (Could argue that lessee's right is to use unit and receive 99% of revenue it generates.)
8	Contingent consideration	✗	Acquired business has not yet made any progress towards earnings threshold at which contingent consideration would be payable. (Could argue that goodwill acquired is full amount of goodwill in business less CU5 million retained by former owner.)

Approach 3: Focus on past events instead of future events

15. An entirely different approach could be to focus on past rather than future events. An entity could be viewed as having a present obligation if, as a result of past events, it has an obligation to transfer economic resources to another party on more onerous terms than would have been required in the absence of these past events. That obligation to transfer resources could be unconditional (i.e. exercisable immediately or at a specified future date) or conditional on the occurrence or non-occurrence of a future event.

16. The rationale would be similar to that used in IAS 19 *Employee Benefits* for requiring entities to recognise liabilities for unvested employee benefits, i.e. 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'[2].

Table 3: Applying approach 3 to examples

	Example	Present obligation?	Reason
1	Employee bonus with vesting conditions	✓	Employees have provided two years of service. As a result of employees' past service, entity will have to pay employees a five-year bonus in exchange for only three further years of service.
2	Rail levy with threshold	✓	Because the entity has already earned revenue of CU450 million, it will pay a levy on future revenue in excess of CU50 million. In the absence of the past revenue, the entity would have had to pay a levy only on future revenue in excess of CU500 million.
3	Electricity supplier levy	✓	As a result of revenue earned in 20X0, electricity supplier will be required to pay a levy if operating on 1 April 20X1. In the absence of that past revenue, it would pay no levy on 1 April 20X1

2 IAS 19, paragraph 69.

	Example	Present obligation?	Reason
4	Bank levy	✓	As a result of operating in first half year, any levy that the bank will be liable for at end of its reporting period will be higher than it would have been if it had not operated in the first half year. (The portion of the levy that is attributable to its first half year is 0.9%[3] of the bank's expected period-end liabilities.)
5	Waste disposal levy	✗	There has been no past event that will require the manufacturer to pay a bigger levy than would otherwise be the case. Manufacturer will be charged the same levy as a new market entrant achieving the same market share in 20X4.
6	Emissions trading scheme	✓	Power generator will have to deliver more allowances back to scheme administrator at end of compliance period than it would have had to deliver if it had not already received up-front allocation of allowances. If it had not already received allowances, it would be entitled to receive them before having to deliver any allowances back to administrator.
7	Variable lease payments	✓	As a result of past event (having received right of use of retail unit) lessee will have to pay to the lessor 1% of any sales it makes during the remaining lease period.
8	Contingent consideration	✓	As a result of past event (having acquired business from former owner), acquirer will have to pay make payment of cu5 million on the achievement of earnings targets.

17. The identification of a present obligation would not necessarily lead to the recognition of a liability in each of these examples. It is possible that in some of the cases the liability would fail to satisfy the recognition criteria discussed in Agenda Paper 3E. For example, the Board might conclude that in Example 7:

   (a) recognising the lessee's present obligation to make variable lease payments might not provide users with information that is sufficiently relevant to justify the cost, or

   (b) no measure of that obligation would result in a sufficiently faithful representation of the obligation and of changes in it.

[3] [Three months (April-June) x 0.1%] + [three months (July-September) x 0.2%]

Questions for the Board

Discussion of guidance on future events
Which of the approaches discussed above do you think should be included in the discussion paper? Do you have a preliminary view as to which approach should form the basis of guidance in the Conceptual Framework?

Appendix: Other problems that could be covered in this section of the discussion paper

Problems applying the notion of a constructive obligation

A1. We can consider difficulties of distinguishing constructive obligations from economic compulsion. (Difficulties have tended to arise as people seek ways of recognising liabilities that are conditional on future events. So the discussion and tentative views on constructive obligations will depend on the Board's tentative views on the alternative approaches for addressing future events, as discussed in this paper.) Possible solutions could be to:

(a) eliminate the notion of a constructive obligation. Instead state that obligations must be enforceable by legal (or equivalent?) means; or

(b) improve guidance supporting the definition of a constructive obligation. Emphasise need for an obligation to be a duty to another party (the party to whom, or on whose behalf, the entity would be required to transfer resources), rather than an economic imperative. Emphasise that the distinction between a constructive and legal obligation is one of enforcement mechanism, not timing.

A2. The discussion will include examples highlighting the different consequences of the two possible solutions—egg for environmental obligations, employee benefits, restructuring provisions.

Problems specific to contractual obligations

A3. We can consider whether there is a need for general principles on:

(a) combining and segmenting contracts,

(b) the impact of contractual terms that lack commercial substance,

(c) enforceability.

[Obligations to forgo future inflows

A4. We can perhaps consider obligations to refrain from carrying out specific activities or to otherwise forgo future inflows of economic resources. It might be unclear at present whether these meet the definition of a liability. Examples to illustrate principles could be obligations arising under non-compete agreements, agreements to set-aside agricultural land, securitisation of revenue streams and stadium naming rights. Any guidance could either:

(a) confirm that the entity has an obligation to transfer an economic

(b) clarify that the entity does not have an obligation to transfer an economic. It has instead given up rights to receive a resource, i.e. partially disposed of or impaired an asset.

Other points that could be clarified to help people to identify liabilities

A5. The discussion paper could propose to expand the guidance in the conceptual framework to clarify a number of other sundry points. It could clarify that:

(a) an obligation to transfer a resource includes an obligation to provide goods or services.

(b) an obligation may result in an entity paying cash, transferring assets other than cash, granting a right to use an asset, rendering services or providing risk protection.

(c) if a liability exists for one party, an asset always exists for the other party (symmetry), except perhaps for some obligations to clean up damage to the environment. In order to assess whether an obligation exists, it is not necessary to identify the party to whom the obligation is owed. However, for some assets, no corresponding liability exists (egg rights over physical assets).

(d) the following **do not** give rise to a present obligation to transfer economic resources:

(i) a requirement to provide economic resources only if, at the same time or earlier, the entity receives economic resources of equal or greater value (egg forestry replanting, next-year's salaries) [see also executory contracts].

(ii) losses that an entity will have to incur if it chooses to stay in business, but will avoid if it closes the business? [Link to discussion of going concern and future events. Also, the entity will receive services in exchange.]

(iii) obligations that an entity is permitted (or required) to fulfil in their entirety by issuing its own equity instruments as "currency"? Although those equity instruments are a resource for the holder, they are not a resource for the issuer. Therefore, an obligation to issue equity instruments is not an obligation to transfer a resource, because the issuer held no resource before it issued the equity instruments. This is the case even if the issuer previously held those equity instruments as 'treasury shares'. (See agenda paper 3D for a discussion of the distinction between liabilities and equity instruments.)

(iv) a non-binding offer that the entity can withdraw without penalty but will result in an obligation if accepted.

(v) requirements to make payments that would arise only on liquidation (for example payments to ordinary shareholders 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 in operation for the foreseeable future.