STAFF PAPER

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Accounting Standards Advisory Forum

Project	**Conceptual Framework**
Paper topic	Concepts to support the liability definition

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Purpose of paper

1. The Exposure Draft *Conceptual Framework for Financial Reporting* ('the Exposure Draft') proposed concepts to support the liability definition.

2. IASB staff are developing suggestions for possible refinements to those concepts. This paper requests views from ASAF members on the staff suggestions. We will use ASAF members' comments to help develop the suggestions further for future discussion with the Board.

Background

Exposure Draft proposals

3. Paragraphs 4.24–4.39 of the Exposure Draft proposed concepts to support the liability definition. One of the main proposals was a description of the term 'present obligation':

> 4.31 An entity has a present obligation to transfer an economic resource if both:
>
> (a) the entity has no practical ability to avoid the transfer; and
>
> (b) the obligation has arisen from past events; in other words, the entity has received the economic benefits, or conducted the activities, that establish the extent of its obligation.

4. The Exposure Draft proposed additional guidance to accompany this description, and in particular, paragraphs 4.32–4.35 proposed guidance on the meaning of 'no practical ability to avoid'.

5. The Basis for Conclusions explained the three different descriptions of a present obligation that the Board had considered when developing the Exposure Draft, and the Board's reasons for choosing the description proposed in the Exposure Draft (View 2). The other two descriptions were:

   (a) a *narrower* description, which would restrict the term 'present obligation' to legally enforceable, unconditional obligations (View 1); and

   (b) a *broader* definition, which would encompass all possible future transfers resulting from past events, with the probability of the outflow being taken into consideration in deciding whether to recognise and how to measure the liability (View 3).

***Feedback from respondents*[1]**

6. Many respondents commented on the proposed description of a present obligation. Of those who expressed an overall view, many expressed general agreement with the description. Few respondents thought that the Board should have instead developed a narrower (View 1) or broader (View 3) description of a present obligation.

7. Those expressing general agreement included:

   (a) most of the users of financial statements, regulators, standard-setters, accounting firms, and accountancy bodies expressing an overall view; and

   (b) most of the preparers of financial statements expressing an overall view, except banks and organisations representing banks. Most of the (predominantly European) banks and organisations representing banks expressing a view disagreed with the proposals.

8. Banks and organisations representing banks expressed concerns about the implications of the term 'no practical ability to avoid' in identifying liabilities. They tended to refer in particular to the implications for the classification of financial instruments as liabilities or as equity claims. Some expressed particular concern about the role that economic compulsion could play, for example in the classification of instruments with a right of termination for the issuer or step-up clauses. Others referred in particular to the possibility of a change in the classification of the shares of co-operative entities.

9. In contrast to the banks, the Basel Committee on Banking Supervision expressed support for economic compulsion playing a role in classification decisions. While acknowledging the risks that would arise if the door were opened inappropriately to economic compulsion, it expressed concern that an inability to take economic compulsion into account when distinguishing between liabilities and equity can result in instruments that will have the same economic consequences for the issuer being accounted for very differently.

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[1] Extracts from IASB meeting March 2016 Agenda Paper 10E *Conceptual Framework—Feedback summary—Elements of financial statements—Liabilities and equity*. Paragraphs are renumbered.

10. Some respondents from Australia and New Zealand (including the two standard-setters, a preparer of financial statements and an accountancy body), suggested that liabilities must be present claims against the entity's assets, ie that there must be another party (or parties, which could be the public at large) that is entitled to receive, or benefit from, the future transfer of economic resources, and that would therefore suffer harm if the entity failed to meet its obligations. Those respondents expressed a view that, by focusing on the entity's practical ability to avoid a future transfer, the proposed description of a present obligation might be interpreted to encompass items that are not present claims—items such as future asset maintenance costs, future salaries and future operating losses of a start-up company. The standard-setters suggested that:

    (a) the proposed criteria should be replaced by a discussion of the characteristics of a present obligation; and

    (b) the discussion should focus more on determining whether another party has a present claim against the entity's assets, rather than on whether a future transfer of resources can be avoided.

Subsequent IASB discussions

11. In April 2016, the Board discussed its approach to developing concepts for distinguishing between liabilities and equity. As part of that discussion, it considered the concerns raised by banks about the possible implications of some of the concepts proposed in the Exposure Draft.[2]

12. The Board tentatively decided:

    (a) consistently with the proposal in the Exposure Draft:

[2] IASB meeting, April 2016, Agenda Paper 10E *Conceptual Framework—Approach to redeliberations—Concepts for liabilities and equity*.

(i) not to develop concepts to address challenges that arise in classifying financial instruments with characteristics of both liabilities and equity as part of the *Conceptual Framework* project;

(ii) instead, to continue to develop concepts to address those challenges in the Financial Instruments with Characteristics of Equity research project, acknowledging that one outcome of that project might be a need to make further amendments to the revised *Conceptual Framework*;

(b) to continue to develop concepts to address other problems in identifying liabilities (such as the concepts describing a 'present obligation' in paragraphs 4.31–4.39 of the Exposure Draft), and add those concepts to the *Conceptual Framework*, as part of the *Conceptual Framework* project; and

(c) in developing those concepts, to consider refinements to the proposals in the Exposure Draft to reduce the risk of adding to the *Conceptual Framework* new concepts that the Board may need to revisit as a result of future decisions on the classification of financial instruments.

13. The Board also discussed its overall approach to redeliberating the *Conceptual Framework* proposals. The Board decided that it would ask the staff to perform, among other things, a more extensive analysis of the effects that the proposed definitions of assets and liabilities—and the concepts supporting those definitions—could have for current projects. [3]

Next steps

14. The IASB has started redeliberating its proposed revisions to the *Conceptual Framework*. Among the proposals that it will redeliberate are the concepts proposed to support the liability definition. Given the broadly positive feedback that the Board received for those concepts, the staff are using the feedback to develop suggestions for refining the Exposure Draft proposals, rather than fundamentally changing them.

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[3] IASB *Update*, April 2016.

15. The staff plan to analyse the effects of the proposed definitions and supporting concepts *after* developing suggestions for refining the supporting concepts. The effects analysis can then take into account—and test—the suggested refinements.

Possible refinements

16. The possible refinements we are considering focus on two particular objectives:

    (a) clarifying that there must be a present claim against the entity by another party (see paragraphs 17–21); and

    (b) reducing the risk of adding to the *Conceptual Framework* new concepts that the Board may need to withdraw, or substantially amend, as a result of future decisions on classification of financial instruments (see paragraphs 22–30).

A present claim against the entity

17. As noted in paragraph 10, some respondents suggested that the concepts should focus on determining whether another party has a present claim against the entity.

18. In the past, stakeholders have expressed different opinions on whether the definition of a liability should require the existence of another party with a present claim against the entity, ie whether there must be another party to whom the entity has an obligation to transfer an economic resource.

19. Some stakeholders have argued that such a requirement would exclude items that are identified as liabilities at present. For example:

    (a) some stakeholders have suggested that the requirement would prevent the inclusion of future legal fees in provisions relating to litigation or restructuring activities. They observe that no lawyer has a present claim for the legal fees, because no lawyer has yet provided the future legal services.

    (b) some stakeholders have suggested that the requirement would exclude many environmental rehabilitation and asset decommissioning obligations. In their view, for such obligations, there is no other party with a present right to receive an economic resource from the entity. Any employees, or other suppliers of rehabilitation or decommissioning services, have not yet supplied those services.

20. In contrast, other stakeholders have argued that:

(a) the rationale for including the expected costs of future legal services in a provision for litigation or in a provision for restructuring activities is not that the entity has a present obligation to pay for those legal services (which would require the lawyers to have provided the services). Instead, the rationale is that any necessary legal fees should be among the costs included in the measurement of liabilities to other parties that already have a claim against the entity—eg the plaintiff in a lawsuit, or employees who have a right to termination benefits as a result of their past service.

(b) IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* has already established the concept that 'an obligation always involves another party to whom the obligation is owed'. Even with this statement, IAS 37 requires entities to identify liabilities for environmental rehabilitation and asset decommissioning obligations. IAS 37 notes that is not necessary to know the identity of the party to whom the obligation is owed, and that the obligation may be to the public at large. [4] In support of the IAS 37 requirements, it can be argued that:

(i) governments impose environmental obligations on behalf of their citizens, to protect the amenity of all those sharing the environment;

(ii) this amenity is an asset of the public (or society) at large; and

(iii) if an entity impairs the amenity, society at large has a claim against the entity for restoration of the amenity (enhancement of society's asset).

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[4] IAS 37, paragraph 20.

21. The IASB staff think that a requirement for there to be a present claim against the entity could be added to the proposed concepts without fundamentally changing those concepts:

    (a) the Exposure Draft identified liabilities and equity as the 'claims' described in Chapter 1 of the *Conceptual Framework*.[5]

    (b) we think that there are no inconsistencies (or even differences in emphasis) between the notion of a present claim against the entity by another party and the concepts proposed in the Exposure Draft. The primary purpose of some of the proposed concepts—such as the 'past events' and 'no practical ability to avoid' criteria—is to help identify when a present claim arises.

    (c) paragraph 4.25 of the Exposure Draft included a statement that if one party has an obligation to transfer an economic resource (a liability), another party has a right to receive that economic resource (an asset). That statement could be rephrased to describe the other party as having a claim against the entity (a particular type of asset).

Reducing the risk of future changes

22. A second objective of possible refinements could be to reduce the risk of adding to the *Conceptual Framework* new concepts that the Board may need to withdraw, or significantly amend, as a result of future decisions on the classification of financial instruments.

23. The IASB staff have identified three refinements that we think could each contribute to this objective.

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5 Exposure Draft, paragraph 4.4.

Identify 'essential characteristics' of a liability

24. One refinement could be to identify essential characteristics of a liability, without listing those characteristics as the criteria that make up the description of a present obligation. The description of a present obligation proposed in paragraph 4.31 of the Exposure Draft was developed primarily to help identify when a present claim arises (not how that claim should be classified). We think that expressing the criteria within that description as 'essential characteristics' would require the characteristics to be present for the entity to identify a liability, but need not lead to the conclusion that any claim with those characteristics would necessarily be a liability (rather than an equity claim).

25. The existing *Conceptual Framework* uses the term 'essential characteristic', so the term would not be new.

Omit any concepts that apply only to classification

26. Another refinement could be to omit any concepts that would apply in practice only to questions of how to classify a claim, ie that would not address any other problems in identifying liabilities.

27. The staff suggest that such a refinement could involve omitting from the revised *Conceptual Framework* the Exposure Draft proposals that:

    (a) an obligation of an entity to transfer its own equity claims to another party is not an obligation to transfer an economic resource;[6] and

    (b) if an entity prepares financial statements on a going concern basis, the entity has the practical ability to avoid a transfer that would be required only on the liquidation of the entity or on the cessation of trading.[7]

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[6] Exposure Draft, paragraph 4.30.

[7] Exposure Draft, paragraph 4.33(b).

Be less conclusive about the meaning of ‘no practical ability to avoid’

28. Finally, we could be less conclusive about the circumstances in which an entity has ‘no practical ability to avoid’ a transfer.

29. Paragraph 4.32 of the Exposure Draft proposed that an entity has no practical ability to avoid a transfer if any action necessary to avoid the transfer would cause significant business disruption or would have economic consequences significantly more adverse than the transfer itself. But it can be argued that:

    (a) although significant business disruption or adverse economic consequences may be sufficient in many circumstances, they might not be sufficient in all circumstances—there might be other relevant factors to take into consideration for some types of transaction; and

    (b) the Board should decide how to interpret ‘no practical ability to avoid’ for particular transactions when developing Standards for those transactions.

30. So we think that, while the *Conceptual Framework* should identify significant business disruption and significantly adverse economic consequences as factors that could be relevant in judging whether an entity has the practical ability to avoid a future transfer (because in previous projects there has been doubt about whether these factors are relevant), the *Conceptual Framework* should not imply that the presence of one of these factors would always be sufficient.

Drafting illustration

31. The appendix to this paper illustrates one way in which we think the possible refinements discussed in this paper could be drafted if they were to be approved by the Board (and assuming that the Board does not decide to make more fundamental changes to the proposed concepts).

Questions for ASAF members

Concepts to support the liability definition	
1	Do you think that the concepts supporting the definition of a liability should specify the need for a present claim against the entity by another party (paragraphs 17–21)?
2	Do you agree with the refinements suggested to reduce the risk of adding to the *Conceptual Framework* new concepts that the Board may need to withdraw, or significantly amend, as a result of future decisions on the classification of financial instruments (paragraphs 22–30)?
3	Do you have any comments on the illustrative drafting of the possible refinements in the appendix to this paper?

APPENDIX—Drafting illustration—possible refinements to concepts supporting the liability definition

The original text is from the Exposure Draft. Paragraphs have been reordered, but keep their original paragraph numbers for ease of reference back to the Exposure Draft. The suggested additions and deletions are marked.

Definition of a liability

4.24 A liability is a present obligation of the entity to transfer an economic resource as a result of past events.

~~Present obligation~~

~~4.31 An entity has a present obligation to transfer an economic resource if both:~~

~~(a) the entity has no practical ability to avoid the transfer; and~~

~~(b) the obligation has arisen from past events; in other words, the entity has received the economic benefits, or conducted the activities, that establish the extent of its obligation.~~

4.24A A liability has three essential characteristics:

(a) it embodies an obligation to another party (or parties);

(b) it is a present obligation that exists as a result of past events;

(c) the obligation has the potential to require the entity to transfer an economic resource to, or on behalf of, the other party (or parties).

Obligation to another party (or parties)

4.24B One essential characteristic of a liability is that it embodies an obligation to another party (or parties).

4.25 As noted in paragraph 4.4, a liability is one form of claim against an entity. A liability embodies an obligation to the ~~If one party has an obligation to transfer an economic resource (a liability), it follows that another~~ party (or parties) that holds the claim ~~has a right to receive that economic resource (an asset)~~. ~~The~~ That other party (or parties) could be a specific person or entity, a group of people or entities, or society at large. It is not necessary to know the identity of the other party (or parties).

~~No practical ability to avoid the transfer~~

4.34 An obligation is a duty or responsibility that the entity has no practical ability to avoid. Many obligations are legally enforceable as a consequence of a contract, legislation or similar means. Obligations can also arise, however, from an entity's customary practices, published policies or specific statements that require the transfer of an economic resource. If the entity has no practical ability to act in a manner inconsistent with those practices, policies or statements, the entity has an obligation. The obligation that arises in such situations is often described as a constructive obligation.

4.35 In some situations, the ~~requirement for an entity to transfer an economic resource~~duty or responsibility may be expressed as being conditional on a particular future action by the entity, such as conducting particular activities or exercising particular options within a contract. The entity has an obligation if it has no practical ability to avoid that action.

4.32 Judgement may be required when deciding whether, and in what circumstances, an entity has no practical ability to avoid a duty or responsibility to transfer an economic resource. An entity ~~has~~ may have no practical ability to avoid a transfer if, for example, ~~the transfer is legally enforceable, or~~ any action necessary to avoid the transfer would cause significant business disruption or would have economic consequences significantly more adverse than the transfer itself. ~~It~~ However, it is not sufficient that the management of the entity intends to make the transfer or that the transfer is probable.

4.33 If an entity prepares financial statements on a going concern basis, the entity ~~:~~

~~(a)~~ has no practical ability to avoid a ~~transfer~~ duty or responsibility that could be avoided only by liquidating the entity or ceasing trading. ~~; but~~

~~(b) has the practical ability to avoid (and hence does not have a liability for) a transfer that would be required only on the liquidation of the entity or on the cessation of trading.~~

4.26 A claim against an entity is an economic resource of the party holding the claim. However, ~~A~~ a requirement for ~~one party~~the entity to recognise a liability ~~(or asset)~~ and measure it at a specified amount does not imply that the ~~other~~ party -holding the claim must recognise ~~the~~ its corresponding asset, ~~(or liability)~~ or measure ~~it~~ the asset at the same amount. It may be that the party holding the claim does not produce financial statements. Furthermore, a~~A~~pplying different recognition criteria or measurement requirements to the liability (or asset) of one party and the corresponding asset (or liability) of the other party may sometimes be an outcome of decisions intended to meet the objective of financial reporting.

Present obligation that exists as a result of past events

4.36 ~~An entity has~~A second essential characteristic of a liability is that it is a present obligation that exists as a result of ~~a~~ past events. An obligation exists as a result of past events only if ~~it~~ the entity has already received the economic benefits, or conducted the activities, that establish the extent of its obligation to the other party. The economic benefits received could include, for example, goods or services. The activities conducted could include, for example, operating in a particular market. If the economic benefits are received, or the activities are conducted, over time, ~~a present~~ the entity's obligation to the other party will accumulate over time ~~(if, throughout that time, the entity has no practical ability to avoid the transfer)~~.

4.37 An event establishes the extent of an obligation to another party if it specifies either the amount ~~of the future transfer~~to which the other party is entitled or the basis for determining that amount. For example, an insurer may enter into a contract to provide insurance coverage in return for a single premium. ~~When the insurer receives the premium, it has an obligation to provide insurance coverage because:~~

~~(a) although the amount of any future transfer still depends on whether an insured event occurs, the insurer has no practical ability to avoid transferring an economic resource if an insured event occurs; and~~

~~(b)~~ ~~the~~ The ~~insurer has received~~receipt of the premium ~~that~~ establishes that ~~it~~ the insurer must provide coverage to the extent specified by the contract, and this provides the basis for determining the amount ~~of any future transfer.~~to which the policyholder would be entitled on the occurrence of an insured event. Accordingly, the receipt of the premium is the event that establishes the extent of the insurer's obligation.

4.38 A present obligation can exist at the end of the reporting period even if the ~~transfer of economic resources~~ obligation cannot be enforced until some point in the future. For example, a financial liability may not require a payment to be made until a future date. The payment cannot be enforced until that future date, but the liability exists now. Similarly, a contractual obligation for the entity to perform work at a future date cannot be enforced by the counterparty until that future date, but the obligation arising from the contract exists now if the counterparty has already paid for the work (see paragraphs 4.40–4.42).

4.39 An entity does not have a present obligation for the costs that will arise if it will receive benefits, or conduct activities, in the future (for example, the costs of future operations); the extent of the future transfer will not be determined by reference to benefits that the entity has received, or activities that it has conducted, in the past. If the entity has entered into a contract that is still executory, the entity may have a present right and obligation to exchange economic resources in the future (see paragraphs 4.40–4.42).

~~Obligation~~ Potential to require the entity to transfer an economic resource

4.27 ~~An entity's~~A third essential characteristic of a liability is that the obligation ~~to transfer an economic resource must have~~has the potential to require the entity to transfer an economic resource to, or on behalf of, ~~another~~ the party (or parties) that have a claim against the entity. It need not be certain, or even probable, that the entity will be required to transfer an economic resource, but the obligation must already exist and there must be at least one circumstance in which it will require the entity to transfer an economic resource. One example of such an obligation is an obligation to stand ready to transfer an economic resource if an uncertain future event occurs.

4.28 Obligations ~~to~~ that have the potential to require the entity to transfer an economic resource include, for example, obligations to:

(a) pay cash;

(b) transfer other assets;

(c) exchange economic resources with another party on unfavourable terms (see paragraphs 4.40–4.42);

(d) provide services; or

(e) issue another obligation that ~~will oblige~~has the potential to require the entity to transfer an economic resource.

4.29 Instead of fulfilling an obligation~~ to transfer an economic resource~~, entities sometimes:

(a) settle the obligation by negotiating a release from the obligation;

(b) transfer the obligation to a third party; or

(c) replace the obligation with another obligation~~ to transfer an economic resource~~.

~~4.30 An equity claim does not contain an obligation to transfer economic resources. Furthermore, an equity claim is not an economic resource for the issuer. It follows that an obligation of an entity to transfer its own equity claims to another party is not an obligation to transfer an economic resource.~~