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The formatting of this paper is optimised for reading on paper, printed as a double-sided document, hinged down left (short) edge.

The questions for the Board are in Agenda Paper 10B *Testing the asset and liability definitions—matters arising*

Introduction

Background

In May 2015, the Board published an Exposure Draft *Conceptual Framework for Financial Reporting* (‘the Exposure Draft’) which, among other things, proposed changes to the existing definitions of an asset and a liability, and to the concepts supporting those definitions.

Many respondents to the Exposure Draft expressed broad support for those changes. However, some respondents suggested that the Board should assess the robustness and possible implications of the revised definitions before finalising them.

Purpose of paper

This staff paper sets out views of members of the *Conceptual Framework* project team on:

(a) the outcome of applying the proposed definitions of an asset and a liability, and supporting concepts, to a range of illustrative examples (Sections 1–3); and

(b) ways in which the definitions and supporting concepts could help the Board reach decisions in some of its current projects (Section 4).

The purpose of the paper is to help the Board assess whether the proposed definitions and concepts will enable it to develop IFRS Standards that best meet the needs of existing and potential investors, lenders and other creditors.

The illustrative examples in Sections 1 and 2 were discussed at the World Standard-setters Meeting in September 2016. Meeting participants applied the proposed definitions and supporting concepts to the fact patterns in the examples, and discussed how easy or hard it was to get to an answer in each case. A summary of meeting participants’ views is in Agenda Paper 10B *Testing the proposed asset and liability definitions—matters arising*. The staff have considered participants’ views in reaching the staff views set out in this paper.

How did we choose transactions to illustrate?

In their responses to the Exposure Draft, some respondents referred to particular transactions for which they thought the implications of the proposed definitions were unclear. We have focused on these transactions in developing the illustrative examples.

The examples do not address questions that arise in distinguishing between liabilities and equity claims

The Board is not developing concepts for distinguishing between liabilities and equity claims as part of the Conceptual Framework project. It is developing such concepts in a separate research project on Financial Instruments with Characteristics of Equity.

In reaching decisions in that project, the Board will not be constrained by the concepts in the revised *Conceptual Framework*. Consequently, when the Board completes that project, it may decide that it needs to make further changes to the *Conceptual Framework* definition of a liability, or to the concepts supporting that definition.

A note about recognition

Even if an item meets the definition of an asset or a liability, an entity would not necessarily be permitted or required to include ('recognise') that asset or liability in its statement of financial position. The applicable IFRS Standard could specify that the asset or liability should be recognised only if particular criteria specified in that Standard are met.

Furthermore, there would be no automatic requirement for an entity to disclose information about an unrecognised asset or liability. However, IFRS Standards may specify disclosure requirements for some unrecognised assets and liabilities.

In making decisions about the circumstances in which a particular asset or liability would be recognised, the Board would consider the concepts for recognition in the revised *Conceptual Framework*.

Key aspects of concepts for recognition proposed for the revised *Conceptual Framework*[1]

The Board would apply these concepts in developing IFRS Standards. Preparers of financial statements would apply these concepts in developing or selecting accounting policies for assets and liabilities when no IFRS Standard specifically applies.

An asset or a liability (and any related income, expenses or changes in equity) should be recognised if recognition provides users of financial statements with useful information, ie relevant information about, and a faithful representation of, the asset or the liability (and any related income, expenses or changes in equity).

Recognition of a particular asset or liability may not necessarily provide *relevant information*:

(a) if it is uncertain whether the asset exists, or is separable from goodwill, or whether the liability exists; or

(b) if the asset or liability exists but there is only a low probability that an inflow or an outflow of economic benefits will result.

Recognition of a particular asset or liability may not necessarily provide a *faithful representation*:

(a) if the level of measurement uncertainty is exceptionally high; or

(b) if related assets and liabilities are not recognised.

It will often be a combination of factors, instead of any single factor, that would mean that recognition does not provide useful information.

As with all other areas of financial reporting, cost constrains recognition decisions. Recognition of an asset or a liability (and any related income, expenses or changes in equity) is appropriate only if the benefits of the information provided to the users of financial statements are sufficient to justify the cost.

[1] Exposure Draft proposals, updated for refinements that the Board has tentatively decided upon in light of feedback on the Exposure Draft.

Contents

Section 1 Illustrative examples—Assets

		Page
Proposed definition and key supporting concepts		**7**
Examples		
1.1	Goodwill	8
1.2	Production process	9
1.3	Assembled workforce	10
1.4	Option to purchase commodity at a fixed price	11
1.5	Jointly-controlled real estate	12
1.6	Deferred tax—unused tax loss	13

Section 2 Illustrative examples—Liabilities

		Page
Proposed definition and key supporting concepts		15
Examples		
2.1	Product warranties	16
2.2	Contaminated land constructive obligation	17
2.3	A court case	18
2.4	Long service leave	19
2.5(a)–(c)	Levies (three examples)	20–22
2.6(a)–(b)	Restructuring costs (two examples)	23–25
2.7	Legal requirement to fit smoke filters	26
2.8	Refurbishment costs	27
2.9(a)–(b)	Deferred tax (two examples)	28–29
2.10	Non-compete agreement	30
2.11	Government grant	31

Contents (continued)

Section 3
Illustrative examples—Executory contracts

		Page
Proposed concepts		33
Examples		
3.1	Executory purchase contract	34
3.2	Executory sale contract	35

Section 4
Possible implications for IFRS Standards

	Page
General implications for existing IFRS Standards and current and future projects	37
Possible implications for a selection of active and pipeline projects	
Standard-setting projects	
4.1—Rate-regulated activities	38
Active research projects	
4.2—Goodwill	39
Pipeline research projects	
4.3—Provisions (review of IAS 37)	40
4.4—Pollutant pricing mechanisms	41
4.5—Variable and contingent consideration	42

Section 1—Illustrative examples—Assets

Section 1—Illustrative examples—Assets

This section applies the proposed definition of an asset and supporting concepts to a range of illustrative examples. The examples have been chosen to test different aspects of the proposed definition and supporting concepts.

The examples in this paper illustrate transactions that are within the scope of existing IFRS Standards.

The conclusions reached applying the proposed concepts to some of these transactions might be inconsistent with the existing requirements of the applicable IFRS Standard.

Any inconsistency would not mean that the existing requirements will necessarily change. As explained further on page 37, the *Conceptual Framework* does not override existing IFRS Standards and the Board will not automatically amend existing IFRS Standards as a result of changes to the *Conceptual Framework*.

Proposed definition and key supporting concepts

An **asset** is a present economic resource controlled by the entity as a result of past events.

An **economic resource** is a right that has the potential to produce economic benefits.

In principle, each of an entity's rights is a separate asset. However, for accounting purposes, related rights are often treated as a single asset, namely the 'unit of account'.

For an economic resource to have the **potential to produce economic benefits**, it need not be certain or even probable that the economic resource will produce economic benefits. It is only necessary that the economic resource already exists and that there is at least one circumstance in which it would produce economic benefits. (However, if the probability of future economic benefits is low, the Board might decide in some cases that the applicable IFRS Standard should not require recognition of the asset—see page 3.)

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

Example1.1 —Goodwill

Facts

An entity has an established and profitable logistics business. Among other things, it has distribution vehicles, warehouses, logistics management IT systems, an assembled workforce, a recognisable brand and well-established relationships with customers and suppliers. The business is worth more than the fair values of the entity's identifiable assets (ie the assets that are separable from the business or that arise from contractual or legal rights). The extra component is the entity's goodwill. Does that goodwill meet the definition of an asset?

Criterion	Met?	Comments
Right	✓	The entity has rights that are not identifiable assets, but could be viewed as components of goodwill. Such rights could be described as rights to operate the particular business that the entity has already established.
Controlled by entity	✓	The entity can choose how to use these rights and to obtain any economic benefits that flow from them.
As a result of past events	✓	The rights all exist as a result of the past activities of the entity, such as assembling assets and establishing operating procedures.
Potential to produce economic benefits	✓	The entity can obtain economic benefits that are not immediately available to other parties starting up in the same market because it has all the competitive advantages of an already established business and assembled assets.

Asset?	✓	Similar to the analysis of 'core goodwill' in paragraphs BC313–BC318 of IFRS 3 *Business Combinations*.

Would this asset be recognised?

The proposed concepts for recognition (see page 3) envisage that IFRS Standards may not require the recognition of some assets.

If the Board were to apply these concepts to the asset identified in this example, it could select, if appropriate, requirements similar to those already set out in IAS 38 Intangible Assets and IFRS 3 Business Combinations. *Applying IAS 38, internally generated goodwill is not recognised. Applying IFRS 3, goodwill acquired in a business combination is recognised.*

The Board has no intention at present to review the recognition requirements in IAS 38 or IFRS 3.

Example 1.2—Production process

Facts

An entity has developed an efficient process for producing a new material. The entity has not yet patented the process, but has successfully kept it secret. The process has the potential to produce significant economic benefits for the entity. But the material is not yet in commercial production, so those economic benefits are highly uncertain—the range of possible outcomes is extremely wide and the likelihood of each outcome is exceptionally difficult to estimate. Does the entity have an asset?

Criterion	Met?	Comments
Right	✓	The entity has the right to use the process, ie to direct how the process is used and to obtain the economic benefits, if any, that flow from its use.
Controlled by entity	✓	The entity controls this right of use: it can choose whether (and if so how) to use the right itself, or to sell the right to another party. In future, the entity's control may be strengthened by a patent. But in the meantime, the entity has control through its ability to keep the production process secret and to obtain the economic benefits, if any, that flow from it.
As a result of past events	✓	The entity's right to use the process arises from its past development activity.
Potential to produce economic benefits	✓	It need not be certain, or even probable, that the right will produce economic benefits.

Asset?	✓	The proposed definition gives a clearer answer than IAS 38 *Intangible Assets*. IAS 38 applies the existing definition of an asset, which requires that the resource is 'expected' to result in an inflow of economic benefits. The term 'expected' has been interpreted in different ways.

Would this asset be recognised?

The proposed concepts for recognition (see page 3) envisage that IFRS Standards may not require the recognition of some assets for which the probability of future economic benefits is low, or whose values are subject to very high measurement uncertainty.

If the Board were to apply these concepts to the asset identified in this example, it could select, if appropriate, requirements similar to those already set out in IAS 38. Applying IAS 38, intangible assets are recognised if future economic benefits are probable and if their cost can be measured reliably. IAS 38 states that assets arising from the research phase of a project would not meet these criteria, and that assets arising from a development phase would meet the criteria only in specified circumstances.

The Board has no intention at present to review the recognition requirements in IAS 38.

Example 1.3—Assembled and trained workforce

Facts

An entity has assembled and trained a workforce to operate its business efficiently.

Employees must give three months' notice to terminate their contracts of employment. However, employees are likely to make their services available for longer periods. So the value of the assembled workforce is higher than the value of the entity's contractual right to exchange three further months' service from each employee for three further months' salary.

Does the assembled and trained workforce give rise to an asset *beyond* any asset arising from the entity's contractual right to exchange three further months' service from each employee for three further months' salary?

(Example 3.1—*Executory purchase contract* illustrates the type of asset that might arise from the contractual right to exchange three months' service for three months' salary.)

Criterion	Met?	Comments
Right Controlled by entity	?	*View 1* The entity has rights to operate the particular business that it has already established. Example 1.1—*Goodwill* identifies such rights as goodwill. There are no further rights that the entity controls as a result of its assembled and trained workforce (beyond the rights arising from the employees' three-month notice periods). *View 2* The entity has a right to retain any economic benefits generated as a result of the contracts with the assembled workforce, and controls this right, even though some of the benefits are expected to arise beyond the earliest date at which employees could terminate their contracts.
As a result of past events	✓	The assembled and trained workforce is the result of entering into employment contracts and conducting training activities.
Potential to produce economic benefits	✓	The assembled and trained workforce means that the entity has the potential to operate more efficiently than other similar entities that do not have such a workforce. This potential increases the value of the entity's right to operate its business.

⇩

Asset?	?	The conclusion from View 1 would be that the assembled workforce is not an asset that is identifiable separately from goodwill—but its existence increases the value of the entity's goodwill. (This analysis seems consistent with that in IAS 38 (paragraph 15) and IFRS 3 (paragraph B37).) The conclusion from View 2 would be that the assembled workforce is an identifiable asset.

Example 1.4—Option to purchase commodity at a fixed price

Facts

An entity has entered into a contract that gives it an option to purchase a commodity for a fixed price of CU10,000[2]. The entity can exercise the option at any time in the next year. The current price of the commodity is CU9,000. The entity paid CU100 for the option. The option cannot be traded.

Does the entity have an asset, and if so, what is that asset?

Criterion	Met?	Comments
Right	✓	The option is a contractual right to exercise an option to purchase a commodity.
Controlled by entity	✓	The entity (rather than any other party) has the ability to: • direct the use of the right. The entity has the ability to decide whether and when to exercise the option. • obtain the economic benefits (if any) that flow from the right.
As a result of past events	✓	The right arose when the entity entered into the contract and paid for the option.
Potential to produce economic benefits	✓	The right has the potential to produce economic benefits even though the price of the commodity is currently lower than the exercise price of the option. The right will produce economic benefits if the price of the commodity rises above the exercise price before the end of the exercise period. It need not be certain, or even probable, that the right will produce economic benefits.

⇩

Asset?	✓	The asset is the right to exercise the option to purchase the commodity. The asset is not the commodity itself.

[2] In these examples, monetary amounts are denominated in 'currency units' (CU).

Example 1.5—Jointly-controlled real estate

Facts

Entities A, B and C jointly purchased, and now own, commercial real estate on terms that provide them with 25 per cent, 40 per cent and 35 per cent respectively of the economic benefits flowing from that real estate.

Any decision to change the way in which the real estate is used, or any decision to sell the real estate, requires the unanimous consent of all three entities.

An entity may sell its share in the real estate. However, it must first offer the share to the other two entities.

Does entity A have an asset and, if so, what is that asset?

Criterion	Met?	Comments
Right	✓	No individual entity has the right to direct the use of the real estate, so no individual entity has the right of use of the real estate in its entirety. However, each individual entity has a right to participate in the future economic benefits generated by the real estate.
Controlled by entity	✓	No individual entity controls the real estate in its entirety. However, each individual entity controls its own right to participate in the future economic benefits. It can choose whether to hold the right or to sell it.
As a result of past events	✓	Each entity controls its right as a result of the past purchase.
Potential to produce economic benefits	✓	Each entity's share of the real estate has the potential to produce economic benefits such as rental income.

⇩

Asset?	✓	Each individual entity's asset is its right to a share in the future economic benefits generated by the real estate, not the underlying real estate.

Example 1.6—Deferred tax—unused tax loss

Facts

An entity has incurred a tax loss for the period. The tax loss cannot be carried back to recover current tax of a previous period, so remains unused at the end of the period. Tax law permits entities with unused tax losses to carry those losses forward for up to 10 years and offset them against future taxable profits. Does the entity have an asset?

Criterion	Met?	Comments
Right	✓	The entity has a legal right to offset the unused tax loss against future taxable profits.
Controlled by entity	✓	The entity controls this right: the entity, rather than any other party, has the ability to choose how to use the tax loss (within the uses permitted by tax law) and to obtain the benefits from its use.
As a result of past events	✓	The right has arisen as a result of a tax loss incurred before the end of the period.
Potential to produce economic benefits	✓	The unused tax loss has the potential to reduce future tax payments. It need not be certain, or even probable, that future taxable profits will be available.

⇩

Asset?	✓	Consistent with IAS 12 *Income Taxes*

Would this asset be recognised?

The proposed concepts for recognition (see page 3) envisage that IFRS Standards may not require the recognition of some assets for which the probability of future economic benefits is low, or whose values are subject to very high measurement uncertainty.

If the Board were to apply these concepts to the asset identified in this example, it could select, if appropriate, requirements similar to those already set out in IAS 12. Applying IAS 12, the asset arising from an unused tax loss is recognised to the extent that it is probable that future taxable profit will be available against which the unused tax loss can be utilised.

The Board has no intention at present to review the recognition requirements in IAS 12.

Section 2—Illustrative examples—Liabilities

Section 2—Illustrative Examples—Liabilities

This section applies the proposed definition of a liability and supporting concepts to a range of illustrative examples.

In their responses to the Exposure Draft, some respondents referred to particular transactions for which they thought the implications of the proposed definition were unclear. The examples include those transactions.

Respondents often highlighted transactions within the scope of IAS 37 Provisions, Contingent Liabilities and Contingent Assets *and IFRIC 21* Levies. *So the examples in this section include a variety of transactions within the scope of IAS 37 and IFRIC 21.*

The conclusions reached applying the proposed concepts to some of these transactions might be inconsistent with the existing requirements of the applicable IFRS Standard.

Any inconsistency would not mean that the existing requirements will necessarily change. As explained further on page 37, the *Conceptual Framework* does not override existing IFRS Standards and the Board will not automatically amend existing IFRS Standards as a result of changes to the *Conceptual Framework*.

Proposed definition and key supporting concepts

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

An entity's obligation to transfer an economic resource must have the **potential** to require the entity to **transfer an economic resource to another party**. 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. (However, if the probability of a transfer is low, the Board might decide in some cases that the applicable IFRS Standard should not require recognition of the liability—see page 3.)

An entity has an **obligation** if it has no practical ability to avoid the transfer. An entity has no practical ability to avoid a transfer if, for example, the transfer is legally enforceable, or 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.

An obligation is **a result of past events** (and hence a **present** obligation) if the entity has received the economic benefits or conducted the activities that establish the extent of its obligation. An event establishes the extent of an obligation if it specifies either the amount of the future transfer or the basis for determining that amount.

Example 2.1—Product warranties

Facts

A manufacturer gives warranties at the time of sale to purchasers of its product. Under the terms of the contract for sale the manufacturer undertakes to make good, by repair or replacement, manufacturing defects that become apparent within three years from the date of sale.

The manufacturer has sold a batch of products. No defects have yet been reported to it.

Does the entity have a liability?

The facts are the same as those of Example 1 in Section C of the guidance accompanying IAS 37.

Criterion	Met?	Comments
Potential to require transfer of economic resource to another party	✓	Transfer of repair services or replacement product to the customer if manufacturing defects become apparent.
As a result of past events	✓	The entity has entered into the contracts and received the economic benefits (sales proceeds) that establish the extent of its obligation.
No practical ability to avoid	✓	The obligation is contractual so can be enforced by the customer.

⇩

Liability?	✓	Consistent with the conclusion in IAS 37 (that the obligating event is the sale of product with a warranty).

Would this asset be recognised?

Whether this asset is recognised might depend on the probability of future claims. The proposed concepts for recognition (see page 3) envisage that IFRS Standards may not require the recognition of some liabilities with a low probability of outflows of economic benefits.

If the Board were to apply these concepts to this example, it could select, if appropriate, requirements similar to those already in IAS 37. Applying IAS 37, liabilities are recognised if, among other things, it is probable that an outflow of resources will be required to settle the obligation. Where there are a number of similar obligations, the probability of an outflow is determined by considering the class of obligations as a whole.

In its 'research pipeline', the Board has a project to consider whether to review some aspects of IAS 37. However, on the basis of the evidence gathered to date, the staff do ***not*** *expect to recommend that the Board reviews the existing recognition criteria.*

Example 2.2—Contaminated land constructive obligation

Facts

An entity in the oil industry causes contamination and operates in a country where there is no environmental legislation. However, the entity has a widely published environmental policy in which it undertakes to clean up all contamination that it causes. The entity has a record of honouring this published policy.

Does the entity have a liability?

The facts are the same as those of Example 2B in Section C of the guidance accompanying IAS 37.

Criterion	Met?	Comments
Potential to require transfer of economic resource to another party	✓	Transfer of clean-up services required to restore the amenity of the environment. The obligation is to society at large.
As a result of past events	✓	The extent of past contamination establishes the extent of the entity's obligation.
No practical ability to avoid	Depends (but likely to be ✓)	Entity has no practical ability to avoid transfer if it has no practical ability to act in a manner inconsistent with its published policy, ie, if failure to honour the published policy would cause reputational damage with a cost significantly in excess of the costs of cleaning the contamination. Judgement would be required. However, the entity's past record of honouring the policy may be evidence that it has no practical ability to do otherwise.

⇩

Liability?	Depends (but likely to be ✓)	IAS 37 identifies a liability on the basis that, as a result of the published policy, the entity had 'created a valid expectation among other parties' that it will clean up the contamination. The focus is slightly different, but the outcome is possibly similar in many cases.

Example 2.3—A court case

Facts

After a wedding, ten people died, possibly as a result of food poisoning from products sold by the entity. Legal proceedings are started seeking damages from the entity. The entity disputes that its products were the cause of the deaths. Does it have a liability?

The facts are the same as those of Example 10 in Section C of the guidance accompanying IAS 37.

Criterion	Met?	Comments
Potential to require transfer of economic resource to another party	Uncertain	It is uncertain whether the entity supplied contaminated products, and hence whether the entity has an obligation to the estates of those who have died. Any transfer would be a transfer of cash to the estates of those who have died.
As a result of past events	✓	The activity that would have established the extent of the obligation is the supply of contaminated products.
No practical ability to avoid	✓	The court can enforce damages against the entity.

Liability?	Existence uncertain	The court will decide whether a liability exists. If the liability exists, it came into existence when the entity supplied the product. Consistent with the conclusion in IAS 37.

How would we account for the existence uncertainty?

*Applying the proposed recognition concepts, the Board would specify in relevant IFRS Standards the circumstances in which an entity should recognise a liability whose existence is uncertain—**see page 3.*

IAS 37 requires entities to recognise a liability if it is more likely than not that a liability exists.

*In its 'research pipeline', the Board has a project to consider whether it should review some aspects of IAS 37. However, on the basis of the evidence gathered to date, the staff do **not** expect to recommend that the Board reviews the existing recognition criteria.*

Example 2.4—Long service leave

Facts

Employees have a statutory entitlement to two months' paid long service leave if they work for the same employer for 10 years.

If an employer terminates an employee's services after five years (for any reason other than serious misconduct), the employee is entitled to a pro-rata payment.

An entity has employed:

- one group of employees for nine years; and
- a second group of employees for two years.

Does it have a liability?

Criterion	Met?	Comments
Potential to require transfer of economic resource to another party	✓	Transfer of cash to employees during periods of leave when the employees provide no commensurate services in exchange.
As a result of past events	✓	The extent of the entity's obligation is established by the receipt of employee services. To the extent that the future payments to employees relate to past services, they are the result of past events. Thus any liability accumulates over the employees' service periods
No practical ability to avoid	Decide at Standards level	The entity has no practical ability to avoid paying benefits to employees with *nine* years' service. The entity may, or may not, have the practical ability to avoid paying benefits to employees with *two* years' service. It would need to have the practical ability to terminate the contracts with these employees before they have completed five years' service, without compensating the employees for loss of long-service leave benefits. The applicable Standard could specify criteria for assessing whether the entity has the practical ability to terminate contracts in this way. The conclusions reached might depend on the unit of account specified in the Standard. If the benefits to the two groups of employees (or to each employee) are treated as separate obligations, the entity might judge that it has the practical ability to avoid its obligation to employees who have provided only two years' service.

⇩

Liability?	Decide at Standards level	The most useful information might be provided by treating the obligations as a single unit of account. The measurement of the liability could take into account expectations regarding the number of employees who will become eligible for long service benefits.

Example 2.5(a)—Levy triggered when entity generates revenue in two periods

Facts

A government charges levies on entities as soon as they generate revenue in 20X1. The amount of the levy that each entity pays is calculated by reference to the revenue the entity generated in 20X0.

An entity's reporting period ends on 31 December 20X0. The entity generated revenue in 20X0, and in 20X1 it starts to generate revenue on 3 January 20X1.

Does the entity have a liability at 31 December 20X0 for the levy charged on 3 January 20X1?

The facts are consistent with those in Illustrative Example 2 accompanying IFRIC 21.

Criterion	Met?	Comments
Potential to require transfer of economic resource to another party	✓	Potential to require transfer of cash to the government.
As a result of past events	✓	The revenue generated in 20X0 establishes the extent of the entity's obligation.
No practical ability to avoid	Depends (but likely to be ✓)	The entity could avoid the levy only by generating *no* revenue in 20X1. Given the fact pattern, the staff think that the economic consequences of generating no revenue are likely to be significantly more adverse than the cost of the levy.

⇩

Liability at 31 December 20X0?	Depends (but likely to be ✓)	If the entity has no practical ability to avoid generating revenue in 20X1, the liability for the levy charged on 3 January 20X1 accumulates as the entity generates revenue in 20X0. This conclusion is different from the consensus in IFRIC 21. The consensus in IFRIC 21 is that the event that gives rise to a liability for a levy is the activity that triggers payment of the levy. In this example, that activity is the first generation of revenue in 20X1. Accordingly, the conclusion in Example 2 accompanying IFRIC 21 is that the liability for arises in full on 3 January 20X1.

Example 2.5(b)—Levy triggered if entity operates at end of reporting period

Facts

A government charges levies on entities that are operating as banks at the end of their reporting period. The amount of the levy is 0.1% of liabilities reported in the entity's statement of financial position at the end of the reporting period. If the reporting period is longer or shorter than 12 months, the levy is increased or reduced proportionately. For example, for a 9-month reporting period, the levy is 9/12ths of the initial amount calculated.

An entity with a 12-month reporting period ending on 31 December 20X1 is preparing interim financial statements at 30 June 20X1. Does it have a liability at 30 June 20X1 for the levy chargeable at the end of the reporting period?

The facts are consistent with those in Illustrative Example 3 accompanying IFRIC 21.

Criterion	Met?	Comments
Potential to require transfer of economic resource to another party	✓	Potential to require transfer of cash to the government.
As a result of past events	✓	The extent of the obligation is established by the length of the reporting period. The portion of the levy that has accumulated by 30 June 20X1 is a result of past events.
No practical ability to avoid	Depends (but likely to be ✓)	The entity could avoid the levy only by ceasing to operate as a bank, or by extinguishing all of its liabilities, before the end of its reporting period. Given the fact pattern, the staff think that the economic consequences of those actions are likely to be significantly more adverse than the cost of the levy.

Liability at 30 June 20X1?	Depends (but likely to be ✓)	If the entity has no practical ability to avoid the levy, the liability accumulates over the reporting period. This conclusion is different from the consensus in IFRIC 21. The consensus in IFRIC 21 is that the event that gives rise to a liability for a levy is the activity that triggers payment of the levy. In this example, that activity is operating as a bank at the end of the reporting period. Accordingly, the conclusion in Example 3 accompanying IFRIC 21 is that no liability arises until 31 December 20X1.

Example 2.5(c)—Threshold levy

Facts

A government charges levies on entities that generate revenue in excess of CU50 million in a calendar year. The levy rate is two per cent of the revenue in excess of CU50 million.

An entity generates revenue from profitable activities evenly through the year. Its 20X1 revenue reaches CU50 million on 17 July 20X1.

The entity's reporting period ends on 30 June 20X1. Does it have a liability at that date for the 20X1 levy?

The facts are consistent with those in Illustrative Example 4 accompanying IFRIC 21.

Criterion	Met?	Comments
Potential to require transfer of economic resource to another party	✓	Potential to require transfer of cash to the government.
A result of past events	Decide at Standards level	When developing a Standard, it would be necessary to reach a view on whether the activity that establishes the extent of the entity's obligation is: 1. generation of revenue above the threshold (in which case, at 30 June, none of the 20X1 levy would be viewed as a result of past events) ; or 2. generation of revenue that contributes to the amount on which the levy will be charged (in which case, at 30 June, a portion of the expected levy for 20X1 would be viewed as a result of past events).
No practical ability to avoid	Depends (but likely to be ✓)	The entity could avoid the 20X1 levy only by suspending its revenue-generating activities for more than five months. Given the fact pattern, the staff think it is likely that the economic consequences of suspending those activities would be significantly more adverse than the cost of the levy.

Liability at 30 June 20X1?	Decide at Standards level	The decision would depend on the view reached about the activity that establishes the extent of the entity's obligation. The requirements could differ from those in IFRIC 21. The conclusion in Example 4 accompanying IFRIC 21 is that the liability arises as the entity generates revenue above the threshold, ie between 17 July 20X1 and 31 December 20X1.

Example 2.6(a)—Restructuring costs—employee termination benefits

Facts

An entity is required by law to make payments to employees if it terminates their employment contracts. The amount paid to each employee depends on the duration of that employee's past service. In the normal course of business, the entity rarely if ever needs to make termination payments. However, as a result of a recent acquisition, the entity now has excess production capacity. It has prepared a plan for closing one factory and terminating the contracts of all employees at that factory. It has announced that plan to the employees.

Does the entity have a liability for employee termination benefits?

Criterion	Met?	Comments
Potential to require transfer of economic resource to another party	✓	Potential to require transfer of cash to employees. This would be a *transfer* of economic benefits because the entity would not receive further employee services in exchange.
As a result of past events	✓	The receipt of employee service establishes the extent of the entity's obligation. Accordingly, the past events criterion is satisfied over time, as the employees provide the service that increases the amount of termination benefits to which they are entitled.
No practical ability to avoid	✓	In the normal course of business, the entity has the practical ability to avoid making termination payments: it rarely if ever has to terminate employment contracts. However, an acquisition has resulted in surplus production capacity. The announcement of the plan for closing a particular factory is evidence that the economic consequences of closing that factory are significantly less adverse than alternative courses of action and that, as a result of the acquisition, the entity no longer has the practical ability to avoid the termination payments.

⇩

Liability?	✓	The 'past events' criterion is satisfied as the employees provide their services. The 'no practical ability' to avoid criterion is satisfied when the entity makes the acquisition that results in surplus production capacity. The announcement of the plan is evidence of the consequences of the acquisition.

Example 2.6(b)—Restructuring costs—associated legal fees

Facts

The entity described in Example 2.6(a) will need expert advice to help it calculate the exact amounts of termination benefits owed to each employee. The entity has entered into a contract with a firm of specialist employment lawyers to provide that advice. The lawyers have not yet started providing their services.

Does the entity have a liability for the expected legal fees?

Criterion	Met?	Comments
Potential to require transfer of economic resource to another party	✓	Transfer of cash to lawyers.
As a result of past events	X	The entity has not received the economic benefits (legal services) that establish the extent of its obligation.
No practical ability to avoid	✓	The legal services are necessary to calculate the termination benefits to employees.

⇩

Liability?	X	The entity does not yet have a liability for the fees for future legal services. However, in measuring its liability for employee termination benefits (Example 2.6(a)), the entity might be required to include costs that are necessarily incurred to settle that liability (depending on the measurement basis applied in the applicable IFRS Standard). Consequently, the liability for employee termination benefits might be measured at an amount that includes the fees for future legal services.

Comparison of conclusions in Example 2.6 with requirements of IAS 37

IAS 37 states that an obligation for restructuring costs arises only when an entity has a detailed formal plan for the restructuring and has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.[3]

Although applying the proposed new concepts could change the wording of the requirements for restructuring costs, the practical implications might not be great. Applying the concepts, entities would be required to recognise liabilities for each cost when both of the two general criteria for identifying a present obligation are satisfied, ie when the entity has both (a) received benefits or conducted activities that establish the extent of its obligation and (b) no practical ability to avoid transferring an economic resource. However, the announcement of a restructuring plan might be identified as an event that provides evidence that the 'no practical ability to avoid' criterion has been satisfied and so might be an event that triggers the recognition of liabilities for some costs.

A plan to restructure an operation is identified in IAS 36 *Impairment of Assets* as a trigger for impairment reviews of assets used in that operation.[4] Accordingly, a restructuring plan would remain a potential trigger for reviewing whether the entity has incurred liabilities (including liabilities for contracts that become onerous as a result of the restructuring) or impairment losses, or both.

IAS 37 requires restructuring provisions to include the direct expenditures that are 'necessarily entailed by the restructuring' and 'not associated with the ongoing activities of the entity'. The legal fees discussed in Example 2.6(b) might be an example of such expenditures.

[3] IAS 37, paragraph 72.

[4] IAS 36, paragraph 12(f).

Example 2.7—Legal requirement to fit smoke filters

Facts

Under new legislation, an entity is required to fit smoke filters to its factories by 30 June 20X1. At the end of the entity's reporting period (30 December 20X0), the entity has not fitted the smoke filters.

The entity could be fined for operating without smoke filters after 30 June 20X1.

Does it have a liability at 30 December 20X0?

The facts are consistent with those of part (a) of Example 6 in Section C of the guidance accompanying IAS 37.

Criterion	Met?	Comments
Potential to require transfer of economic resource to another party	✓	The legislation has the potential to require the entity to pay fines. The legislation also has the potential to require the entity to purchase smoke filters. However, the purchase of smoke filters would be an exchange of economic resources (exchange of cash for smoke filters). An obligation to exchange economic resources is an obligation to *transfer* an economic resource only if the exchange is on unfavourable terms. See Section 3 for further discussion of obligations to exchange economic resources.
As a result of past events	X	The entity has not received any economic benefits or conducted any activities in 20X0 that establish the extent of an obligation to transfer an economic resource. (Receiving smoke filters would be the activity that establishes the extent of an obligation to pay for them. Operating without filters after 30 June 20X1 would be the activity that establishes the extent of any obligation for fines that might be charged for non-compliance.)
No practical ability to avoid	✓	Assuming that the economic consequences of failing to fit the filters by 30 June 20X1 would be significantly more adverse than the costs of the filters, the entity has no practical ability to avoid fitting those filters by that date.

⇩

Liability?	X	Consistent with the conclusion in IAS 37. If the cost of the smoke filters is high, and the entity will not be able to recover those costs, the new legislation could be an indication that the factory and/or other assets are impaired.

Example 2.8—Refurbishment costs

Facts

An airline is required by law to overhaul its aircraft once every three years.

It is two years since the airline last overhauled its aircraft. Does the entity have a liability?

The facts are the same as those of Example 11B in Section C of the guidance accompanying IAS 37.

Criterion	Met?	Comments
Potential to require transfer of economic resource to another party	X	Overhauling aircraft enhances the airline's assets – it restores the service potential of the aircraft for a further three years. So the legal requirement creates an obligation to enter into an exchange of economic resources. An obligation to exchange economic resources is an obligation to *transfer* an economic resource only if the exchange is on unfavourable terms (which the staff have assumed it is not). See Section 3 for further discussion of obligations to exchange economic resources.
As a result of past events	✓	Use of the aircraft over the past two years has established the extent of overhaul already required. (The use has resulted in a loss of service potential, which should be recognised by depreciating a component of the cost of the aircraft over three years.)
No practical ability to avoid	Depends	May depend on whether the entity has the practical ability to stop using the aircraft before the next overhaul is due. (The entity could avoid the overhaul by selling the aircraft. However, the need for an overhaul would affect the selling price, so selling the aircraft would not avoid the economic cost of the overhaul.)

Liability?	X	The outcome is consistent with that in IAS 37 (and with the depreciation requirements of IAS 16 *Property, Plant and Equipment*). However, the rationale is slightly different from that in IAS 37. IAS 37 focuses on the entity's ability to avoid the future expenditure (for example by selling the aircraft). Applying the proposed concepts, the focus might instead be on the absence of an obligation to transfer an economic resource.

Example 2.9(a)—Deferred tax—income recognised before it is taxable

Facts

At the end of the current reporting period, the entity has earned income that it has not yet received. It has recognised the income in its statement(s) of financial performance and its right to receive cash in its statement of financial position. The income is taxable when it is received.

Does the entity have a liability for the tax on the income that it has recognised but not yet received?

Criterion	Met?	Comments
Potential to require transfer of economic resource to another party	✓	Transfer of cash to the government, if the entity has taxable profits in a future period.
As a result of past events	✓	The entity has received the economic benefits (the right to income) that establish the extent of the additional tax that it will pay as a result of that income.
No practical ability to avoid	✓	Tax law is legally enforceable. It is implicit in the recognition of the income in the entity's financial statements that the income will be received, and hence that the entity will have no practical ability to avoid paying the tax that will be payable as a result of receiving the income.

⇩

Liability?	✓	Consistent with IAS 12 *Income Taxes*

Example 2.9(b)—Deferred tax—expense deductible before it is recognised

Facts

An entity purchases equipment for CU10,000 at the start of a year. The entity depreciates the equipment on a straight-line basis over five years. Consequently, at the end of the year of purchase, the carrying amount of the equipment is CU8,000.

The full cost of the equipment is deductible for tax purposes in the year of purchase. Profits (before depreciation) earned using the equipment are taxable. If the entity were to sell the equipment, the proceeds of disposal would also be taxable.

Does the entity have a deferred tax liability at the end of the year in which it purchased the equipment?

Criterion	Met?	Comments
Potential to require transfer of economic resource to another party As a result of past events	?	On one hand, it could be argued that the entity has received economic benefits (a tax deduction) that establish the extent of an obligation (to transfer additional tax on recovering the carrying amount of existing equipment). On the other hand, it might be argued that the receipt of the tax deduction does not itself have the potential to require a transfer of an economic resource. Instead that receipt is the realisation of one of the economic benefits expected to be produced by the equipment. The receipt reduces the economic value of an existing asset (the equipment), rather than creating a new obligation.
No practical ability to avoid	✓	Assuming that the entity has taxable profits in future, it will have no practical ability to avoid paying tax on any amount recovered from use or disposal of the equipment. It would be inconsistent with measuring the equipment at CU8,000 to conclude that the entity has the practical ability to avoid recovering that amount.

⇩

Liability?	?	Even if there is no liability, it could be argued that: - it is necessary to recognise deferred tax to reflect the equipment at its economic (post-tax) cost; - it is more understandable and operational to combine and present all components of deferred tax in a single balance than to offset each component against the asset or liability to which it relates. In other words, recognising all components of deferred tax in a single balance is a way of providing relevant, understandable information about, and a faithful representation of, the entity's financial performance and financial position, at cost that does not exceed the benefits.

Example 2.10—Non-compete agreement

Facts

An entity that operates restaurants in cities throughout a region sells one of its restaurants. It receives a fee in exchange for agreeing not to open another restaurant in that city for five years.

Does the entity have a liability?

Criterion	Met?	Comments
Potential to require transfer of economic resource to another party	X	The agreement has taken away a right previously held by the entity, rather than given rise to an obligation that has the potential to require the transfer of an economic resource. Before the agreement, the entity had a right to operate restaurants in any city. The entity's ability to obtain economic benefits from that right would have been reflected in the value of its goodwill (and possibly other assets). The agreement takes away the entity's right to operate in one particular city, reducing the value of the entity's goodwill (and possibly other assets).
As a result of past events	✓	The entity has received the benefit (the fee) that has resulted in it losing its right to operate a restaurant in one particular city.
No practical ability to avoid	✓	The agreement is legally enforceable.

⇩

Liability?	X	The entity has lost rights, rather than incurred obligations. Whether the loss of rights is recognised in the entity's financial statements would depend on whether the entity's goodwill (or other affected assets) are recognised and, if so, the amounts at which those assets are measured.

Example 2.11—Government grant

Facts

A government provides grants to entities that invest in a region that has high rates of unemployment.

An entity has just received a grant towards the cost of building a manufacturing plant in that region. As a condition of the grant, the entity must employ at least 10,000 people in the plant for at least 10 years. If the entity fails to meet this condition it must repay some of the grant. The amount repayable will depend on how many fewer people are employed and for how long. The grant agreement is legally enforceable.

Does the entity have a liability?

Criterion	Met?	Comments
Potential to require transfer of economic resource to another party	?	The entity must either (a) employ people or (b) repay the grant. Employing people would involve *exchanging* economic resources (exchanging cash for employee services). This exchange would be a *transfer* of economic resources only if the exchange is on unfavourable terms. It might be argued that the existence of the grant is evidence that a grant is necessary to make the investment attractive, and hence evidence that the exchange is otherwise unfavourable. See Section 3 for further discussion of obligations to exchange economic resources.
As a result of past events	✓	The entity has received the economic benefit (the grant) that establishes the extent of its obligation (to employ staff or repay the grant).
No practical ability to avoid	✓	The grant agreement is legally enforceable. The entity has no practical ability to avoid its obligations to either employ people or repay a portion of the grant.

⇩

Liability?	?	The key question would be whether the obligation to employ people requires an unfavourable exchange and hence is an obligation to transfer an economic resource. The portion of the grant that is refundable on any particular date might, or might not, be a measure of the extent to which the remaining exchange is unfavourable.

Section 3—Illustrative examples—Executory contracts

Section 3—Illustrative examples—Executory contracts

Paragraphs 4.40-4.42 of the Exposure Draft proposed concepts on the nature of the assets and liabilities that arise in executory contracts. This section applies the proposed concepts to two common contracts—a contract for the purchase of inventory and a contract for the sale of services.

Proposed concepts

An executory contract is a contract that is equally unperformed: neither party has fulfilled any of its obligations, or both parties have fulfilled their obligations partially and to an equal extent.

An executory contract establishes a right and an obligation to exchange economic resources. Entering into the contract is the activity that establishes the extent of the entity's right and obligation to exchange economic resources. That right and obligation are interdependent and cannot be separated. Hence the combined right and obligation constitute a single asset or liability:

- the entity has an asset if the terms of the exchange is favourable;
- it has a liability if the terms of the exchange are unfavourable.

Whether the asset or the liability is included in the financial statements depends on both the recognition criteria and the measurement basis adopted for that contract.

To the extent that either party has fulfilled its obligations under the contract, the contract is no longer executory:

- if the entity performs first, that act of performance changes the entity's right and obligation to exchange resources into a right to receive an economic resource (ie an asset).
- if the other party performs first, that act of performance changes the entity's right and obligation to exchange economic resources into an obligation to transfer an economic resource (ie a liability).

Example 3.1—Executory purchase contract

Facts

An entity measures its inventory at the lower of cost and net realisable value.

It enters into a non-cancellable contract to purchase inventory. The terms of the contract require the entity to pay for the inventory *after* delivery.

For simplicity, the time value of money is ignored.

How would the concepts apply?

Applying the concepts at contract inception

Rights and obligations?	At inception, the contract is executory. The entity has a combined right and obligation to exchange cash for inventory.
Asset or liability?	Whether the entity has an asset or a liability at contract inception depends on whether the exchange is favourable or unfavourable.
Favourable or unfavourable exchange?	Whether the exchange is favourable or unfavourable can be assessed by comparing the values of the economic resources to be exchanged. The values assigned to those resources would depend on the measurement bases applied. The Board might, for example, specify the same measurement bases for the resources to be exchanged as are applied to measure the rights and obligations that arise once the exchange has taken place. If so, a comparison would be made between: (a) *the value assigned to the inventory:* the lower of cost (the transaction price) and net realisable value; and (b) *the value assigned to the obligation to pay cash:* the transaction price.
Conclusion	Applying these measurement bases, the difference between the values assigned to the resources being exchanged would be zero, unless the net realisable value of the inventory was lower than its cost (the transaction price). In other words, at contract inception, no asset or liability would be identified unless the contract was onerous (in which case, a liability would be identified).

Applying the concepts when one party performs

Change in rights and obligations	In this example, the supplier is the first party to fulfil its obligations under the contract. It delivers inventory to the entity. As a result of the supplier's act of performance, the entity's rights and obligations under the contract change: • *from* a right and obligation to exchange cash for inventory, • *to* an obligation to transfer cash (a liability).

Example 3.2—Executory sale contract

Facts

An entity earns revenue by repairing machinery. The entity provides repairs under 5-year fixed-fee service contracts. Customers pay service fees annually at the start of each year.

The entity measures its performance obligations at the higher of the transaction price (the fee received) and the best estimate of the expenditure required to provide the repair service.

For simplicity, the time value of money is ignored.

How would the proposed concepts apply?

Applying the concepts at contract inception

Rights and obligations?	When the entity enters into a contract with a customer, the contract is executory. The entity has a combined right and obligation to exchange a repair service for fees.
Asset or liability?	Whether the entity has an asset or a liability on entering into the contract depends on whether the exchange is favourable or unfavourable.
Favourable or unfavourable exchange?	Whether the exchange is favourable or unfavourable can be assessed by comparing the values of the economic resources to be exchanged. The values assigned to those resources would depend on the measurement bases applied. The Board might, for example, specify the same measurement bases for the resources to be exchanged as are applied to measure the rights and obligations that arise once the exchange has taken place. If so, a comparison would be made between: (a) *the value assigned to the service fees:* the transaction price; and (b) *the value assigned to the service obligations:* the higher of the transaction price and the best estimate of the expenditure required to provide the repair service.
Conclusion	Applying these measurement bases, the difference between the values assigned to the economic resources being exchanged would be zero, unless the best estimate of the expenditure required to provide the repair service was higher than the transaction price. In other words, at the inception of a contract, no asset or liability would be identified unless the contract was onerous (in which case, a liability would be identified).

Applying the concepts when one party performs

Change in rights and obligations	The customer is the first party to fulfil some of its obligations under the contract. When the customer pays the first annual fee, the entity's rights and obligations for the first year of the contract change: • *from* a right and obligation to exchange a repair service for fees, • *to* an obligation to provide a repair service for the first year (a liability). The rest of the contract (ie years 2–5) remains executory.

Section 4—Possible implications for IFRS Standards

Section 4—Possible implications for IFRS Standards

General implications

Implications for existing IFRS Standards

The Conceptual Framework is not an IFRS Standard and it does not override IFRS Standards. Furthermore, the Board will not automatically amend existing IFRS Standards as a result of changes to the *Conceptual Framework*. If an existing IFRS Standard works well in practice, the Board will not propose an amendment to that Standard solely because it is inconsistent with the revised Conceptual Framework.

So the proposed changes to the definitions of an asset and a liability, and to the concepts supporting those definitions, would not have an immediate effect on the financial statements of most reporting entities that apply IFRS Standards. Entities would be affected only if and when they need to use the *Conceptual Framework* definitions to develop or select an accounting policy for a particular transaction because no IFRS Standard specifically applies to that transaction.

Implications for current and future projects

The proposed new definitions, and the additional concepts proposed to support those definitions, will guide the Board and the IFRS Interpretations Committee as they develop new IFRS Standards, amendments to IFRS Standards, and interpretations of IFRS Standards.

The aim of clarifying the definitions and adding more supporting concepts is to help ensure that IFRS Standards best meet the needs of investors, lenders and other creditors, by:

- making it clearer when an asset or a liability exists, and exactly what the asset or liability is;
- promoting consistency between IFRS Standards; and
- enabling a more effective dialogue between the Board and stakeholders.

The rest of this section illustrates how the proposed definitions and supporting concepts could help the Board reach decisions in some of its standard-setting and research projects.

We have not sought to identify all the concepts that may be relevant in a particular project. Instead, for each project, we have highlighted one or two concepts that might be particularly important and considered how those concepts could influence the Board's decisions.

4.1—Possible implications for the standard-setting project on rate-regulated activities

The objective of this project is to decide how IFRS Standards should be amended to recognise the financial effects of rate regulation.

Why the definitions are relevant

Entities may be subject to rate regulation if they provide essential services, such as utilities, with little or no competition. Regulatory service agreements may impose service obligations on the entities and constrain the prices that entities can charge customers.

At the start of a period, a regulator may set prices that aim to allow an entity to earn a specified margin in that period. If the actual margin earned by the entity turns out to be lower (or higher) than the allowed margin, the regulator may increase (or decrease) the prices that the entity can charge in future periods.

One of the questions being considered in this project is whether a rate-regulated entity's right to increase future prices (or obligation to decrease future prices) is an asset (or a liability) for that entity.

Outcome of a previous project

In a previous project, the Board was unable to reach a decision on whether rate-regulated entities' rights to increase future prices, and obligations to reduce future prices, meet the definitions of assets and liabilities.

Some people concluded they do not. Those people noted that most entities (that are not subject to rate regulation) have a right to increase prices, but do not treat that right as an asset. Similarly, entities that will be compelled to reduce prices do not recognise a liability (except to the extent that existing contracts with existing customers become onerous).

However, other people noted that the rights and obligations of rate-regulated entities differ from those of other entities. In particular, the adjustments to future prices can include adjustments that compensate for past events, and that could not be made in the absence of those past events.

How the proposed concepts could help

Several concepts proposed to support the proposed asset and liability definitions seek to explain the terms 'right' and 'obligation' and so could help the Board develop alternative analyses of the rights and obligations of rate-regulated entities. The box to the right illustrates an analysis that could be developed applying the proposed concepts for executory contracts.

Illustration—applying the proposed concepts on executory contracts

The concepts propose that an executory (equally unperformed) contract establishes a right and an obligation to exchange economic resources, and that the combined right and obligation constitute an asset if the terms are favourable, or a liability if the terms are unfavourable.

The Board could consider whether these concepts should be applied to regulatory service agreements. Such agreements may give a regulated entity a right and an obligation to provide services to the public in exchange for revenue at a regulated price.

The Board could consider situations in which, to compensate for prices that were too low (or high) in the past, the regulated price for the future services is increased above (or decreased below) the price that would otherwise be set for these services. The Board might conclude that as a result of the adjustments, the future exchange will be on favourable (or unfavourable) terms. Or in other words, that the rate-regulated entity has an asset (or a liability) whose value reflects the financial effects of the price adjustment.

4.2—Possible implications for the research project on goodwill and impairment

In this research project, the Board is considering how to address several matters identified in the Post-implementation Review of IFRS 3 *Business Combinations.*

Why the asset definition is relevant

In this project, the Board is considering, among other things, whether some intangible assets acquired in a business combination should be subsumed in goodwill (instead of being recognised and measured separately from goodwill). The Board is considering this question because some stakeholders have expressed a view that separate recognition and measurement of some intangible assets does not provide useful information, and is complex and costly. Concerns primarily relate to intangible assets whose values tend to be subjective, such as customer relationships.

The Board is also considering possible improvements to the guidance in IFRS 3 on which intangible items are identifiable separately from goodwill. The Board has been told that the guidance on customer relationships has been subject to different interpretations. Improving this guidance could help to mitigate some of the concerns about separate recognition of customer relationships.

How the proposed asset definition could help

A review of the guidance on customer relationships would include, among other things, consideration of whether, and if so when, such relationships are assets that are identifiable separately from goodwill and other intangible assets, such as brands.

Defining an asset as a 'right' could give the Board a clearer process for reaching decisions on this question. The process could involve:

(a) identifying the right that gives rise to the benefits produced by a particular type of customer relationship; and

(b) deciding whether that right is different from the rights that constitute goodwill (see Example 1.1 on page 8) or another intangible asset.

The Board could explore a range of different analyses of the rights arising from customer relationships. For example, one possible analysis could be that existing relationships with customers give an entity a right to retain any economic benefit that may be generated by those relationships. That right is identifiable, and hence distinguishable from the rights that constitute goodwill. (In contrast, the entity's right to retain any benefit that may be generated by possible *future* relationships with possible future customers is one of the rights that constitute goodwill.)

An alternative analysis could be that:

(a) *to the extent that benefits will be obtained from existing profitable contracts:* the entity has a right to exchange economic resources with a customer on favourable terms. This contractual right is an identifiable asset.

(b) *to the extent that the benefits will be obtained from possible future contracts:* the only right the entity has is to conduct profitable business in future with any willing customers. The right to conduct business in future (with the ability to conduct it more profitably than other entities could) is goodwill. So it might be argued that existing customer relationships add value to goodwill or another intangible asset—they are not identifiable assets.

4.3—Possible implications for a research project on provisions (review of IAS 37)

This project is in the 'research pipeline'—the Board plans no further work on this project until the revised *Conceptual Framework* is closer to finalisation.

Problems with IAS 37

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* sets out concepts for identifying liabilities, in particular for identifying whether an entity has a 'present obligation'.

However, aspects of those concepts seem contradictory:

(a) on one hand, IAS 37 states that a present obligation exists 'independently of an entity's future actions'. This statement is often interpreted as meaning that liabilities must be unconditional—an entity does not have a liability for future outflows that it could avoid through its future actions, even if those actions are unrealistic.

(b) on the other hand, IAS 37 defines an obligating event as an event that 'results in the entity having no realistic alternative to settling the obligation'. This definition is often interpreted as meaning that an entity does have a liability for future outflows that it could avoid through its future actions, if those actions are unrealistic.

These apparently contradictory concepts have given rise to problems in practice. It is unclear which concept should apply to transactions within the scope of, but not specifically addressed by, IAS 37 and stakeholders have expressed particular dissatisfaction with one interpretation, IFRIC 21 *Levies*, which identifies liabilities arising only once obligations are unconditional.

IFRIC 21, in combination with Standards addressing the identification of assets, results in some recurring periodic levies being recognised as expenses at a single point in time. Some stakeholders have suggested that the economic substance of a recurring levy is that the entity is paying to operate over a period, and that this substance would be more faithfully represented by spreading the expense over the period to which the levy refers.

How the proposed liability concepts could help

The new concepts proposed to support the definition of a liability could replace the existing concepts in IAS 37. The Board could then update the application requirements and illustrative examples in IAS 37 and IFRIC 21, to make them consistent with the new concepts.

The IASB staff think that applying the new concepts could lead to:

(a) requirements for levies that are different from those in IFRIC 21 (see examples 2.5(a)–(c) in this paper).

(b) requirements for restructuring costs that are expressed differently from those in IAS 37. There might be a different process for identifying liabilities, but possibly not major differences in the timing of recognition of many restructuring costs (see examples 2.6(a)–(b)).

(c) no changes to the requirements for some other transactions illustrated in IAS 37 (see examples 2.1, 2.2, 2.3, 2.7 and 2.8).

4.4—Possible implications for a research project on pollutant pricing mechanisms

This project is in the 'research pipeline'—the Board plans no further work on this project until the revised *Conceptual Framework* is closer to finalisation.

Why the definitions are relevant

Pollutant pricing mechanisms are designed to achieve a reduction of greenhouse gases.

The mechanisms can vary. For example, with 'baseline and credit' emissions trading schemes, participants in the scheme are charged (or credited) for polluting above (or below) a baseline amount in a period. Credits and charges are settled using tradable allowances that the administrator issues to participants in credit at the end of the period.

With 'cap and trade' emissions trading schemes, allowances for a baseline amount of pollution may be allocated to participants free of charge at the start of the period. Participants are free to trade the allowances throughout the period, but must have sufficient allowances at the end of the period to pay for their pollution.

In this project, the Board will be considering how entities could reflect the financial effects of pollutant pricing mechanisms. The analysis could include identifying *what* rights and obligations (assets and liabilities) arise for participants, and *when* those rights and obligations arise.

How the proposed definitions could help

The proposed definitions and supporting concepts could be of particular help with three questions.

One question concerns *when* a participant in a baseline and credit scheme incurs a liability for polluting above (or acquires an asset for polluting below) its baseline threshold. Does a liability arise only when the participant exceeds the baseline, or earlier as it makes progress towards that outcome? Does an asset arise only when the assessment period ends without the participant reaching the baseline, or earlier as the participant makes progress towards that outcome? The analysis could be similar to that set out in Example 2.5(c) *Threshold levy* (see page 22).

A second question concerns the rights and obligations that arise from cap and trade schemes. One possible analysis is that these schemes give rise to two sets of rights and obligations:

(a) rights and obligations that arise when a participant receives allocated allowances. Tradable allowances are a mechanism for pricing pollution at an amount that incentivises a reduction in pollution. The allowances could be viewed as a currency that the government lends into the scheme. Applying this analysis, the proposed concepts could suggest that a participant has both an asset (rights over the allowances) and a liability (an obligation to repay the currency lent to it).

(b) a separate obligation (or right) for polluting above (or below) the level covered by allocated allowances. It could be argued that this obligation (or right) is essentially the same as the liability (or asset) that arises in a baseline and credit scheme, so should be recognised in the same way and at the same time.

A third question concerns the measurement of the assets (if any) arising from the allowances held by participants. The decisions the Board reaches could depend on how it thinks the allowances should be classified, eg as a currency, inventory, or an intangible asset. The focus on identifying the 'rights' that are conferred by the allowances could help the Board made decisions about classification.

4.5—Possible implications for a research project on variable and contingent consideration

This project is in the 'research pipeline'—it is among the projects that the Board intends to commence before 2021.

Why the liability definition is relevant

This project will consider variable and contingent payments for the purchase of tangible and intangible assets. Such payments are widespread, particularly in the extractive, pharmaceutical, biotech, real estate and telecommunications industries.

The variable or contingent payments may depend on the future performance or use of the asset. For example, they may depend on the revenue generated by the asset or the output of the asset.

One of the main objectives of the project would be to decide when a liability arises for variable or contingent payments that depend on the purchaser's future activity. Does the liability arise when the purchaser receives the right to use the asset, or when it conducts the activities on which the variable or contingent payments depend?

How the proposed concepts could help

This project raises a question that is similar to questions that have arisen on several other projects. If a series of events must occur before an entity has an unconditional obligation to transfer an economic resource, which event causes a liability to arise?

The proposed concepts aim to help the Board reach answers that are consistent across IFRS Standards. To apply the proposed concepts on this project, the Board would seek to identify when the purchaser:

(a) has received the benefits, or conducted the activities, that establish the extent of its obligation for the variable or contingent payments; and

(b) has no practical ability to avoid making the variable or contingent payments.

The Board might conclude that the terms of many asset purchase agreements leave purchasers no practical ability to avoid variable and contingent payments. Even if the payments depend on the purchaser's future activities (such as generating revenue), it is often in the purchaser's best interests to conduct those activities.

Accordingly, the focus of this project could be on deciding when a purchaser has received the benefits or conducted the activities that establish the extent of its obligation for variable or contingent payments.

Two contrasting views could be that:

(a) the extent of the purchaser's obligation is established only when it conducts the activities on which the variable or contingent payments depends; or

(b) the extent of the purchaser's obligation is established by the receipt of the right of use of the asset. At that time, the purchaser becomes obliged to pay for the right of use. Even though the amount will be variable, a value could be put on the obligation by estimating the expected outcomes.

The conclusion might depend on identifying precisely what rights the entity acquires when it receives the tangible or intangible asset.