

STAFF PAPER

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IASB Meeting

Project	Conceptual Framework
Paper topic	Sweep issue—concepts supporting the liability definition

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Overview of paper

1. When commenting on the pre-ballot draft of the *Conceptual Framework for Financial Reporting (Conceptual Framework)*, several Board members and external reviewers expressed concerns about an aspect of the concepts supporting the liability definition. The staff think that the concerns reflect a problem with the drafting in the pre-ballot draft, rather than with the Board decisions that the drafting was aiming to reflect. Accordingly, we recommend that we address the concerns by improving the drafting—there is no need for the Board to revisit its previous decisions. However, because the concerns were fairly widespread among reviewers, the staff would like the Board to consider the comments received and approve our recommendation.
2. This paper:
 - (a) identifies the paragraphs of the pre-ballot draft that gave rise to concerns (paragraphs 4–6 of this paper);
 - (b) explains the concerns expressed by reviewers (paragraphs 7–10);
 - (c) analyses the problem identified by reviewers and ways of solving that problem (paragraphs 11–24); and
 - (d) sets out the staff recommendation and planned drafting amendments (paragraphs 25–26).

3. The drafting amendments planned by staff include:
 - (a) clarifying in the introduction to the ‘definition of a liability’ section of the *Conceptual Framework* (paragraph 4.26 of the pre-ballot draft) that all three of the criteria listed in that introduction must be satisfied to meet the definition of a liability.
 - (b) redrafting paragraph 4.46 of the pre-ballot draft:
 - (i) to clarify that an entity does not yet have a present obligation to transfer an economic resource if it has not yet received economic benefits, or taken an action, that will or may require it to transfer that resource—*even if* it already has no practical ability to avoid receiving those benefits or taking that action in the future; and
 - (ii) to clarify the link to executory contracts.
 - (c) omitting the phrase ‘or simply being in existence’ from the list of actions that could give rise to a present obligation (paragraph 4.43 of the pre-ballot draft).

Draft concepts

4. The *Conceptual Framework* will include a definition of a liability and concepts to support that definition. In developing those concepts, the Board identified three criteria that must be satisfied to meet the definition of a liability:
 - (a) the entity must have an obligation;
 - (b) the obligation must be to transfer an economic resource; and
 - (c) the obligation must be a present obligation that exists as a result of past events.

5. The *Conceptual Framework* will also include concepts to explain these criteria. Notable concepts are that:
 - (a) an obligation is a duty or responsibility that the entity has no practical ability to avoid.
 - (b) an obligation to transfer an economic resource ‘exists as a result of past events’ only if the entity has already received economic benefits, or taken an action,

that will or may require it to transfer an economic resource that it would not otherwise have had to transfer.

- (c) an executory contract establishes a combined right and obligation to exchange economic resources, which is a liability only if the terms of the exchange are currently unfavourable.

6. Several reviewers expressed concerns about the consequences of three paragraphs explaining those concepts. The paragraphs are set out below. The text is marked to show changes from the Exposure Draft¹, and two changes that attracted particular comment from reviewers are emphasised in *bold italics*:

4.332 ~~If an entity~~ An entity's decision to prepares financial statements on a going concern basis, ~~implies that~~ the entity has no practical ability to avoid ~~a transfer an obligation~~ that could be avoided only by liquidating the entity or by ceasing trading.

...

4.3643 An entity has a present obligation that exists as a result of ~~a past events~~ only if ~~it~~ the entity has already received ~~the~~ economic benefits, or taken an action ~~conducted the activities~~, that will or may require it to transfer an economic resource that it would not otherwise have had to transfer ~~establish the extent of its obligation~~. The economic benefits received could include, for example, goods or services. The action taken ~~activities conducted~~ could include, for example, conducting particular activities, operating in a particular market ***or simply being in existence***. If the economic benefits are received, or the actions are taken ~~activities are conducted~~, over time, the resulting present obligation may ~~will~~ accumulate over time (~~if, throughout that time, the entity has no practical ability to avoid the transfer~~).

...

4.3946 An entity does not have a present obligation for the costs that ~~will arise~~ the entity will incur only if it ~~will~~ receives benefits, or only if it takes an action ~~conduct activities~~, in the future (for example, the costs of future operations), ***unless the entity has no practical ability to avoid taking that action***; ~~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 4.55–4.57 4.40–4.42).

¹ Exposure Draft *Conceptual Framework for Financial Reporting*, May 2015

Concerns expressed by reviewers

7. Several reviewers suggested that, taken together, the concepts in paragraphs 4.32, 4.43 and 4.46 of the pre-ballot draft would lead to a conclusion that an entity has a present obligation for all future costs (into perpetuity) that it will have no practical ability to avoid as a going concern. Such costs could include payments required to maintain future production capacity (for example, salaries or repairs and maintenance), future losses and future years' taxes and levies.

8. Most of the reviewers raising concerns focused on paragraph 4.46. They suggested that, applying that paragraph as it is worded in the pre-ballot draft, an entity would be viewed as having a present obligation for all future costs that it has no practical ability to avoid—even costs that cannot yet be attributed to past events. Some reviewers noted that such a conclusion would be inconsistent with the Board's previous decisions and with the fundamental concept that a liability must exist as a result of past events. One reviewer suggested that paragraph 4.46 would render the liability definition 'virtually useless and not reconcilable to any requirement for a present obligation'.

9. Some reviewers also expressed concern about the phrase 'simply being in existence' in paragraph 4.43. They suggested that:
 - (a) the phrase reinforces the message in paragraph 4.46 that a past event is not required.

 - (b) treating 'simply being in existence' as a past event:
 - (i) would mean that the past event criterion has no substance; or
 - (ii) contradicts paragraph 4.44, which states that:

The enactment of legislation is not in itself sufficient to give an entity a present obligation. Similarly, an entity's customary practices, published policies or specific statements mentioned in paragraph 4.30 are not sufficient to give that entity a present obligation. The entity must have received benefits, or taken an action, that bring the entity within the scope of that legislation, or of such a practices, policies or statements.

10. Some reviewers suggested remedies. Suggestions included:

- (a) amending paragraph 4.46 by:
 - (i) deleting the phrase 'unless the entity has no practical ability to avoid taking that action'; or
 - (ii) clarifying that a past event is essential for a liability to exist.
- (b) amending paragraph 4.43 by:
 - (i) deleting the phrase 'or simply being in existence'; or
 - (ii) clarifying that 'simply being in existence' could give rise to a present obligation only if the reason for an entity having an obligation is that it existed at a particular past time.
- (c) amending paragraph 4.32 on going concern by:
 - (i) deleting the paragraph; or
 - (ii) clarifying that the fact that an entity's financial statements are prepared on a going concern basis does not imply that the entity has a present obligation for all costs that will arise from actions it will have to take in future to remain a going concern. The going concern assumption is relevant when assessing whether an entity has the practical ability to avoid transferring an economic resource. But unless an obligation to make the future transfer exists as a result of past events, the entity does not yet have a liability.

Staff analysis

Concerns about paragraph 4.46—the need for a past event

11. On reflection, the staff think that it was a mistake to add to paragraph 4.46 the phrase ‘unless the entity has no practical ability to avoid taking that action’. The purpose of paragraph 4.46 is to emphasise that a past event is a necessary criterion for identifying a liability—without a past event, there is no present obligation for a future transfer, *even if* (not ‘unless’) the entity has no practical ability to avoid the transfer.

12. The paragraph could be corrected by removing the phrase, or by changing ‘unless’ to ‘even if’:
 - 4.46 An entity does not have a present obligation for the costs that the entity will incur only if it receives benefits, or only if it takes an action, in the future (for example the costs of future operations), ~~unless~~ even if the entity has no practical ability to avoid taking that action. 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 4.55–4.57).

13. The staff added the phrase ‘unless the entity has no practical ability to avoid taking that action’ in response to comments on an earlier draft. Those earlier comments suggested that the intended message of paragraph 4.46 was not clear. So the staff have considered whether any further drafting changes could clarify the message.

14. We think that three aspects of paragraph 4.46 make its message unclear:
 - (a) the paragraph makes no reference to past events.
 - (b) the statement that an entity does not have a present obligation for costs that it will incur only if it receives benefits or takes an action in future is ambiguous: it could be misinterpreted as meaning that an entity does not have a present obligation if the requirement to transfer an economic resource depends on future events. However, paragraph 4.46 is not trying to say that the outcome of the obligation (for example, the amount that ultimately needs to be transferred) must be independent of *future* events; it is trying to say that the obligation to

make the transfer must exist as a consequence of *past* events (whether or not the outcome depends on future events).

- (c) the link between the statement about future events and the statement about executory contracts is not clear.

15. The staff think that we could improve paragraph 4.46 by redrafting it and adding a simple example to illustrate both the concept and the link to executory contracts. A re-drafted paragraph 4.46 could say something like:

Illustrative drafting

4.46 ~~[Whole of previous paragraph]~~ An entity does not yet have a present obligation to transfer an economic resource if it has not yet received economic benefits, or taken an action, that will or may require it to transfer that resource—even if it has no practical ability to avoid receiving those benefits or taking that action (and hence no practical ability to avoid transferring the resource) in the future. For example, if an entity has entered into a contract to pay an employee a salary in exchange for the employee’s services, the entity does not have a present obligation to pay the salary until it has received the employee’s services. Before then, the contract is executory and, if the entity has a present obligation, that present obligation would be to exchange future salary for future employee services—see paragraphs 4.55–4.57.

16. The message that there must be a past event could also be emphasised in the introduction to the ‘definition of a liability’ section of the *Conceptual Framework*. It could be emphasised by adding an explicit statement that all three of the criteria listed in the introduction must be satisfied for an entity to have a liability:

Illustrative drafting

4.26 ... for an entity to have a liability, three criteria must all be satisfied:

- (a) the entity ~~it~~ must have an obligation ... (see paragraphs 4.27–4.35);
- (b) the obligation must be to transfer an economic resource (see paragraphs 4.36–4.41); and
- (c) the obligation must be a present obligation that exists as a result of past events (see paragraphs 4.42–4.46).

Concerns about paragraph 4.43—‘or simply being in existence’

17. As explained in paragraph 9 of this paper, some reviewers expressed concern about the addition of ‘or simply being in existence’ to the list of actions that could be ‘past events’. They thought the phrase implied that there was no need for a past event (action), or that the requirement for a past event had no substance. As noted in paragraph 10(b), some reviewers suggested either deleting the phrase, or qualifying it to clarify that being in existence could give rise to a present obligation only if the reason an entity has an obligation is that the entity existed at a particular past time.
18. The staff think that there could be circumstances in which being in existence as a particular type of entity at a particular time could give rise to a present obligation. For example, a government might charge a levy on all entities that are authorised to conduct particular activities on 1 January in a particular year. In such circumstances, existing as an authorised entity on 1 January could be the event that gives an entity a present obligation on that date.
19. However, we accept that in such circumstances, the entity is likely to be doing more than simply existing: in the example above, it could be argued that the entity has received benefits (authorisation), or that it has taken an action (obtained the authorisation needed to operate in a particular market). It is likely to be rare that an obligation arises for *all* entities *solely because* they exist. So adding the phrase ‘or simply being in existence’ is unnecessary in many cases (perhaps even all cases) and could be misleading.
20. The phrase ‘or simply being in existence’ was not in the Exposure Draft and the staff added it to the pre-ballot draft as a drafting change—not because of a Board decision. Given that the phrase has caused confusion among reviewers and could be misleading, we now think we should reverse our earlier drafting change, ie omit the phrase ‘or simply being in existence’ from the list of actions that could give rise to a present obligation.

Concerns about paragraph 4.32—going concern

21. Paragraph 4.32 of the pre-ballot draft was carried forward from the Exposure Draft. It explains how the going concern assumption would affect judgements about whether an entity has the practical ability to avoid particular obligations.
22. As detailed in paragraph 10(c) of this paper, one reviewer suggested deleting paragraph 4.32, and another suggested clarifying that the fact that an entity’s financial statements are prepared on a going concern basis does not imply that the entity has a present obligation for all costs that will arise from actions it will have to take in future to remain a going concern.
23. However, neither reviewer raised concerns with paragraph 4.32 itself. Instead they expressed concern about the consequences of combining the concepts in paragraph 4.32 with those in paragraph 4.46.
24. The staff think that, if the drafting of paragraph 4.46 is clarified as illustrated below paragraph 15 of this paper—in particular to emphasise that the ‘no practical ability to avoid criterion’ and the ‘past events’ criterion must both be satisfied— there is no need to also amend the discussion of going concern in paragraph 4.32.

Staff conclusions

25. The staff have concluded that the concerns discussed in this paper reflect a problem with the drafting in the pre-ballot draft, rather than with the Board decisions that the drafting was aiming to reflect. Accordingly, we recommend that we address the concerns by improving the drafting—there is no need for the Board to revisit its previous decisions.

Question 1

Do you agree with this recommendation?

26. The drafting amendments planned by staff include:
- (a) clarifying in the introduction to the ‘definition of a liability’ section of the *Conceptual Framework* (paragraph 4.26 of the pre-ballot draft) that all three of the criteria listed in that introduction must be satisfied to meet the definition of a liability. (See illustration following paragraph 16 of this paper.)
 - (b) redrafting paragraph 4.46 of the pre-ballot draft:
 - (i) to clarify that an entity does not yet have a present obligation to transfer an economic resource if it has not yet received economic benefits, or taken an action, that will or may require it to transfer that resource—*even if* it already has no practical ability to avoid receiving those benefits or taking that action in the future; and
 - (ii) to clarify the link to executory contracts.

(See illustration following paragraph 15 of this paper.)
 - (c) omitting the phrase ‘or simply being in existence’ from the list of actions that could give rise to a present obligation (paragraph 4.43 of the pre-ballot draft).

Question 2

Do you have any comments on the planned drafting amendments?