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Section 3

Additional guidance to support the asset and liability definitions

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

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Section overview

What does this section cover?

This section discusses areas in which the IASB could add further guidance to the Conceptual Framework to support the definitions of an asset and a liability.

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

There are three reasons for adding more guidance on those definitions.

First, as explained in Section 2, the IASB proposes to change aspects of the definitions. Further guidance would help to explain revised terms within the definition.

Secondly, some aspects of the existing definition of a liability are unclear: there is little guidance in the Conceptual Framework and the principles underlying different IFRSs can appear inconsistent. For example, it is unclear whether an entity can have a present obligation while any requirement to transfer resources remains conditional on the entity's future actions. As a result, the Board, the IFRS Interpretations Committee and others have had difficulty reaching conclusions on whether and when some transactions give rise to liabilities. Additional guidance could establish principles on which to base future requirements.

Finally, other aspects of the existing asset and liability definitions have become clearer in recent years as the IASB has developed requirements and guidance within individual IFRSs. For example, several IFRSs now give guidance on the nature of liabilities—such as insurance contract liabilities—whose outcome depends on events that are outside the entity's control. And several IFRSs now give guidance on identifying the substance of contractual rights and obligations. The IASB thinks it would be helpful to update the Framework to include the general principles underpinning that guidance.

What are the IASB's preliminary views?

The IASB proposes to add guidance to the Conceptual Framework on the following matters:

To support the definition of an asset, guidance on:

- The meaning of 'economic resource'
- The meaning of 'control'.

To support the definition of a liability, guidance on:

- Constructive obligations
- The impact of future events
- The meaning of 'transfer an economic resource'.

To support the definitions of both an asset and a liability, guidance on:

- Reporting the substance of contractual rights and obligations
- Executory contracts.

The discussion on constructive obligations considers the possibility of narrowing the definition of a liability to include only obligations that are enforceable by legal or equivalent means. However, the IASB tentatively favours retaining the existing definition of a liability—which encompasses both legal and constructive obligations—and adding more guidance to help distinguish constructive obligations from economic compulsion.

The discussion on the impact of future events considers three alternative approaches and the different practical implications of each. The IASB tentatively favours an approach that [description of favoured approach if the Board reaches a preliminary view]. / [The IASB has not reached a preliminary view on which of the approaches to use as the basis of guidance in the Conceptual Framework.]

Introduction

1. This section considers areas in which the IASB could add further guidance to the Conceptual framework to support the definitions of an asset and a liability. It discusses:

   (a) to support the definition of an *asset*, guidance on:

      (i) economic resources (paragraphs 2-16)

      (ii) control (paragraphs 17-31).

   (b) to support the definition of a *liability*, guidance on:

      (i) transfer of an economic resource (paragraphs 32-35)

      (ii) constructive obligations (paragraphs 36-59)

      (iii) obligations whose outcome depends on future events (paragraphs 60-78).

   (c) to support *both definitions*, guidance on:

      (i) contractual rights and contractual obligations (paragraphs 79-89); and

      (ii) executory contracts (paragraphs 90-94).

Economic resources

2. As discussed in Section 2, the IASB proposes to define an asset as 'an economic resource controlled by the entity' and to define an economic resource as 'a right, or other source of value, that is capable of producing economic benefits, but only for the party that controls the item'. The IASB thinks that further guidance would help to explain the proposed new definition of 'economic resource'. It proposes that guidance should cover the matters set out below.

3. The proposed definition of an economic resource includes the notions that the resource:
   (a) will generate economic benefits only for the party that controls it. Public goods that are open to all, such as open roads, provide benefits to all, and are not economic resources.
   (b) is capable of producing economic benefits.

4. Economic resources may take various forms:
   (a) enforceable rights established by contract, law or similar means:
      (i) enforceable rights arising from a financial instrument, such as an investment in a debt security or an equity investment.
      (ii) enforceable rights over physical objects, such as property, plant and equipment or inventories. Such rights might include ownership of a physical object, the right to use a physical object, or the right to the residual value of a leased object.
      (iii) enforceable rights to receive another economic resource if the holder of the right chooses to exercise that right (an option to acquire the underlying economic resource) or is required to exercise that right (a forward contract to buy the underlying economic resource). Examples include options to receive other assets, net rights under forward contracts to buy or sell other assets, rights to receive services for which the entity has already paid.
      (iv) enforceable rights to benefit from the stand-ready obligations of another party (paragraphs 63 and 64 discuss stand-ready obligations).
      (v) enforceable intellectual property rights (eg registered patents).
   (b) rights arising under a constructive obligation of another party (see paragraphs 36-59).

(c) other sources of value if they are capable of generating economic benefits, but only for the party that controls the economic resource. Paragraphs 17-30 discuss how an entity establishes control of such economic resources. Examples of such economic resources include:

   (i) know-how

   (ii) customer lists

   (iii) customer and supplier relationships

   (iv) an existing work force

   (v) goodwill. The IASB concluded in paragraphs BC313-323 of the *Basis for Conclusions on* IFRS 3 *Business Combinations* that goodwill does meet the definition of an asset. However, paragraph 9(d) in Section 4 [Agenda Paper 10D(a)] notes that recognising internally generated goodwill is not necessary to meet the objectives of financial statements and would not pass a cost-benefit test.

(d) some assets, particularly many services, that are consumed immediately on receipt.[1]

5. The guidance would clarify that economic benefits derived from an asset are the potential cash flows that can be obtained directly or indirectly in many ways, such as by:

   (a) using the asset to produce goods or provide services.

   (b) using the asset to enhance the value of other assets.

   (c) using the asset to fulfil liabilities or reduce expenses.

   (d) selling or exchanging the asset.

[1] Revenue recognition ED paragraph 31

(e) receiving services from the asset.

(f) pledging the asset to secure a loan.

(g) holding the asset.

6. The supporting guidance would clarify that, for a physical object, such as an item of property, plant and equipment, the economic resource is not the underlying object but a right (or set of rights) to obtain the economic benefits generated by the physical object. Accordingly, although there is a difference in degree between full unencumbered legal ownership of, for example, a machine and a right to use such a machine for a fixed period under a lease, there is no difference in principle. Both the right of full ownership and the right to lease are assets, and both provide rights to use the underlying machine (albeit for a period that may be less than the useful life in the case of the leased asset):

   (a) In the case of the right to use under a lease, the holder's right is to obtain some of the benefits generated by the machine – those benefits generated during the period for which the lessee has the right of use.

   (b) In the case of full unencumbered legal ownership the holder's right is to obtain all of the benefits generated by the machine throughout its useful life.

7. In many cases, economic resources will comprise various different rights. For example, if an entity has legal ownership of a physical object, the economic resource will comprise rights such as:

   (a) the right to use the object

   (b) the right to sell the object

   (c) the right to pledge the object.

   (d) legal title to the object (ie any rights conferred by legal title that are not mentioned separately above).

8. In many cases, one party holds all these rights. Sometimes, as in a lease, different parties hold these rights, in which case each party recognises the rights that it controls.

9. In many cases, an entity treats all of those rights as a single asset. Nevertheless, an entity would treat some of the rights as one or more separate assets if such separation produces information that is relevant to users and provides a faithful representation of the resources, at a cost that does not exceed the benefits of doing so. There is further discussion on unit of account in paragraphs 54-60 in Section 2 of this discussion paper [Agenda Paper 10B(a)].

10. An entity should describe an economic resource in a manner that is clear, concise and understandable. For example, if an entity has legal ownership of a machine and all rights associated with that machine, strictly speaking the entity's asset is the bundle of all rights associated with that machine. However, it would generally be perfectly clear, concise and understandable to describe the entity's asset as a machine, rather than as rights to a machine. More detailed and sophisticated descriptions of the asset would be needed only in unusual circumstances when a summarised or non-technical description would not convey the nature of the asset. Furthermore, it would typically be acceptable, and indeed preferable, to use a concise label on the face of the statement of financial position, providing any necessary detail in the notes.

11. Sometimes, a single resource contains a package of obligations as well as rights. For example, contracts create a series of rights and obligation for each party. The unit of account (see paragraphs 54-60 in Section 2 [Agenda Paper 10B(a)]) will determine whether the entity accounts for that package as a single asset (or single liability) or as one or more separate assets and one or more separate liabilities. In practice, when a package of rights and obligations arises from the same source, an entity will generally account for them at the highest level of aggregation that enables the entity to depict the rights and obligations, and changes in them, in the most relevant, faithful and understandable manner.

12. The unit of account will determine whether a contract is viewed as giving rise to a single net right or net obligation, or to one or more separate rights and obligations and liabilities. Offsetting is not the same as having a single (net) right or single (net) obligation. When a single (net) right or single (net) obligation exists in a particular case, the entity has only a single asset or single liability. For example, suppose that an entity holds an option to buy an asset if it pays CU100 and that the asset will have a value of CU140 if the entity exercises the option. The entity does not have an asset of CU140 and a liability to pay the strike price of CU100. Instead, the entity has an asset of CU40. In contrast, offsetting arises when an entity has both an asset and liability and recognises and measures them separately, but presents them as a single (net) amount (possibly with net disclosure of the separate asset and liability).

13. Paragraph 4 refers to enforceable rights. A right is enforceable if the holder of the right can ensure that it is the party that will receive and can retain any economic benefits generated by the right. Enforceability does not mean that the entity can ensure that those economic benefits will arise. For example, shares normally give the holder an enforceable right to receive its share of any dividends that the issuer chooses to pay, even if the holder cannot compel the issuer to declare a dividend.

14. In assessing whether an item meets the definition of an asset or liability, attention would need to be given to its underlying substance and economic reality and not merely its legal form. In some cases, the legal form is an important part of the substance. In other cases, the legal form is only a minor part of the substance.

15. The following are examples of items that do not meet the definition of an economic resource and hence do not meet the definition of an asset :
    (a) Debt or equity instruments issued by the entity and repurchased by it (eg treasury shares). Similarly, in consolidated financial statements, debt or equity instruments issued by one member of the consolidated group and held by another member of that group are not economic resources of the group. Those

instruments are not capable of providing economic benefits to the reporting entity because the entity cannot have a claim on itself.[2] (However, if another party held those equity instruments, they would be an asset for that party because they are capable of providing economic benefits, such as dividends.)

(b) A call option on the entity's own equity instruments. This is not an asset for the issuer because the underlying equity instruments that would be received on exercise are not an asset for the entity. (However, if another party held that call option, the call option would be an asset for that party, because the equity instruments would be an asset for that party.)

(c) Fish in water to which access is not restricted. Although a potential source of economic benefits, this is not an economic resource because those benefits are available to any party. (A right to catch fish would be an asset of an entity that has an exclusive right to catch them. Similarly, if fishing quotas are introduced, the quota of each party would become an asset of that party, though the rights associated with possession of the fish would still not become an economic resource until the fish are caught.)

(d) Knowledge that is in the public domain and freely available to anyone without significant effort or cost. No party controls such knowledge.

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

[2] A small economic resource may exist because the entity can reissue the debt or equity instruments without incurring the costs that would arise on issuing new instruments. For example, suppose that an entity holds its own shares with a fair value of CU100, and that it would incur costs of CU3 if it issued new shares, but only CU1 if it reissued the shares it holds. The entity controls an economic resource, which is the ability to save issue costs of CU2 by reissuing the shares it already holds.

Control

17. The IASB proposes to retain within the definition of an asset the requirement for the resource to be controlled by the entity. The existing Conceptual Framework does not define the term control. However, the IASB has defined control in some individual IFRSs. The IASB proposes to build on these definitions to define the meaning of control in the context of the definition of an asset.

Existing definitions of control

18. The concept of control is used in IASB's Exposure Draft *Revenue from Contracts with Customers* (the draft Revenue standard), published in November 2011, and IFRS 10 *Consolidated Financial Statements*.

19. The draft Revenue standard uses the concept of control to determine when an entity has transferred an asset to another party and has, consequently, satisfied a performance obligation. It defines control of an asset in this context as follows:

> Control of a promised good or service (ie an asset) is the customer's ability to direct the use of and obtain substantially all of the remaining benefits from the asset.

20. IFRS 10 uses the concept of control to determine when one entity should consolidate another entity. IFRS 10 defines control of an entity as follows:

> An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee.

21. Thus, IFRS 10 sets out the following three elements of the principle of control:

(a) power over the investee;

(b) exposure, or rights, to variable returns from involvement with the investee; and

(c) the ability to use power over the investee to affect the amount of the investor's returns.

22. An investor has power over an investee when the investor has existing rights that give it the current ability to direct the activities that significantly affect the investee's returns.

23. The definitions of control in the draft Revenue standard and in IFRS 10 differ from each other. However, they are based upon the same basic concepts, ie that the entity has the ability to direct the use of the asset (entity) so as to obtain benefits (returns).

Proposed definition for the Conceptual Framework

24. The IASB proposes a definition of control for the Conceptual Framework that is closer to the definition in the draft Revenue standard than to the definition in IFRS 10. This proposal reflects the fact that both the proposed definition and the definition in the draft Revenue standard deal with control of an asset; the definition in IFRS 10 defines control of an entity.

25. For an entity to control an asset, the economic benefits arising from the asset must flow to the entity (either directly or indirectly) rather than to another party. In order to obtain those benefits, the entity must be able to direct the use of the asset. Consequently, the IASB proposes to define control of an asset as follows:

> An entity controls an asset if it has the present ability to direct the use of the asset so as to obtain the economic benefits that flow from the asset.

26. An entity has the ability to direct the use of an asset if it has the right to deploy that asset in its activities or to allow another party to deploy that asset in the other party's activities. Many assets take the form of legally enforceable rights, for example legal ownership or contractually enforceable rights, that establish the entity's ability to direct the use of the asset. However, sometimes an entity establishes its ability to direct the use of the asset by having access that is not available to others, for example by having possession and being able to prevent physical access by others. This can be particularly relevant for assets such as know-how and customer lists.

27. When determining whether an entity controls an economic resource, it is important to identify the resource correctly. For example, entities A, B and C may jointly own real estate on terms that provide them with 25%, 40% and 35% respectively of the economic benefits flowing from that real estate. In such cases, each party controls its proportionate interest in the underlying economic resource (the real estate in this example). No single party controls the underlying real estate in its entirety.

28. Although the definition of control proposed in this Discussion Paper is similar to the definition used in the draft Revenue standard, it does not require that the customer acquires *substantially* all the remaining benefits of the asset The reference to substantially all the benefits was included to help clarify the appropriate treatment when an entity retains some of the benefits associated with an asset (for example the right to receive consideration that is based on future sales generated by the sold asset). However, at a conceptual level this clarification is unnecessary. Consequently, the definition proposed in this Discussion Paper omits the reference to substantially all the benefits associated with an asset.

Control: principal and agent

29. An agent is a party primarily engaged to act on behalf of and for the benefit of another party (the principal). If an entity holds a resource as agent, rather than as principal, the economic benefits arising from the resource flow to the principal rather than to the

agent. Consequently, the agent does not control the resource and does not have an asset. (Accordingly, the agent also has no obligation to transfer the economic benefits derived from the asset).

30. If an entity holds a resource, and is bound by a separate requirement (such as a contractual requirement or legislation) to pass through to another party all the economic benefits flowing from that resource, the entity holds that resource as agent for the other party. Thus, the entity has no asset or liability.

Corresponding guidance for liabilities

31. The proposed definition of a liability of an entity specifies that the obligation must be an obligation of the entity. In other words, the entity must be the party that is bound by the obligation. This feature of the definition corresponds to the fact that the proposed definition of an asset of an entity specifies that the entity must be the party that controls the asset. Identifying which party is bound by an obligation will rarely be difficult because this will normally be evident from the documents or other evidence that establish that the obligation exists.

Transfer of an economic resource

32. The IASB proposes to define a liability as a present obligation to transfer an economic resource. The phrase ‘to transfer an economic resource’ is a change to the existing definition. It reflects the proposal in the draft Revenue standard to define a performance obligation as ‘promise … to transfer a good or service to the customer’. The IASB proposes to clarify the matters set out below.

33. An obligation to transfer an economic resource may result in an entity paying cash, transferring assets other than cash, granting a right to use an asset, rendering services, or standing ready to make a payment on the occurrence of a future event that is outside the entity's control.

34. In some cases, an entity may have an obligation that it will settle by undertaking a second obligation, for example by issuing a financial liability. If that second obligation requires the entity to transfer an economic resource, the first obligation is also an obligation to transfer an economic resource.

35. The following **do not** give rise to a present obligation to transfer an economic resources

(a) a requirement to provide economic resources only if, at the same time or earlier, the entity receives economic resources of equal or greater value. (See also the discussion on executory contracts in paragraphs 90-94.)

(b) an obligation that an entity is permitted (or required) to fulfil by issuing its own equity instruments as "currency". Although those equity instruments are a resource for the holder, they are not an economic resource for the issuer. Therefore, an obligation to issue equity instruments is not an obligation to transfer an economic resource. As explained in paragraph 15(a), this is the case even if the issuer previously held those equity instruments as 'treasury shares'. See Section 5 [Agenda paper 10E(a)] for a discussion of the distinction between liabilities and equity instruments.

Constructive obligations

Existing requirements and guidance

36. The IASB proposes to define a liability as an 'obligation'. The existing Conceptual Framework describes an obligation as 'a duty or responsibility to act in a certain way'. It then states that, although obligations may be legally enforceable as a consequence of a binding contract or statutory requirement, they may also arise 'from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner'[3].

37. IAS 37 *Provisions, Contingent* Liabilities *and Contingent Assets* notes that a liability can arise from a legal obligation or from a 'constructive' obligation, and defines the latter as follows:

> A *constructive obligation* is an obligation that derives from an entity's actions where:
>
> (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
>
> (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

38. Applying this definition, the *Guidance on Implementing* IAS 37 identifies as an example of a constructive obligation the environmental obligations of an entity that, although operating in a country with no environmental legislation, has a record of honouring its widely-published policy of cleaning up all contamination it causes[4].

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[3] Paragraph 4.15.

[4] *Guidance on Implementing* IAS 37, Section C, Example 2A.

39. IAS 19 *Employee Benefits* also refers to constructive obligations. It requires entities to account for both legal and constructive obligations for employee benefits. It describes legal obligations as arising from the formal terms of employment contracts or benefit plans, and constructive obligations as arising from the entity's informal practices. It states that informal practices (such as paying bonuses in excess of those to which employees are contractually entitled) give rise to a constructive obligation if they leave the entity with no realistic alternative but to pay benefits, for example if a change in practices would cause unacceptable damage to the entity's relationship with its employees[5].

40. IFRS 2 *Share-based Payment* also uses the notion of constructive obligations, though without using the label. It states that an entity has a present obligation to settle a share-based payment transaction in cash if 'the entity has a past practice or stated policy of settling in cash, or generally settles in cash whenever the counterparty asks for cash settlement'[6].

Problems in practice

41. Some people using IFRSs have reported that it can be difficult to judge whether and to what extent an entity's past practices, policies or statements are sufficient to have created a valid expectation among other parties that the entity will accept specific responsibilities.

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[5] IAS 19, paragraph 4(c). The description of a constructive obligation in IAS 19, including the notion of 'no realistic alternative', was based on the exposure draft that preceded IAS 37. The IASB's predecessor, the IASC, did not conform the wording in IAS 19 to the final wording in IAS 37 because it did not have a practice of making consequential amendments to other standards.

[6] IFRS 2, paragraph 41.

42. Furthermore, it can be difficult distinguish constructive obligations from situations in which an entity is economically compelled to take a particular course of action in future because that action will be so much more economically advantageous—or less economically disadvantageous—than any of the available alternatives. For example, difficulties arose when the European Union issued a directive that prompted IFRIC Interpretation 6 *Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment*. The directive required manufacturers of electrical and electronic equipment to contribute to the costs of disposing of equipment manufactured in earlier periods (historical waste), with each manufacturer's contribution being proportional to its market share in a specified period (the measurement period). Some people argued that manufacturers had a constructive obligation for the costs of historical waste before the measurement period because 'when it would be necessary for the entity to undertake an unrealistic action in order to avoid the obligation then a constructive obligation exists and should be accounted for'. The IFRIC rejected this argument, concluding that 'a stated intention to participate in a market during a future measurement period does not create a constructive obligation for future waste management costs'. [7]

43. It is perhaps not surprising that people think that economic compulsion can be sufficient to create a constructive obligation. Some (older) IFRSs identify constructive obligations in situations in which the entity might be economically compelled to act in a particular way, but does not necessarily have an obligation to another party to do so. For example:

[7] IFRIC 6, paragraphs BC9 and BC10.

(a) IAS 37 identifies an entity as having a 'constructive obligation' to restructure a business once it has announced or started to implement a detailed restructuring plan[8]; and

(b) IAS 34 *Interim Financial Reporting* identifies a lessee as having a constructive obligation for contingent lease rentals at its interim reporting date, if it expects to achieve by the end of the period a specified level of sales above which contingent lease rentals would become payable.

44. In the contingent lease rental example, any obligation that the lessee has to the lessor is a legal (contractual) one. There is no constructive obligation arising in advance of the legal obligation—the lessee does not have a constructive obligation to continue to make sales for the rest of its reporting period. The IASC appears to have used the term 'constructive obligation' to justify the recognition of a liability before the legal obligation has become unconditional, ie while the outcome depends on the entity's future actions.

Possible solutions

45. There is less risk of 'constructive obligations' being wrongly identified for situations like contingent lease rentals if the IASB provides additional guidance on the impact of uncertain future events (including the entity's own future actions). Such guidance is discussed in paragraphs 60-78 below. If it is clearer that legal obligations can exist before all conditions have been satisfied, people might be less inclined to use the term 'constructive obligation' to describe legal obligations whose outcome depends on the entity's future actions.

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[8] IAS 37, paragraph 72.

46. The IASB could take further steps to improve comparability and distinguish constructive obligations from economic compulsion. These steps could involve:

    (a) adding further guidance to support the definition of a constructive obligation (paragraphs 47-51); or

    (b) limiting the definition of a liability to obligations that another party could *enforce* against the entity (paragraphs 52-58).

Improve guidance on 'constructive obligations'

47. One approach would be to add guidance to support the definition of a constructive obligation. Additional guidance could emphasis that for an entity to have a constructive obligation:

    (a) it must have a duty or responsibility *to another party*. It is not sufficient that an entity will be economically compelled to act in its own best interests or in the best interests of its shareholders;

    (b) the other party must be one who would benefit from the entity fulfilling its duty or responsibility or suffer loss or harm if the entity fails to fulfil its duty or responsibility. In other words, the other party must be the one to whom, or on whose behalf, the entity is required to transfer an economic resource (without receiving resources of equivalent value in exchange); and

    (c) as a result of the entity's past actions, the other party can reasonably rely on the entity to discharge its duty or responsibility.

48. Further guidance could be added to clarify (as IAS 37 already does) that it is not necessary to know the identity of the party to whom the obligation is owed—indeed the obligation may be to the public at large.[9]

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[9] IAS 37, paragraph 20.

49. Adding this guidance should not undermine existing requirements for well-understood examples of constructive obligations—such as obligations for environmental rehabilitation or employee benefits—because in these cases there is usually a counterparty that is reasonably relying on the entity to discharge its responsibilities. However, the guidance would clarify that, although an entity might be economically compelled to continue to operate in a particular market or to restructure an underperforming business, such economic compulsion does not in itself amount to a constructive obligation.

50. The IASB proposed this approach in 2005 in its Exposure Draft of Proposed Amendments to IAS 37 and IAS 19. The IASB proposed additional guidance[10] similar to that set out in paragraph 47 and, on the basis of that guidance, concluded that an entity does not have a constructive obligation to restructure a business, even it if has announced or started to implement a detailed restructuring plan. This is because it has no obligation to others and is not bound by its plan so can avoid an outflow of resources.[11] Consequently, the IASB proposed to delete from IAS 37 the requirements for recognising restructuring provisions and replace them with a statement that 'a cost associated with a restructuring is recognised on the same basis as if that cost arose independently of the restructuring'[12].

51. This proposal—which would have aligned IAS 37 with US generally accepted accounting principles, and would still have required entities to identify liabilities for some individual costs associated with a restructuring—received widespread support from those commenting on the exposure draft. However, the IASB never

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[10] Exposure Draft of proposed amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IAS 19 *Employee Benefits*, published in June 2005, paragraph 15.

[11] Paragraph BC68.

[12] Paragraph 62.

implemented the proposal because it halted its project to amend IAS 37 in the light of comments received on some other changes proposed in the exposure draft.

Define 'obligation' to mean enforceable

52. Alternatively, the IASB could make a more substantial change. Rather than emphasising the need for an obligation to another party, the IASB could limit the definition of a liability to obligations that another party could *enforce* against the entity.

53. The IASB developed such an approach during the *Elements and Recognition* phase of its Conceptual Framework project in 2007-2008. The IASB tentatively approved a working definition of a liability that would require the obligation to be 'enforceable against the entity by legal or equivalent means'. Additional draft guidance explained that 'equivalent means' would be those in which there was both an enforcement mechanism and a separate party to operate the mechanism. Examples of 'equivalent means' included:

    (a) the disciplinary procedures of a self-regulatory body; and

    (b) an arbitration mechanism set up by a commodity exchange to resolve disputes between member traders.

54. Legally enforceable obligations include those that are established by contract or imposed by government. In some jurisdictions, some constructive obligations (as defined in IAS 37) may also be legally enforceable. However, in other cases, constructive obligations might not be enforceable against the entity.

55. Defining a liability as an obligation that is enforceable by legal or equivalent means could eliminate the need to define a constructive obligation.

56. Any requirement for an obligation to be enforceable by legal or equivalent means would refer to the *mechanism* that creates an obligation. It would not affect the assessment of *when* that obligation arises. In other words, it would not rule out obligations that will become enforceable only on the occurrence of an uncertain future event. So it could be applied with any of the approaches discussed in paragraphs 68-77 of this Section of the Discussion Paper.

57. In favour of restricting liabilities to obligations that are enforceable by legal or equivalent means, it could be argued that:

    (a) if a future transfer of resources is not enforceable against the entity, it is not an obligation. An entity is not bound by another party 'reasonably relying' on it to continue its past practices or policies. The entity retains the discretion to balance the benefits of transferring resources (such as maintaining good relationships or avoiding reputational damage) against the costs. If the entity faces financial difficulties, it could change its policies or practices and avoid the transfer of resources. In other words, any future transfer will be discretionary and should be recognised when the discretion is exercised.

    (b) restricting liabilities to enforceable obligations could improve comparability. Identifying a constructive obligation requires the entity to judge whether another party can 'reasonably' rely on the entity to discharge specified responsibilities. Such judgements could be extremely subjective. Arguably, evidence of enforceability is the most tangible evidence that the other party could rely on the entity to discharge its responsibilities.

    (c) restricting liabilities to enforceable obligations would provide users of financial statements with relevant information about the obligations that an entity cannot avoid. For some transactions, it might also be appropriate to require disclosure of information about other (unenforceable) costs that the entity expects to incur in future in relation to past activities (eg for discretionary rehabilitation of previous environmental damage). Any disclosure requirements could be considered in individual standards.

58. However, against restricting the definition of a liability to enforceable obligations, it could be argued that:

    (a) an approach that excludes some constructive obligations could provide less relevant information to users of financial statements about the entity's future cash flows relating to past activities. For example, suppose a mining company has a well-publicised policy of restoring environmental damage to the same standard throughout the world. If, for each jurisdiction in which it operates, it recognised a liability for only the costs that it could be forced to incur applying the legal requirements in that jurisdiction, it would not recognise the full expected costs of its mining activities for the period.

    (b) if concerned about comparability for any particular types of transaction, the IASB could, at a standards level, require liabilities for that type of transaction to be legally enforceable. The US Financial Accounting Standards Board (FASB) took this approach in its requirements for asset retirement obligations. The definition of a liability in the FASB *Statements of Concepts* encompasses legal, equitable and constructive obligations, including obligations that are not legally enforceable[13]. However, the FASB's requirements for asset retirement obligations[14] apply only to legal obligations[15]. The FASB concluded that determining when a constructive obligation exists can be very subjective, so restricting the requirements to legal obligations would achieve more consistent application[16].

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[13] FASB Statement of Concepts No. 6 *Elements of Financial Statements*, paragraphs 36 and 40.

[14] Topic 410-20-15 in the FASB Accounting Standards Codification®

[15] The FASB Codification defines a legal obligation as: An obligation that a party is required to settle as a result of an existing or enacted law, statute, ordinance, or written or oral contract or by legal construction of a contract under the doctrine of promissory estoppel.

[16] FASB Statement No. 143 *Accounting for Asset Retirement Obligations*, Appendix B, Paragraph B16.

The IASB's preliminary view

59. The IASB's preliminary view is that the Conceptual Framework should not limit liabilities to obligations that can be enforceable by legal or equivalent means. The IASB tentatively favours retaining the existing definition of a liability—which encompasses both legal and constructive obligations—and adding more guidance to help distinguish constructive obligations from economic compulsion. The guidance should clarify the matters listed in paragraph 47.

Obligations whose outcome depends on future events

60. The IASB proposes to define a liability as a *present* obligation to transfer an economic resource. A present obligation is one that exists at the reporting date. The economic resource to be transferred need not exist at that date, nor need the entity control it already at that date. In many cases, an entity has a present obligation and will fulfil that obligation with economic resources that it will acquire in the future.

61. To identify a liability it is necessary to distinguish between present obligations and possible future obligations. Difficulties are often encountered in practice because it is unclear whether an entity has a present obligation while any requirement to transfer resources remains conditional on the occurrence of uncertain future events. This question has arisen both for the IASB in developing new standards, and for the IFRS Interpretations Committee and others in interpreting existing standards. The frequent difficulties suggest that the existing Conceptual Framework is not sufficiently clear in this area and that further guidance is required.

62. Future events can be of two types:

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

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

Future events outside the control of the entity

63. In some situations, the outcome of an obligation depends on the occurrence or non-occurrence of future events that are outside the control of the entity. Such obligations include, for example:
    (a) an insurer's obligation to compensate a policyholder on the occurrence of an insured event, such as damage to property;
    (b) a guarantor's obligation to compensate a lender if a borrower defaults;
    (c) an entity's obligation to redeem a financial instrument for cash if the holder of the instrument exercises an option to require redemption; or
    (d) an entity's obligation to make an additional payment for purchased plant or equipment if the plant or equipment meets specified performance levels at a future date.

64. Obligations of this kind are sometimes called 'stand-ready' obligations. Although the entity does not know at the reporting date whether it will be required to transfer resources, it has an unconditional obligation to stand ready to transfer the resources if the specified future event occurs. The IASB has concluded that these unconditional obligations are present obligations that meet the definition of a liability. The requirements of several recent and forthcoming IFRSs—such as the forthcoming IFRS for revenue recognition and the forthcoming exposure draft on insurance contracts—reflect this conclusion. The IASB thinks that it will be helpful if the Conceptual Framework also states the conclusion in general terms.

Future events that depend on the entity's future actions

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

66. There are numerous transactions for which this question arises. Several examples are set out below. The IASB has included these examples to help illustrate the scope of the problems and the possible consequences of different solutions. The IASB does not plan to reproduce the examples in the Conceptual Framework. Neither will it necessarily existing requirements for the transactions illustrated in the examples: any decision to amend an existing IFRS would require the IASB to go through its normal processes for adding a project to its agenda, and for developing an exposure draft and an amendment to that IFRS.

Example 1: Employee bonus with vesting conditions

Under the terms of its employment contracts with a group of employees, an entity will pay a bonus to each employee who completes five years' service with the entity. The employees have completed two of the five years' service at the end of the reporting period. If the entity terminates an employment contract before the end of the vesting period (i.e. before the five years' service is complete) it will not be required to pay any bonus to the employee. However, the employees have performed well and the entity has no reason to terminate their employment contracts.

Example 2: Rail levy with threshold

A government charges a levy on entities that operate trains on the national rail network. The levy is charged at the end of each calendar year. The levy is 1% of revenue earned in the year in excess of CU500 million. A train operator is preparing financial statements for its financial reporting year to 30 June. It has earned revenue of CU450 million between 1 January and 30 June. It expects to have earned revenue of CU900 million by the end of the calendar year and hence to be charged a levy of CU4 million[17] for the year.

17 (CU900 million – CU500 million) × 1%

Example 3: Electricity supplier levy

A government imposes a levy on entities that supply electricity to a domestic energy market on or after 1 April each year. The levy charged on that date is measured as a percentage of the operator's revenue in the *previous* calendar year. An entity with a reporting period ending on 31 December 20X0 earned revenue of CU100 million during 20X0. It will be charged a levy only if it is still supplying electricity to the specified market on 1 April 20X1.

Example 4: Bank levy

A government imposes a levy on banks. The levy is charged on any entity that is operating as a bank at the end of its financial reporting period. The levy is calculated as a percentage of the bank's liabilities at the end of that period. The percentage depends on the length of the bank's reporting period and on the rates in force during that period. In 20X2, the rates are 0.1% per month from January-June and 0.2% per month from July-December. A bank's financial reporting period began on 1 April 20X2. The bank is preparing interim financial statements at 30 September 20X2.

Example 5: Waste disposal levy

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

Example 6: Emissions trading scheme

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

Example 7: Variable lease payments

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

Example 8: Contingent consideration

A contract for the sale of a business requires the acquirer to make an additional payment of CU5 million to the seller if the acquired business meets specified earnings targets in the three years after acquisition. The acquirer is preparing financial statements at the acquisition date. Available evidence suggests that it is highly likely that the earnings targets will be met.

67. The following paragraphs discuss three alternative approaches to determining whether a present obligation exists in each of the above examples.

Approach 1: An obligation must be unconditional

68. One approach would state that an obligation must be unconditional. For as long as the entity could, at least in theory, avoid the transfer of resources through its future actions, it does not have a present obligation. In other words, if a series of actions or events must take place before an entity has an unconditional obligation, no liability exists until *all* of the actions or events have taken place. Following this approach, there would not be a present obligation in any of the examples set out above. In each case, the future transfer is conditional on a future action that the entity could avoid taking:

Table 1: Applying approach 1 to examples

	Example	Present obligation?	Reason
1	Employee bonus with vesting conditions	No	The employer could terminate employment contracts before the end of the vesting period.
2	Rail levy with threshold	No	The rail operator, electricity supplier, bank and electronic equipment manufacturer could stop operating in the relevant market before the date/period on which a levy would become payable.
3	Electricity supplier levy	No	
4	Bank levy	No	
5	Waste disposal levy	No	
6	Emissions trading scheme	No	The power-generating company could install new equipment to avoid emissions or cease production entirely.
7	Variable lease payments	No	The lessee could avoid making sales from leased retail unit.
8	Contingent consideration	No	The acquirer could conduct the operations of the acquired business so that it fails to meet specified earnings targets.

Approach 2: An obligation arises when the entity receives benefits for which it accepts a responsibility to transfer a resource

69. The approach described in paragraph 68 identifies a present obligation by reference to the *last* in the series of events or actions that must take place before the entity is unconditionally required to transfer a resource to another party. However, the last event or action might be a relatively minor one—an incidental condition that the entity does not have the practical ability to avoid and, hence, that the other party can be reasonably assured that the entity will fulfil.

70. It could be argued that, in such circumstances, treating the last event or action as the one that creates a present obligation does not faithfully represent the entity's financial position. An entity normally incurs a liability in exchange for benefits received. And the critical event is the event that gives the entity a responsibility to pay for the benefits received. Such a responsibility can arise before the obligation is unconditional if the entity does not have the practical ability to avoid any remaining conditions.

71. On that basis, an alternative approach (Approach 2) would identify a liability at the earlier of the two following times:

    (a) when the entity incurs an unconditional obligation to transfer an economic resource; or

    (b) when the entity receives benefits in exchange for which it accepts a responsibility to transfer an economic resource.

72. If an entity receives benefits before it incurs an unconditional obligation, judgement would be required to determine whether it has accepted a responsibility to transfer an economic resource in exchange. Indications that the entity has accepted such a responsibility might be, for example, that:

(a) the entity does not have the practical ability to avoid satisfying the future actions that would make the obligation unconditional;

(b) the possibility of the entity not satisfying the conditions has no discernible effect of the pricing of the transaction; or

(c) the entity cannot avoid the future actions if it remains a going concern.

73. In some situations, there is a direct and explicit exchange between the entity and another party—the entity receives benefits from, and accepts a responsibility to transfer a resource to—the same party. For example, it might receive consideration from a customer in exchange for an obligation to transfer goods or services to that customer. However, in other situations, there might not be a direct and explicit exchange with one other party—the entity might incur an obligation to pay *one* party (such as to pay a tax to a government) as a result of receiving benefits from *another* party (such as revenues from customers). In such situations, more judgement might be required to identify the event or action that gives rise to the benefits in exchange for which the entity has accepted a responsibility to transfer an economic resource. Table 2 illustrates how the approach might apply to the examples set out in paragraph 66:

Table 2: Applying approach 2 to examples

	Example	Present obligation?	Reason
1	Employee bonus with vesting conditions	Yes	The employer has received benefits (two years of service from employees) in exchange for which it has accepted a responsibility to pay a bonus. It does not have the practical ability to terminate the employment contracts before the end of the vesting period. It has a present obligation for the portion of the total expected bonus attributable to the benefits already received, ie the first two years of service.

	Example	Present obligation?	Reason
2	Rail levy with threshold	Yes	The rail operator has started to receive the benefits (earn the revenue) for which it accepts a responsibility to transfer a resource, ie to pay a levy if revenues exceed the annual threshold of CU500 million. The rail operator does not have the practical ability to stop earning revenue before it reaches the threshold.
3	Electricity supplier levy	Yes	The electricity supplier has received the benefits (revenues) for which it accepts a responsibility to pay a levy if still in the market on 1 April of the following year. It does not have the practical ability to exit the market before that date.
4	Bank levy	Yes	The bank has received the benefits of operating in the period over which the levy accumulates. It does not have the practical ability to stop operating as a bank before the end of its financial reporting period.
5	Waste disposal levy	No?	The manufacturer has received the benefits (revenues) of selling historical waste, but has not yet received the benefits (revenues) of having market share in 2014. It does not have a present obligation if the entity judges that market share in 2014 is the benefit for which it has accepted a responsibility to contribute to the disposal costs for historical waste.
6	Emissions trading scheme	No	The power generator has not yet started generate power (and emit carbon dioxide) in the compliance period. It has not yet received the benefits (ie the power that it will generate when it emits carbon dioxide) for which it accepts a responsibility to transfer allowances to the scheme administrator.
7	Variable lease payments	No	The lessee has received a right-of-use asset. But the absence of fixed lease payments indicates that the lessee does not accept a responsibility to pay for the right-of-use asset. It accepts a responsibility only to pay for the benefits that it will generate from the right-of-use asset, ie the sales from the retail unit. The lessee has not yet started to receive those benefits.
8	Contingent consideration	No	The rationale is similar to that for the variable lease payments. The acquirer has not yet started to make progress to the earnings threshold. Progress towards the threshold is the benefit for which the acquirer accepts a responsibility to pay contingent consideration.

Approach 3: Focus on past events instead of future events

74. Paragraph 68 describes an approach (Approach 1) that identifies a liability only when the *last* event required to make the obligation unconditional has occurred. At the other extreme would be an approach that identifies a liability if *any* event has occurred that will oblige the entity to transfer economic resources to another party on more onerous terms than would have been required without that past event. That obligation to transfer resources could be unconditional (i.e. exercisable immediately or at a specified future date) or conditional on the occurrence or non-occurrence of a future event.

75. The rationale would be similar to that used in IAS 19 *Employee Benefits* for requiring entities to recognise liabilities for unvested employee benefits, i.e. that 'at the end of each successive reporting period, the amount of future service that an employee will have to render before becoming entitled to the benefit is reduced'[18].

Table 3: Applying approach 3 to examples

	Example	Present obligation?	Reason
1	Employee bonus with vesting conditions	Yes	Employees have provided two years of service. As a result of employees' past service, the entity will have to pay employees a five-year bonus in exchange for only three further years of service.
2	Rail levy with threshold	Yes	Because the entity has already earned revenue of CU450 million, it will pay a levy on future revenue in excess of CU50 million. In the absence of the past revenue, the entity would have had to pay a levy only on future revenue in excess of CU500 million.

18 IAS 19, paragraph 69.

	Example	Present obligation?	Reason
3	Electricity supplier levy	Yes	As a result of revenue earned in 20X0, the electricity supplier will be required to pay a levy if operating on 1 April 20X1. In the absence of that past revenue, it would pay no levy on 1 April 20X1.
4	Bank levy	Yes	As a result of operating in first half year, any levy that the bank will be liable for at end of its reporting period will be higher than it would have been if it had not operated in the first half year. (The portion of the levy that is attributable to its first half year is 0.9%[19] of the bank's expected period-end liabilities.)
5	Waste disposal levy	No	There has been no past event that will require the manufacturer to pay a larger levy than would otherwise be the case. The manufacturer will be charged the same levy as a new market entrant achieving the same market share in 20X4.
6	Emissions trading scheme	Yes	The power generator will have to transfer more allowances to scheme administrator at the end of compliance period than it would have had to deliver if it had not already received its up-front allocation of allowances. If it had not already received allowances, it would be entitled to receive some before having to transfer any back. The present obligation is the value of the allowances that the entity has received for the remaining compliance period (not the value of those it expects to transfer to the administrator at the end of the period). Assuming that the entity would receive proportionally fewer allowances for shorter compliance periods, the liability would gradually reduce to zero over the compliance period. That liability would be a replaced by an unconditional liability to transfer allowances, which will accumulate over the compliance period as the entity emits carbon dioxide.

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

	Example	Present obligation?	Reason
7	Variable lease payments	Yes	As a result of past event (having received right of use of retail unit) the lessee will have to pay to the lessor 1% of any sales it makes during the remaining lease period.
8	Contingent consideration	Yes	As a result of past event (having acquired business from former owner), the acquirer will have to pay cu5 million on the achievement of earnings targets.

76. The identification of a present obligation would not necessarily lead to the recognition of a liability in each of these examples. In some of the cases the liability might not satisfy the recognition criteria discussed in Section 4 [Agenda Paper 10D(a)]. For example, the IASB might conclude that in Example 7:

    (a) recognising the lessee's present obligation to make variable lease payments (and an equal amount as a right-of-use asset) might not provide users with information that is sufficiently relevant to justify the cost or

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

Common features of all approaches

77. Whichever of these approaches applied, the following would not meet the definition of a present obligation:

    (a) requirements to make payments that would arise only on liquidation (for example payments to ordinary shareholders and costs that the entity would incur only on liquidation). As noted in paragraph 4.1 of the existing Conceptual Framework, financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future.

(b) losses that an entity expects to incur if it chooses to stay in business, but will avoid if it closes the business. Even though financial reporting generally presumes that an entity is a going concern, that fact does not mean that the entity is obliged to remain in business. A future loss is not a present obligation to transfer an economic resource.

The IASB's preliminary view

78. [To be discussed at the April 2013 IASB meeting.]

The substance of contractual rights and contractual obligations

Introduction

79. An important class of resources and obligations is the class of resources and obligations that arise under contracts. Entering into a contract gives rise to rights and obligations, if (and only if) those rights and obligations are enforceable.

80. This section considers whether there should be more guidance in the Conceptual Framework on identifying the substance of contractual rights and contractual obligations.

Existing requirements and guidance

81. To give a faithful representation of an entity's contractual rights and obligations, financial statements should report their substance. The existing Conceptual Framework states that 'in assessing whether an item meets the definition of an asset,

liability or equity, attention needs to be given to its underlying substance and economic reality and not merely to its legal form'[20]. Some individual IFRSs also refer to substance. For example IAS 32 Financial Instruments—Presentation states that 'the substance of a financial instrument, rather than its legal form, governs its classification in the entity's statement of financial position'[21]

82. The existing Conceptual Framework gives little further guidance on assessing the substance of contractual rights and obligations. However, several IFRSs give guidance for specific types of transaction. For example:

(a) several IFRSs require entities to disregard contractual terms that have 'no commercial substance', 'lack commercial substance' or are 'not substantive'. For example, IFRS 4 *Insurance Contracts* requires entities to identify the existence of significant insurance risk 'ignoring scenarios that lack commercial substance'[22]. IFRS 2 *Share-based Payment* states that an entity with a choice of settling a share-based payment transaction either in cash or by issuing equity instruments 'has a present obligation to settle in cash if the choice of settlement in equity instruments has no commercial substance'[23]. And IFRS 10 *Consolidated Financial Statements* requires an investor to consider only substantive rights in assessing whether it controls an investee[24].

(b) IFRS 10 provides guidance that 'for a right to be substantive, the holder must have the practical ability to exercise that right'[25]. IFRS10 also gives several examples of factors that might affect an acquirer's practical ability to exercise

[20] Conceptual Framework, paragraph 4.6.

[21] IAS 32, paragraph 18.

[22] IFRS 4, paragraph B23.

[23] IFRS 2, paragraph 41.

[24] IFRS 10, paragraph B22.

[25] IFRS 10, paragraph B22.

its rights relating to an investee. These factors include, for example, barriers (economic or otherwise) that prevent the holder from exercising the rights, such as ‘financial penalties and incentives’ or ‘terms and conditions that make it unlikely that the rights would be exercised’[26].

(c) IFRS 4 defines a scenario that lacks commercial substance as one that has ‘no discernible effect on the economics of the transaction’[27].

83. Consistent principles underlie the guidance in these IFRSs. The IASB thinks that it would be helpful to add those underlying principles to the Conceptual Framework itself. The Conceptual Framework could state that:

(a) an entity should report the substance of a contract. In some cases, the legal form of a contract is an important part of the substance of the contract. In other cases, the legal form is only a minor part of the substance.

(b) a group or series of contracts that achieves, or is designed to achieve, an overall commercial effect should be viewed as a whole. One situation in which this treatment may be particularly important is if rights or obligations in one contract entirely negate obligations or rights in another contract.

(c) conversely, if a single legal document contains two or more sets of rights and obligations that would all have been identical if they had been created through more than one legal document, the entity may need to account for them in the same way as if they were separate contracts.

(d) all terms—whether explicit or implied —should be taken into consideration. Implied terms could include, for example, obligations imposed by statute, such as statutory warranty obligations imposed on entities that enter into contracts for the sale of goods to customers.

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[26] IFRS 10, paragraph B23(a).

[27] IFRS 4, paragraph B23.

(e) terms that have no commercial substance should be disregarded. A term has no commercial substance if it has no discernible effect on the economics of the contract. Terms that have no commercial substance could include, for example:

   (i) terms that bind neither party.

   (ii) rights (including options) that the holder will not have the practical ability to exercise.

(f) if, after disregarding options with no commercial substance, an option holder has only one remaining option, that option is in substance a requirement.

The role of economic compulsion in assessing contractual obligations

84. Some people have asked the IASB for further guidance on the role of economic compulsion in assessing the substance of contractual obligations. They have noted that existing guidance on this matter can appear inconsistent. For example, in 2006, the IASB discussed the role of economic compulsion in identifying 'contractual obligations' within financial instruments. It stated that 'a contractual obligation could be established explicitly or indirectly, but it must be established through the terms and conditions of the instrument. Thus, by itself, economic compulsion would not result in a financial instrument being classified as a liability applying IAS 32'.[28] In contrast, in some forthcoming IFRSs, the IASB proposes to require entities to take into account a 'significant economic incentive' in assessing the extent of their contractual obligations.

[28] IASB *Update*, June 2006

85. Problems that arise in practice often concern the role of economic compulsion in determining the appropriate classification—ie as liabilities or equity—of particular types of financial instrument, such as that described below:

> **Example: Financial instrument with 'dividend blocker' and 'step-up' clauses**
>
> The terms of a financial instrument are such that the issuer has no contractual obligation to pay an annual dividend to the holder, or to ever redeem the instrument. However:
>
> (a) the issuer has an *option* to pay a dividend of a specified amount. Unless the issuer pays the full amount, it cannot pay any dividend to its ordinary shareholders; and
>
> (b) the issuer has an *option* to redeem the instrument at a specified future date. If it does not redeem the instrument on that date, the dividend 'steps up' to an amount that would give a cost of finance higher than the issuer would otherwise have to incur.

86. In this example, the issuer appears to have options, but not obligations. However, the linkage to dividends on the ordinary shares and the 'step-up' clause may economically compel the issuer to redeem the instrument on the specified date. Otherwise, it could suffer the adverse economic consequences of the disaffection of ordinary shareholders, difficulties in raising similar finance again and a higher cost of finance than it would otherwise have to incur. Thus, the holders can be reasonably assured of receiving the redemption proceeds (including any 'discretionary' dividends not already paid before redemption), ie the same benefits as the holders of fixed-rate debt.

87. Depending on the specific terms of the step-up clause, the guidance proposed in paragraph 83 above might be sufficient to lead to a conclusion that the instrument is in substance a liability. If the terms of the step-up clause are so disadvantageous to the issuer that the instrument is priced and behaves like fixed-term debt, it could be argued that the option to *not* redeem the instrument on the specified date has 'no discernible effect on the economics of the transaction'. In that case, applying the guidance

proposed in paragraph 83(e), the entity would disregard this option. The issuer would have only one remaining ‘option’, namely to redeem the instrument. Applying the guidance proposed in paragraph 83(f), this single remaining ‘option’ would be regarded as a requirement—an obligation to redeem—which would make the instrument a liability.

88. However, the analysis might be less straightforward if the terms of the step-up clause give *some* commercial substance to the issuer’s option not to redeem—although it is highly likely that the issuer will redeem the instrument on the specified date, it is possible that in some circumstances it will opt not to, for example if is in severe financial difficulties at the time.

89. The IASB thinks that, even if the option not to redeem has some commercial substance, the overall substance of the instrument might still be that of a liability, not equity. It might be appropriate to take economic compulsion or significant economic incentives into account in determining whether a claim against the entity is a liability or part of equity. However, the IASB thinks that it should consider any further requirements or guidance on this matter in the context of specific transactions, ie when developing individual IFRSs, rather than in the Conceptual Framework. Hence it proposes to limit the guidance in the Conceptual Framework to widely-applicable principles, such as those set out in paragraph 83.

Executory contracts and other forward contracts

90. In principle, a net asset or net liability arises under a contracts for which neither party has yet performed (an executory contract) if the contract is enforceable.

91. However, if the contract was priced on arm's length terms, the initial measurement of that contract would typically be zero because the rights of one party have the same value as its obligation to the other party. Accordingly, typically neither party has a (net) asset or (net) liability at inception. After inception, one or both parties may need to recognise its asset liability, depending on the measurement basis applied.

92. The nature of the purchaser's rights and obligation under an executory contract or other forward contract may depend on the circumstances.

    (a) in some cases, the purchaser might have a single net right or net obligation to exchange the underlying asset and the purchase price simultaneously. Often, that net right or net obligation would be measured at zero.

    (b) in other cases, the purchaser might have a separate gross right to receive the asset and a separate gross obligation to pay the purchase price. In practice, such rights and obligations are sometimes offset. Paragraph 12 discusses the distinction between offsetting separate assets and obligations, and having a single net right or net obligation.

93. In practice, executory contracts and other forward contracts are typically measured as follows:

    (a) if the contract will result in the receipt of assets that will be measured on a cost basis: at zero, unless the contract is, or has become, onerous. If the entity prepays for those assets, the contract is measured at the amount, adjusted for any impairment loss (if the contract has become onerous) and possibly also for the time value of money (accretion of interest).

(b) if the contract will result in the delivery of goods or services: at zero, unless the contract is, or has become, onerous. If the counterparty prepays for the goods or services, the contract is measured at the amount, adjusted if the contract has become onerous and possibly also adjusted for the time value of money (accretion of interest).

(c) if the contract will result in the receipt or delivery of financial instruments that will be measured both initially and subsequently at fair value: at fair value.

94. In current practice, a forward contract is sometimes treated as equivalent to the underlying asset or liability. For example, when trade date accounting is used for some a financial instruments, an entity accounts for the underlying instrument as if it had already been delivered at the trade date. In contrast, when settlement date accounting is used, an entity accounts for the forward contract until delivery, and then accounts for the underlying instrument from the delivery date.

Questions for respondents

95. Do you agree with the proposed definition of control proposed in paragraph 25?

96. Do you agree with the Board's preliminary view in paragraph 59 that the Conceptual Framework should not limit liabilities to obligations that can be enforceable by legal or equivalent means but should retain the existing definition of a liability—which encompasses both legal and constructive obligations?

97. Do you agree with the Board's preliminary view on obligations that are conditional on the entity's future actions, ie that [preliminary view to insert]?

98. Do you have comments on any of the other guidance proposed in this section to support the asset and liability definitions?