STAFF PAPER

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IASB Meeting

Project	**Conceptual Framework**
Paper topic	**Liability definition—present obligation**

CONTACTS	Joan Brown	jbrown@ifrs.org	
	Peter Clark	pclark@ifrs.org	+44 (0)20 7246 6451

OVERVIEW OF PAPER

1 The IASB has tentatively decided to define a liability as:

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

2 This paper seeks to develop concepts to explain the term 'present obligation', in particular to address situations in which the entity has some, but less than complete, discretion to avoid a future transfer. This paper uses the term 'constrained discretion' to describe these situations.

3 The staff recommend that:

> An entity has a present obligation to transfer an economic resource as a result of past events if both:
>
> (a) the entity has no practical ability to avoid the transfer; and
>
> (b) the amount of the transfer is determined by reference to benefits that the entity has received, or activities that it has conducted, in the past.

4 The staff also recommend adding guidance to explain when an entity has no practical ability to avoid a transfer. The staff recommend stating that:

(a) Most obligations arise from contracts, legislation or some other operation of the law. In the absence of legal enforceability, an entity has no practical ability to avoid transferring an economic resource if its customary practices, published policies or specific statements create a valid expectation of another party that the entity will transfer the resource to (or on behalf of) that other party. In such situations, the entity has a constructive obligation to transfer the resource.

(b) In some situations, an entity might be required to transfer an economic resource if it takes a particular course of action in the future, such as conducting particular activities or exercising particular options within a contract. In such situations, the entity has no practical ability to avoid the transfer if it has no practical ability to avoid the particular course of action that would require the transfer. If the other criterion is also met (the amount of the transfer is determined by reference to benefits that the entity has received, or activities that it has conducted, in the past), the entity has a present obligation.

(c) Courses of action that an entity has no practical ability to avoid include those that would cause significant business disruption or have economic consequences significantly more adverse than the transfer itself.

(d) An entity that prepares financial statements on a going concern basis has no practical ability to avoid a transfer that could be avoided only by liquidating the entity or ceasing trading.

5 Finally, the staff recommend that no guidance is needed in the *Conceptual Framework* on the role of constrained discretion in the identification of *assets*.

BACKGROUND

Problems in practice

6 It is generally accepted that, if an entity has an unconditional, legally enforceable obligation to transfer (or to stand ready to transfer) an economic resource, the entity has a present obligation—in such situations, the entity has no ability to avoid the transfer.

7 However, there are some situations in which an entity might have some, but not complete, discretion to avoid a future transfer. Problems have arisen in practice because it is unclear how constrained the entity's discretion must be for it to have a 'present obligation'. Different Standards have applied different approaches.

IASB's preliminary views

8 In the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting*, the IASB considered and reached preliminary views on three types of situation in which an entity is not (yet) legally obliged to transfer an economic resource, but nevertheless does not have full discretion to avoid the transfer because it is constrained by:

(a) its <u>past</u> practices, published policies or statements (see paragraphs 9-10 below);

(b) requirements that already exist but whose outcome depends on the entity's <u>future</u> actions (paragraphs 11-13); or

(c) the restrictions placed on alternative courses of action (paragraphs 14-16).

An entity's discretion is constrained by its <u>past</u> practices, published policies or statements

9 First, the Discussion Paper considered situations in which an entity does not have a legally enforceable obligation to transfer an economic resource but its discretion to avoid the transfer is constrained by its past practices, published policies or statements. Examples are situations in which:

(a) an employer has an established, informal practice of paying bonuses in excess of those to which employees are contractually entitled; or

(b) a mining company has a publicly-stated policy of restoring mined land to a similar standard throughout the world, even in countries whose legislation demands lower standards.

10 The IASB tentatively supported retaining an approach like that in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. It tentatively decided that, in the absence of legal enforceability, an entity has a liability—a 'constructive obligation'—if, as a result of an established pattern of past practices, published policies or sufficiently specific current statements, the entity has a duty or responsibility to transfer an economic resource to another party, and that other party can reasonably rely on the entity to discharge its duty or responsibility.[1]

An entity's discretion is constrained by requirements that already exist, but whose outcomes depend on the entity's <u>future</u> actions

11 Secondly, the Discussion Paper considered several scenarios in which a requirement already exists for an entity to transfer an economic resource, but the outcome of that requirement depends on the entity's own future actions. These scenarios included employee bonuses subject to future performance, levies subject to future operating, lease payments subject to future sales, and contingent consideration subject to future earnings targets.

12 The Discussion Paper suggested that there is a present obligation arising from past events only if the amount of the future transfer is determined by reference to benefits already received, or activities already conducted, by the entity.

13 The IASB considered whether it is also necessary for the entity to be unable to avoid the future transfer. It tentatively rejected a view that, for a present obligation to exist, the entity must have no ability, even in theory, to avoid the future transfer ('View 1'). It did not reach a view on whether the entity must have no *practical* ability to avoid the future transfer ('View 2') or whether it is sufficient that the entity has received

1 Discussion Paper, paragraphs 3.39-3.62, *Constructive obligations*

benefits or conducted activities as a consequence of which it may have to transfer an economic resource if further conditions are met ('View 3').[2]

An entity's discretion is constrained by the restrictions placed on alternative courses of action

14 Thirdly, the Discussion Paper considered questions relating to the classification of financial instruments as either liabilities or part of equity. It considered instruments that economically compel the issuer to act in a particular way, even though the instruments appear to give the issuer an option to avoid acting in that way. The result is that, although not contractually obliged to transfer an economic resource, the entity's discretion to avoid the transfer is constrained by the adverse economic consequences of not making the transfer.

15 To illustrate such situations, the Discussion Paper considered as an example a financial instrument that gives the issuer discretion to pay a dividend up to a specified amount each year and to redeem the instrument on a specified date. The issuer is not contractually required to pay the dividend or redeem the instrument, but:

(a) if the entity does not pay the full amount of the discretionary dividend, it cannot pay a dividend to its ordinary shareholders, and

(b) if the entity does not redeem the instrument on the specified future date, the dividend 'steps up' to an amount that would give a cost of finance higher than the issuer would otherwise have to incur.

The adverse consequences of not redeeming the instrument on the specified future date are such that the issuer may be economically compelled to redeem it.

16 The IASB's tentative view was that:

(a) although economic compulsion does not in itself create an obligation in the absence of a contract or other legal mechanism, it might be appropriate to take economic compulsion or significant economic incentives into account when determining whether a contractual claim against the entity is a liability or part of equity; but

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2 Discussion Paper, paragraphs 3.72-3.97, *Future events that depend on the entity's future actions*

(b) the IASB should consider any further requirements or guidance on this matter when developing or reviewing applicable Standards, rather than in the *Conceptual Framework*.[3]

Overview of feedback on Discussion Paper

17 Many respondents commented on these preliminary views. And amongst those who commented, there was widespread agreement that:

(a) the *Conceptual Framework* should include concepts to help apply the definition of a liability in situations of constrained discretion; and

(b) the definition of 'present obligation' should encompass at least some situations in which an entity has some discretion to avoid a future transfer. Nearly all respondents supported both:

i) the IASB's tentative view that the definition should continue to encompass both legal and constructive obligations; and

ii) the IASB's tentative rejection of the view that the entity must have no discretion (even in theory) to avoid a future transfer through its future actions ('View 1').

18 There were different views on *how* constrained an entity's discretion must be for an obligation to exist if the outcome depends on the entity's future actions. Many respondents supported the view that the entity must have no practical ability to avoid the future transfer ('View 2'). Some respondents supported the view that it is sufficient that there has been a past event as a consequence of which the entity may have to transfer an economic resource ('View 3'). Some respondents suggested modifications of Views 2 or 3. Those modifications are considered later in this paper.

[3] Discussion Paper, paragraphs 3.103-3.108, *The role of economic compulsion in assessing the substance of contractual obligations*.

19 Respondents indicated that several aspects of the discussion were unclear or needed further development. They suggested that:

(a) the IASB needs to clarify the role of economic compulsion in identifying liabilities, and in the classification of financial instruments.

(b) the issues underlying all situations of constrained discretion are similar. The IASB should consider them together and seek a single overarching concept or threshold that could apply in all circumstances.

(c) the IASB needs to state more clearly the conceptual differences between View 2 and View 3 and identify more examples where their consequences would be different.

(d) more guidance is needed on the meaning of 'no practical ability to avoid'.

STRUCTURE OF THIS PAPER

20 This paper re-examines matters explored in the Discussion Paper, taking into account feedback from respondents.

21 The staff analysis is divided into five sections:

A What is the role of economic compulsion in the identification of an obligation (paragraphs 23-34)?

B How constrained must the entity's discretion be for it to have an obligation (paragraphs 35-60)?

C Is there a better term than 'no practical ability to avoid' (paragraphs 61-74)?

D Is more guidance needed on the meaning of that term (paragraphs 75-81)?

E What are the consequences for the definition of an asset (paragraphs 82-89)?

22 Respondents made other suggestions, which the staff think do not need to be discussed further as part of this project. These suggestions, and the staff responses, are listed in the appendix.

A — WHAT IS THE ROLE OF ECONOMIC COMPULSION?

Introduction

23 The Discussion Paper considered the role of economic compulsion when discussing each of the three sources of constrained discretion listed in paragraph 8 of this paper.

24 Some respondents to the Discussion Paper thought that the conclusions the IASB reached in the three different contexts were contradictory and that, as a consequence, the guidance on the liability definition was unclear. Respondents noted that:

(a) in the context of *constructive obligations,* the IASB seemed to have concluded that economic compulsion cannot create a liability.

> 3.53 … 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.

(b) in the context of *obligations that are conditional on the entity's future actions*, the IASB was considering a view that seemed to suggest that economic compulsion *could* create a liability. Applying 'View 2' in the Discussion Paper, an entity would be treated as having a liability if it had 'no practical ability' to avoid the transfer. Respondents thought that the examples given suggested that economic compulsion could play a role.

> 3.79 … Arguably, [an entity might not have the practical ability to avoid an obligation if it could avoid it] only by ceasing to operate as a going concern, significantly curtailing operations or leaving specified markets.

(c) finally, in the context of *liability-equity classification,* the IASB seemed to leave the question open.

> 3.108 … Although economic compulsion does not in itself create an obligation in the absence of a contract or other legal mechanism, it might be appropriate to take economic compulsion or significant

> economic incentives into account when determining whether a contractual 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 or revising particular Standards, rather than in the *Conceptual Framework*.

25 Respondents asked the IASB to reconcile the apparent differences. Some suggested that the IASB should reconsider its tentative view that economic compulsion does not play a role in the creation of constructive obligations.

26 Some respondents agreed that the *Conceptual Framework* should not address the role of economic compulsion in the classification of financial instruments. However, other respondents—including some users and regulators—thought that there ought to be guiding principles in the *Conceptual Framework*, even if the assessment for specific transactions is left individual Standards. Of this latter group:

(a) most respondents—including users and regulators—thought that economic compulsion *should* always be taken into account in the classification of financial instruments.

> In our view, economic compulsion … clearly indicates the existence of a liability … Excluding the existence of economic compulsion alone can cause items that we may regard as liabilities in our analysis to be excluded from the balance sheet, or included as equity. The example given in paragraph 3.104 of the Discussion Paper serves to illustrate this. *Standard & Poors*

(b) a few respondents thought that economic compulsion should *not* be taken into account, arguing that it is not compatible with the definition of a liability.

Staff analysis

27 The staff think that it is possible to reconcile the different conclusions in the Discussion Paper and that, in doing so, we can produce clearer guidance in the Exposure Draft.

28 Although it did not list them together, the Discussion Paper separately identified two criteria that need to be satisfied for an entity to have a 'present obligation' to transfer an economic resource:

(a) there must be a constraint that creates an *obligation*—the entity must have less than complete discretion to avoid the future transfer; and

(b) there must have been a *past event*—the amount of the transfer must be determined by reference to benefits that the entity has received, or activities that it has conducted, before the end of the reporting period.

29 Benefits that the entity has received could include, for example, goods, services or loan proceeds. Activities that the entity has conducted could include, for example, making sales, earning profits or operating on a particular date.

30 In most commercial transactions, the source of the constraint is a legal requirement (arising from legislation, a contract or another operation of the law). And in most commercial transactions, that legal requirement eliminates all discretion because the past event (receipt or activity) is sufficient to create an unconditional obligation. However, in the circumstances discussed in this paper, some discretion remains.

31 The staff think that all of the conclusions reached in the Discussion Paper were consistent with a view that:

(a) economic compulsion might be one of the factors that increases the degree of constraint, reducing the entity's discretion to avoid a future transfer—so it may be considered in the assessment of whether the constraint criterion is met; but

(b) constrained discretion (and hence economic compulsion) is not the only criterion for a present obligation—there is also the requirement for the obligation to have arisen from a past receipt or past activity of the entity. Hence, economic compulsion alone is insufficient to create a liability.

Staff recommendation

32 The staff recommend that the *Conceptual Framework* lists together the two criteria that must be satisfied to meet the definition of a ‘present obligation’, and emphasises that both criteria must be met. Question 1 after paragraph 74 asks the IASB to approve a definition that incorporates this recommendation.

33 The staff think that if the criteria are listed in this way, it will be clear that satisfying either one of the criteria is insufficient on its own to create a liability. Hence, there would be no need for a statement that constrained discretion (and hence economic compulsion) is insufficient on its own to create a present obligation—a statement that could be misinterpreted if taken out of context.

34 Further guidance on the role of economic compulsion could be incorporated into guidance on constraints. The possible content of such guidance is considered later in this paper (see paragraphs 75-81).

B — HOW CONSTRAINED MUST THE ENTITY'S DISCRETION BE?

Introduction

35 This section analyses views on how constrained the entity's discretion must be for it to have an 'obligation'.

36 In response to the feedback from respondents, this section:

(a) considers together all three types of constrained discretion addressed in the Discussion Paper (see paragraph 8) , and seeks a single overarching concept that could apply to all types.compares the three concepts suggested in the Discussion Paper, ie:

i) the entity has <u>no ability to avoid</u> the future transfer ('View 1' described in paragraphs 3.75 and 3.76 in the Discussion Paper);

ii) the entity has <u>no practical ability to avoid</u> the future transfer ('View 2' described in paragraphs 3.77-3.83 in the Discussion Paper); or

iii) the entity has <u>less than complete discretion to avoid</u> the future transfer ('View 3' described in paragraphs 3.84-3.88 of the Discussion Paper).

(b) considers the implication of each concept for both the statement of comprehensive income, and the statement of financial position.

(c) considers suggestions that the concept chosen should have an effect that is somewhere between the effects of View 2 and View 3, and be based on the amounts that it is <u>probable</u> (or expected) that the entity will transfer.

37 The term 'no practical ability to avoid' is used to convey the concept that the entity could avoid the transfer only by taking actions that would cause such significant business disruption or have economic consequences that are so adverse that the entity is, in substance, obliged to make the transfer. Later sections consider whether there might be a better term to describe this concept and whether more guidance is needed on the meaning of whichever term is preferred.

Comparisons of different concepts

Table 1: Application to different types of constraint

Concept ➔ Source of constraint ➔	No ability to avoid	No practical ability to avoid	Less than complete discretion to avoid
Established practices, published policies or specific statements (constructive obligations)	Not obligations.	Obligations if entity has no practical ability to change its practices, policies or stated actions.	Obligations, because entity's discretion is constrained by its past practices, published policies or statements. Changing them could have adverse consequences.
Requirements that depend on the entity's future actions	DP View 1 Not obligations	DP View 2 Obligations if entity has no practical ability to take avoiding actions.	DP View 3 Obligations, because entity's discretion is constrained by requirements that depend on its future actions.
Contractual restrictions on exercising alternative courses of action	Not obligations, unless the only alternative course of action is a non-genuine option, ie one that has no commercial substance whatsoever. Such options would be disregarded applying general concepts for reporting the substance of contractual rights and obligations.[4]	Obligations if entity has no practical ability to take alternative courses of action.	Obligations, because entity's discretion is constrained by the restrictions placed on alternative courses of action.

4 See paragraph 3.201(d) of the Discussion Paper.

Table 2: Implications for statement of financial position and statement of comprehensive income

Concept → Effects on: ↓	**No ability to avoid**	**No practical ability to avoid**	**Less than complete discretion to avoid**
Liability definition	Narrower	⟺	Broader
Statement of financial position **(if the liability is recognised)**	Includes only legally enforceable unconditional obligations.	Includes obligations that entity has no practical ability to avoid.	Could include all future transfers whose amount is determined by reference to past events. (But those for which outflows are unlikely or very uncertain may not be recognised[5].)
Statement of comprehensive income	Costs are recognised in the same period as the other effects of the benefits/activities from which they result only to the extent that the entity has an unconditional, legally enforceable obligation to pay them. Others are recognised when they become unconditional and legally enforceable.	Costs are recognised in the same period as the other effects of the benefits/activities from which they result to the extent that the entity does not have the practical ability to avoid them. Others are recognised when the entity no longer has the practical ability to avoid them.	Estimated costs are recognised in the same period as the other effects of the benefits/activities of the period from which they result. Later changes in estimates are recognised in the period in which the estimates change.

5 In May 2014 the IASB tentatively decided that the *Conceptual Framework* should describe factors to consider in deciding whether to recognise an asset or a liability. Those factors would include, amongst others, whether the resulting information would be relevant. Information might not be relevant if, for example, it is unlikely that future flows of economic benefits will occur or if there is very significant measurement uncertainty associated with the item.

Feedback from respondents

View 1—an obligation must be legally enforceable and strictly unconditional

39 A few respondents to the Discussion Paper thought that the definition of a liability should encompass only legally enforceable, unconditional obligations, ie those that the entity has <u>no</u> ability to avoid (the View 1 approach).

40 They argued that such a concept:

(a) is rigorous: unless a requirement is unconditional, it is avoidable and not an obligation at the reporting date.

(b) would provide useful information about the future outflows that an entity has <u>no</u> ability to avoid.

(c) would enhance comparability because it has the clearest criteria for identifying liabilities: an approach that required an assessment of an entity's practical ability to avoid a future transfer (View 2) would be more subjective and might not be operational.

View 2—an entity must have no practical ability to avoid a future transfer

41 Nearly all respondents who commented thought that the definition of a liability should encompass both constructive obligations and at least some obligations that are conditional on the entity's future actions.

42 Most of those respondents expressed a leaning towards a concept that would identify as a liability any obligation that the entity has <u>no practical ability</u> to avoid (View 2). They argued that such a concept would give the most faithful representation (or best report the substance) of the obligations that an entity cannot avoid.

43 However, several respondents suggested that the term 'no practical ability to avoid' could be difficult to interpret—more guidance would be needed. (The need for supporting guidance is considered later in this paper—see paragraphs 75-81.)

View 3—less than complete discretion to avoid

44 Some respondents thought that the definition of a liability should encompass all future transfers that arise from past events, ie whose amount is determined by reference to benefits received or activities conducted by the entity before the end of the reporting period (a View 3 approach). They argued that such a concept would ensure that entities match expected costs with the benefits or activities to which they relate.

45 However, against such a concept, some respondents argued that:

(a) it could result in the recognition and subsequent reversal of liabilities that the entity takes action to avoid and so never has to settle.

(b) the additional liabilities that would be identified—ie those that the entity would have the practical ability to avoid—could be difficult to measure, because the measurement would need to take into account the possibility and economic consequences of the entity taking the avoiding action. Recognition criteria would be needed to filter out very unlikely or very uncertain future transfers. Without such criteria, the accounting would be complex and subjective.

46 One respondent suggested that some of the amounts recognised as liabilities would not be 'obligations' in the ordinary sense of that word. The respondent suggested redefining a liability to include both obligations and other future outflows for expenses that have been incurred in earning the income of the period.

Other suggestions

47 Some respondents suggested alternative approaches that incorporate elements of View 2 or View 3 but modify them. Most notably, several respondents suggested a probability threshold: an entity should be regarded as having an obligation if it is probable (or reasonably certain) that the requirement will result in the entity transferring an economic resource. They argued that such a threshold would provide the most relevant measure of the costs associated with the benefits received and activities conducted by the entity in the period. The staff note that a probability threshold would identify as liabilities a broader range of items than View 2 would, and a narrower range than View 3 would.

Possible conflicts with existing standards

48 The staff note that at present, Standards take different approaches to constrained discretion. Consequently, specifying any of the concepts discussed in this paper would create conflicts between the *Conceptual Framework* and some existing Standards.

49 If the *Conceptual Framework* required an obligation to be legally enforceable and strictly unconditional (View 1), there would be inconsistencies between the *Conceptual Framework* and:

(a) existing standards that require recognition of constructive obligations (ie those that arise from an entity's customary practices, published policies or recent statements). These Standards include IFRS 15 *Revenue from Contracts with Customers*, IAS 19 *Employee Benefits* and IAS 37.

(b) existing standards that require recognition of some obligations that are conditional on the entity's future actions. These Standards include IFRS 2 *Share-Based Payments* and IAS 19, both of which require recognition of payments that are subject to vesting conditions.

50 If the *Conceptual Framework* defined an obligation as one that the entity has no practical ability to avoid (View 2) the main inconsistency would be between the *Conceptual Framework* and IFRIC 21 *Levies*. The inconsistency would affect in particular levies that accumulate over time but are payable only if a further condition is met, for example if the entity is still operating in the market on a later date. Applying IFRIC 21, liabilities are identified only when all conditions are met. Applying View 2, liabilities would be identified as accruing over time, unless the entity could avoid the remaining conditions (eg leave the market) without significant business disruption, and without economic consequences significantly more adverse than paying the levy. We think it is likely that, in practice, many levy liabilities would be identified as accruing over time.

51 If the *Conceptual Framework* defined an obligation as one that the entity has less than complete discretion to avoid (View 3), there would again be inconsistencies between

the *Conceptual Framework* and IFRIC 21. Applying View 3, levies that accumulate over time would be identified as accruing over time, irrespective of remaining conditions.

52 All of these differences relate to the *identification* of liabilities. The amount at which an entity would recognise any liabilities identified would depend on the recognition and measurement requirements specified in the applicable standard. Most notably, the recognition criteria and measurement requirements for liabilities identified applying a View 3 concept could take into account the probability of remaining conditions being met.

Staff conclusions and recommendation

53 The staff think that the definition of a present obligation should include the concept that the entity has <u>no practical ability to avoid the </u>transfer. The reasons are set out below.

54 First, the staff think that the IASB should reject the suggestion (in paragraph 47) of applying a threshold based on the probability of future outflows. The definition of a liability focuses on an obligation. Hence, the staff think the supporting guidance should focus on what the entity is able (or not able) to do—not on the likelihood of the possible outcomes. The possible outcomes could have a bearing on whether the liability is recognised and on the amount at which it is measured. But the likelihood of the outcomes should not be the basis on which a liability is judged to exist or not exist.

55 Secondly, the staff think that the IASB should confirm its previous tentative rejection of a concept that would limit the definition of a liability to obligations that are legally enforceable and strictly unconditional (View 1). Such a concept ignores other factors that might limit an entity's discretion to avoid a future transfer. Nearly all respondents to the Discussion Paper agreed that it would define a liability too narrowly.

56 This leaves two concepts to consider: an obligation exists if the entity has no practical ability to avoid a transfer (View 2) and an obligation exists if the entity has less than complete discretion to avoid a transfer (View 3).

57 The staff prefer View 2 because we think that it more clearly distinguishes obligations from claims that give the entity substantial discretion to avoid future transfers (such as

the claims of ordinary shareholders who have a right to participate in distributions of dividends, but not to force the entity to make distributions).

58 We also think that the View 2 concept would provide a faithful representation of the entity's performance in the period. We note the argument that a View 3 concept would provide a more complete 'matching' of costs with the activities or benefits to which they relate. However, we think that, even the View 2 concept will lead to liabilities being identified for all costs that are closely linked to the benefits the entity has received and activities it has conducted in the period. There might be little difference in practice between the practical consequences of View 2 and View 3 in many cases:

(a) for constructive obligations (ie if the entity's discretion is constrained by its past practices, published policies or statements), the resources that the entity expects to transfer in future are likely to be very similar in amount to the resources that it judges it has no practical ability to avoid transferring.

(b) most commercial transactions—whether direct exchanges or charges levied by governments—link the amounts payable by an entity to benefits that the entity receives. And the terms are typically designed so that, after the entity has received the benefits, it has no practical ability to avoid the transfer through its future actions. (This is evidenced by the similarity of the practical consequences of Views 2 and 3 as outlined for six scenarios in the Discussion Paper.)

59 Accordingly, limiting the definition of a liability to those situations where the entity has no practical ability to avoid a future transfer is unlikely to create significant mismatches between the recognition of benefits and closely-associated expenses.

Staff recommendation

60 The staff recommend the definition of a present obligation should include the concept that the entity has <u>no practical ability to avoid</u> the transfer. Question 1 following paragraph 74 asks the IASB to approve a definition that incorporates this recommendation.

C—IS THERE A BETTER TERM THAN 'NO PRACTICAL ABILITY TO AVOID'?

Introduction

61 Some respondents to the Discussion Paper suggested that terms such as the following could be easier to interpret than 'no practical ability to avoid':

(a) 'no realistic alternative'; or

(b) 'little or no discretion to avoid'.

62 This section considers the advantages and disadvantages of each of these terms.

Staff analysis

No practical ability to avoid

63 We suggested the term 'no practical ability to avoid' in the Discussion Paper primarily because we thought that it most effectively conveys the need to identify what the entity is *able* to do, rather than what the probable outcome will be. In favour of this term, it can further be argued that:

(a) it mirrors the term 'practical ability' applied in IFRS in the context of assessing whether an entity has control of an asset:

i) IFRS 9 *Financial Instruments* states that an entity has not retained control of a transferred asset if the transferee has the practical ability to sell the asset.[6]

ii) IFRS 10 *Consolidated Financial Statements* states that, in determining whether an entity's rights give it power (one element of control) over an investee, the entity considers whether it has the practical ability to direct the relative activities unilaterally. It considers rights that it has the practical ability to exercise.[7]

6 IFRS 9, paragraph 3.2.9

7 IFRS 10, paragraphs B18 and B22

The concept underlying both IFRS 9 and IFRS 10 is that entity has control of rights that it has the practical ability to exercise. It would have an obligation if it does *not* have practical ability to avoid a transfer of rights.

(b) the term ‘practical ability’ is explained in IFRS 9 and IFRS 10 with a meaning that is consistent with that intended for the liability definition. It requires an entity to look beyond its legal rights and obligations and consider what it can do in practice.[8] Application guidance in IFRS 10 refers to economic barriers and incentives, which are often a major factor constraining an entity’s discretion to avoid a future transfer.[9]

(c) the term ‘no practical ability to avoid’ works particularly well for stand-ready and similar obligations, for which a future transfer of economic resources depends on events that are outside the entity’s control. The point is not that a transfer is certain, but that the entity does not have the practical ability to avoid the transfer if the events outside its control occur.

No realistic alternative

64 The term ‘no realistic alternative’ is already applied in several IFRSs. IAS 37 defines an obligating event as ‘an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation’.[10] Other Standards also use the term to identify liabilities for future transfers that are not legally enforceable or depend on the entity’s future actions:

(a) IAS 19 states that informal practices give an entity a constructive obligation if the entity has no realistic alternative but to pay employee benefits.[11]

(b) IAS 34 *Interim Financial Reporting* requires an entity to recognise a liability in interim periods for expected year-end employee bonuses and contingent lease payments because the entity has no realistic alternative but to make the payments.[12]

8 IFRS 9, paragraph B3.2.8
9 IFRS 10, paragraph B23.
10 IAS 37, paragraph 10.
11 IAS 19, paragraphs 4(c), 19, 21 and 61.
12 IAS 34, Illustrative Examples, paragraphs B6 and B7.

65 We avoided the term 'no realistic alternative' in the Discussion Paper because its application in IAS 37 has been subject to differing interpretations. For example, IFRIC 21 rejects the notion that a liability would arise if an entity has no realistic alternative other than to meet the conditions for paying a levy. The Basis for Conclusions states that:

> …if this rationale were applied, many types of future expenditure within the scope of IAS37 would be recognised as liabilities. Indeed, in many cases, entities have no realistic alternative but to pay expenditures to be incurred in the future.[13]

66 However, on reflection, the staff think that the IAS 37 interpretation difficulties have arisen not from the term 'no realistic alternative' itself but from two other factors:

(a) the statement in IAS 37 that 'it is only those obligations arising from past events existing independently of an entity's future actions (ie the future conduct of its business) that are recognised as provisions'. This statement has been interpreted as precluding the possibility that a liability can be conditional on the entity's future actions, even if the entity has no realistic alternative other than to meet the conditions; and

(b) the absence of a definition of a past event. It is the need for the amount of any future transfer to be determined by reference to past benefits or activities—not the entity's ability to avoid a future transfer—that distinguishes some present obligations from some possible future obligations.

The staff believe that the recommended improvements to the *Conceptual Framework* would provide greater clarity on both of these matters.

67 In support of using 'no realistic alternative' instead of 'no practical ability to avoid', it could be argued that:

(a) 'no realistic alternative' is already used in IFRSs for the purposes of identifying liabilities—especially constructive obligations. Changing the term in the *Conceptual Framework* could raise questions about whether to revise individual IFRSs that use the term.

[13] IFRIC 21, Basis for Conclusions, paragraph BC16.

(b) the term ‘no realistic alternative’ possibly expresses better the nature of the constraint that gives rise to constructive obligations (obligations arising from an entity’s past practices, published policies or statements). Although the term ‘no practical ability to avoid’ works well for situations in which an entity would have to take positive action in future to avoid a transfer (for example by exercising options or changing its business operations), it might work less well for constructive obligations, where the entity does not have to do anything to avoid a transfer—the entity simply does not make the transfer and suffers any adverse economic consequences.

Little or no discretion to avoid

68 The term ‘little or no discretion to avoid’ is used in FASB Concepts Statement 6 to describe one of the essential characteristics of a liability. The first essential characteristic is that the liability ‘embodies a present duty or responsibility’ that entails transfer or use of assets. The second essential characteristic is that ‘the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice’.

69 The term ‘little or no discretion to avoid’ possibly does not communicate as well as other terms the need to consider the extent of the entity’s *realistic,* or *practical* (as opposed to legal) discretion. However, if this were viewed as a shortcoming, it could be remedied by refining the term to ‘little or no discretion in practice to avoid’.

70 In favour of using a term that includes the word ‘discretion’, it could be argued it conveys better than the word ‘ability’ the nature of the constraints that prevent the entity from avoiding the transfer of an economic resource.

Staff conclusions and recommendations

71 The staff think that all of the three terms ‘no practical ability to avoid’, ‘no realistic alternative’ and ‘little or no discretion (in practice) to avoid’ convey the notion that the IASB would be intending to convey, ie of an obligation that an entity could avoid but

only by taking actions that would cause significant business disruption, or have economic consequences significantly more adverse than the transfer itself.

72 The staff recommend using the term ‘no practical ability to avoid’ instead of alternatives suggested by respondents. We recommend this term primarily for the reasons in paragraph 63(a): it mirrors the term ‘practical ability’ already used in IFRSs in the context of assessing control of assets.

Question for the IASB

73 So far in this paper, the staff have recommended that the *Conceptual Framework*:

(a) lists together two criteria that must be satisfied to meet the definition of a ‘present obligation’, and emphasises that both criteria must be met (paragraph 32);

(b) includes as one of the criteria the concept that the entity has ‘no practical ability to avoid’ the transfer (paragraph 60); and

(c) uses the term ‘no practical ability to avoid’ to describe that concept, instead of other terms suggested by respondents (paragraph 72).

74 Combining these recommendations, the staff recommend the following definition of a present obligation:

> An entity has a present obligation to transfer an economic resource as a result of past events if both:
>
> (a) the entity has no practical ability to avoid the transfer; and
>
> (b) the amount of the transfer is determined by reference to benefits that the entity has received, or activities that it has conducted, in the past.

Question 1: meaning of present obligation
Do you agree with the definition recommended in paragraph 74?

D—IS MORE GUIDANCE NEEDED ON THE MEANING OF 'NO PRACTICAL ABILITY TO AVOID'?

Introduction

75 If the IASB decides to define liabilities as obligations that the entity has no practical ability to avoid (or a similar concept expressed using a different term), it will need to consider whether it should add supporting guidance to explain that term.

76 This section identifies further guidance that the IASB could add. (The guidance could easily be adapted if the IASB decides to use a term other than 'no practical ability to avoid'.)

Discussion paper and feedback from respondents

77 In the context of *constructive obligations*, the Discussion Paper suggested including guidance in the *Conceptual Framework* to emphasise that an entity must have a duty or responsibility to transfer a resource to another party (it is not sufficient that an entity is compelled to act in its own best interests), that the other party must be the one that would benefit from the entity fulfilling its duty or responsibility, and that as a result of the entity's past actions, the other party can reasonably rely on the entity to discharge its duties or responsibilities.

78 In the context of *obligations that are conditional on an entity's future actions*, the Discussion Paper acknowledged that any assessment of whether an entity has the practical ability to avoid a future transfer would require judgement. It suggested that further guidance might be needed, possibly in individual standards. It further suggested that cases in which an entity might not have the practical ability to avoid a future transfer might include those in which it could do so only by ceasing to operate as a going concern, significantly curtailing operations or leaving specific markets.

79 Commenting on these suggestions:

(a) many respondents said they thought that further guidance was needed, a few suggesting that such guidance could be in individual Standards rather than in the *Conceptual Framework.*

(b) some respondents asked for clarification of how an entity's practical ability to avoid an obligation interacts with the going concern assumption. In contrast, one national standard setter suggested that the going concern assumption is a basic assumption on which financial statements are prepared and, therefore, it should not be used to determine whether an entity has a present obligation.

(c) some respondents asked for general concepts on the role of economic compulsion—particularly to help answer questions relating to the classification of financial instruments as either liabilities or part of equity.

(d) a few respondents suggested that guidance on constructive obligations should be in individual standards, with only the high-level concepts in the *Conceptual Framework.*

> We are not convinced that the Framework is the appropriate vehicle for developing detailed guidance on the nature of constructive obligations. In our view, this is a matter for standards-level guidance. We believe that the focus of the conceptual discussion should be on the avoidability or otherwise of an outflow of economic resources… *Grant Thornton International*

Staff comments

80 The staff have the following comments on the respondents' suggestions:

(a) If the *Conceptual Framework* refers to the going concern assumption, it should clarify that other constraints could also be relevant.

(b) The staff think that the *Conceptual Framework* should explain the role that economic compulsion could play in constraining an entity's discretion. A respondent suggested the following general concept:

> An entity has no practical ability to avoid a future transfer if it could avoid the transfer only through another course of action that would have economic consequences significantly more adverse than the transfer itself.

This wording does not use the term 'economic compulsion', but because it explains exactly what the term means, the staff think that it would not be necessary to use the term itself.

(c) The *Conceptual Framework* could incorporate wording similar to that used in IFRS 15 or IAS 37 to identify constructive obligations:

> IFRS 15 refers to 'promises that are implied by an entity's customary business practices, published policies or specific statements if … those promises create a valid expectation of the customer that the entity will transfer a good or service to the customer.'[14]
>
> IAS 37 states that 'an established pattern of past practices, published policies or a sufficiently specific current statement may leave an entity with no realistic alternative other than to transfer an economic resource if:
>
> (a) the entity has indicated to another party that it will transfer the resource to that other party; and
>
> (b) as a result, the other parties can reasonably rely on the entity to transfer the resource.'[15]

Staff recommendation

81 The staff recommend including limited supporting guidance in the *Conceptual Framework* to explain the meaning of 'no practical ability to avoid'. We recommend stating that:

14 IFRS 15, paragraph 24.

15 IFRS 37, paragraph 10.

(a) Most obligations arise from contracts, legislation or some other operation of the law. In the absence of legal enforceability, an entity has no practical ability to avoid transferring an economic resource if its customary practices, published policies or specific statements create a valid expectation of another party that the entity will transfer the resource to (or on behalf of) that other party. In such situations, the entity has a constructive obligation to transfer the resource.

(b) In some situations, an entity might be required to transfer an economic resource if it takes a particular course of action in the future, such as conducting particular activities or exercising particular options within a contract. In such situations, the entity has no practical ability to avoid the transfer if it has no practical ability to avoid the particular course of action that would require the transfer. If the other criterion is also met (the amount of the transfer is determined by reference to benefits that the entity has received, or activities that it has conducted, in the past), the entity has a present obligation.

(c) Courses of action that an entity has no practical ability to avoid include those that would cause significant business disruption or have economic consequences significantly more adverse than the transfer itself.

(d) An entity that prepares financial statements on a going concern basis has no practical ability to avoid a transfer that could be avoided only by liquidating the entity or ceasing trading

Question for the IASB

Question 2: Supporting guidance on the meaning of 'no practical ability'
The staff recommend that, to clarify the situations in which an entity has 'no practical ability to avoid' transferring an economic resource, the *Conceptual Framework* should include the supporting guidance set out in paragraph 81. Do you agree?

E—WHAT ARE THE CONSEQUENCES FOR THE DEFINITION OF AN ASSET?

Preliminary views in Discussion Paper

82 Paragraph 3.34 of the Discussion Paper stated that:

> If a liability exists for one party, an asset always exists for another party or parties, except perhaps for some obligations to clean up damage to the environment. However, for some assets, such as rights over physical objects, no corresponding liability exists.

83 As a specific example of the symmetry between assets and liabilities, paragraph 3.5 of the Discussion Paper suggested that the definition of an asset includes 'rights arising from a constructive obligation of another party'.

84 However, the Discussion Paper did not discuss further the possible implications for the definition of an asset of constructive obligations and other situations of constrained discretion.

Feedback

85 A few respondents noted that the Discussion Paper considered the consequences of constrained discretion purely within the context of liabilities. They suggested that the IASB should assess the various concepts for constrained discretion by also taking into account their implications for the identification of assets (especially given the statement in the Discussion Paper about the symmetry between the asset and liability definitions):

(a) one thought that the stated symmetry could help the IASB reach a view on the circumstances in which a liability exists;

(b) a few suggested that there might be a tension between the notions of constructive and conditional obligations on one hand, and the notion of control of an asset on the other hand. Of those respondents, some thought that the IASB should not define assets and liabilities in a way that would lead one party to identify a liability without another party identifying an asset. Others thought that there necessarily would be some asymmetries, which the *Conceptual Framework* should acknowledge.

Staff analysis

86 The Discussion Paper considered constrained discretion only in the context of liabilities because problems have tended to arise for the IASB and Interpretations Committee in that context. There are several reasons why problems are less likely to arise in the context of assets:

(a) for questions relating to liability-equity classification, there are few classification problems for the instrument holder: the holder classifies the instrument as a financial asset irrespective of the classification by the issuer.

(b) for questions relating to constructive obligations or obligations conditional on the entity's future actions:

i) the parties holding any corresponding rights are often not reporting entities, or not reporting entities for which the IASB develops Standards. In practice, they are often employees (with rights to employee benefits), governments (with rights to levies) or the public at large (with rights to restoration of the environment in which citizens live).

ii) even if the party holding rights is a reporting entity, in practice the entity may have concluded that the asset does not meet the recognition criteria in a particular Standard, or in the *Conceptual Framework*. In such cases, the entity may not have felt the need to determine whether the asset exists.

87 The staff think that, in a situation in which one party (eg an employer) is judged to have present obligation to transfer a resource as a result of past events (eg receipt of employment services), another party (the employee) controls a present right to receive that resource as a result of the same past events (provision of the employment services)—even if the first party has some discretion to avoid the transfer. The staff have reached that conclusion because:

(a) the second party has rights that it would not have had in the absence of those past events (eg, a right to receive a bonus if further conditions are met); and

(b) the second party controls the right because, although it cannot enforce the transfer, it can ensure that, if the transfer occurs, it (rather than any other party) will receive the resource. As the Discussion Paper suggested in its discussion of the meaning of control:

> 3.27 For an entity to control an economic resource, the economic benefits arising from the entity must flow to the entity (either directly or indirectly) rather than to another party. This requirement does not imply that the entity can ensure that the resource will generate economic benefits in all circumstances. Instead it means that, if the resource generates economic benefits, the entity is the party that will receive them.

Staff conclusions and recommendations

88 In the light of this analysis, the staff conclude that:

(a) the proposed criteria for identifying a liability (no practical ability to avoid a future transfer whose amount is determined by reference to past events) does not create tension between the asset and liability definitions. Even though the transferee's present right to receive the resource is conditional on the transferor's future actions, that present right arises from past events and is controlled by the transferee.

(b) the Discussion Paper was correct to suggest that assets include present rights arising from the constructive obligations of another party.

(c) this suggestion, and the more general statements in the Discussion Paper on the meaning of control provide the concepts needed to interpret the asset definition in situations where an entity's present rights are conditional on another party's future actions.

89 Accordingly, the staff recommend that no further guidance need to be included in the *Conceptual Framework* to explain the role of constrained discretion in the identification of assets.

Question for the IASB

Question 3—the role of constrained discretion in the identification of assets
Do you agree that no guidance is needed in the *Conceptual Framework* on the role of constrained discretion in the identification of *assets*.

Appendix—Other suggestions from respondents

The table explains why the staff think that the IASB does not need to discuss these suggestions. We will not raise any of them for discussion unless requested to do so.

Suggestion	Staff comment
Concepts for constrained discretion The *Conceptual Framework* could explain the factors that might be considered in determining whether a present obligation exists, instead of trying to encapsulate these factors into a single concept. The relative importance of different factors might depend on the nature of the obligation and so the final determination should be made in individual Standards.	The staff think that such an approach would need to be explored only if, having considered the discussion in paragraphs 35-60 of this paper, the IASB cannot identify a single concept that would work well for all situations of constrained discretion. A single concept is preferable because it would enhance the coherence of financial statements—all items identified as present obligations would share a common characteristic.
Concepts for constrained discretion—a hybrid approach For situations of constrained discretion, apply a hybrid approach that gives weight to the effect on the statement of comprehensive income, ie: (a) that applies View 3 (as described in paragraph 13 of this paper) if the recognition of a liability also leads to the recognition of an expense. In such situations, recognising an expense provides a more useful measure of financial performance. It is more useful to recognise these expenses in the accounting period to which they relate, than to wait until they become an unavoidable commitment. (b) that applies View 2 (as described in paragraph 13 of this paper) if the recognition of a liability has no effect on performance but instead gives rise to the recognition of an asset or to a change in equity. In such situations, View 2 does not provide any less useful information about performance, and provides more useful information about the entity's financial position.	The staff think that this should be a matter of recognition, not identification—the definition of a liability should be unaffected by the nature of the corresponding debit entry. The IASB tentatively decided in May 2014 that the Conceptual Framework should describe factors to consider in deciding whether to recognise an asset or liability. Agenda Paper 10B for the IASB meeting in May 2014 contains an initial draft describing those factors. That draft states, among other things, that, in deciding whether to recognise an asset or liability, it is necessary to consider whether the resulting income or expenses will provide relevant information and result in a faithful and understandable representation.

Suggestion	Staff comment
Constructive obligations The Discussion Paper suggested that the announcement or implementation of a restructuring plan does not create a constructive obligation to complete the plan. The IASB should reconsider this suggestion because often entities have no practical ability to avoid completing the restructuring.	This matter is specific to IAS 37 and will be considered as part of the IAS 37 research project.
Meaning of past event There is insufficient discussion of why the 'past event' that is necessary to create an obligation is defined as the event that determines the amount of any future transfer. The amount of a liability is a matter of measurement, not definition.	The definition reflects the fact that the terms of an obligation establish a link between specified events and the amount of the transfer. Accordingly those events cause the liability to exist. Respondents did not identify any specific problems arising from the definition suggested in the Discussion Paper.
Further guidance on meaning of past event More consideration is needed of how to identify the past event that creates a present obligation: • For some government-imposed levies, it might be difficult to identify the relevant receipt or activity. • For variable lease payments, there are two receipts that could be regarded as determining the amount of the obligation—the receipt of the right or use and the receipt of the sales proceeds that trigger the variable payments. • For some transactions, the past event could depend on the unit of account (for example, when leases contain renewal options).	The definition of the past event will require interpretation for particular transactions, such as levies, variable lease payments and lease renewal options. But these will be transaction-specific questions that should be considered in developing or amending the applicable Standards.
• it is unclear whether, and in what circumstances, the signing of a contract is a past event for the purposes of identifying obligations. This clarification could be included in guidance on executory contracts.	The assets and liabilities arising from executory contracts were considered in Agenda Paper 10D for the June 2014 meeting.

Suggestion	Staff comment
Suggestions for minor improvements • In the discussion of past events, clarify that future losses and the costs of future operations are not present obligations. • In the discussion of constructive obligations, expand the notion of 'established pattern of past practices' from the entity's own past practices to also include established industry practices. • Explain why past practices or published dividend policies do not create an obligation to pay dividends. • Clarify whether constructive obligations include equitable obligations.	These suggestions can be considered as part of drafting.