International Financial Reporting Standards

Conceptual Framework Exposure Draft

A closer look at liabilities and executory contracts

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The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

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Before we start…

- You can download the slides by clicking on the event resources button to the left side of your screen
- This webinar is a recording (it is not live), so we are unable to take any questions
- The views expressed are those of the presenters, not necessarily those of the IASB or IFRS Foundation

Conceptual Framework webinar schedule

Previously-recorded webinars	
17 / 06	Overview of Conceptual Framework Exposure Draft
06 / 08	Chapters 4 and 5—the elements of financial statements: definitions and recognition
This webinar	
13 / 08	Chapter 4—a closer look at liabilities and executory contracts
Future webinars	
20 / 08	Chapter 6—measurement
27 / 08	Chapter 7—classification of income and expenses (profit or loss vs. OCI)
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10 / 09	Chapter 3—the reporting entity
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24 / 09	Possible implications of the proposals—with provisions and contingent liabilities case study

Proposed concepts

Proposed concept—‘liability’

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

Proposed concept—‘present obligation’

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

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

b) the obligation has arisen from past events, ie the entity has received the economic benefits, or conducted the activities, that establish the extent of its obligation.

4.32 For example:

- if the transfer is legally enforceable, or
- if action necessary to avoid the transfer would:
  - cause significant business disruption; or
  - have economic consequences significantly more adverse than the transfer itself.

Implications of focus on ‘practical ability’

4.34 Constructive obligations

It is not necessary for the obligation to be legally enforceable.

Liabilities may arise from an entity’s customary practices, published policies or statements…

…if the entity has no practical ability to act in a manner inconsistent with those practices, policies or statements.

4.35 Conditional obligations

It is not necessary for the obligation to be unconditional.

Liabilities may be conditional on a particular future action of the entity…

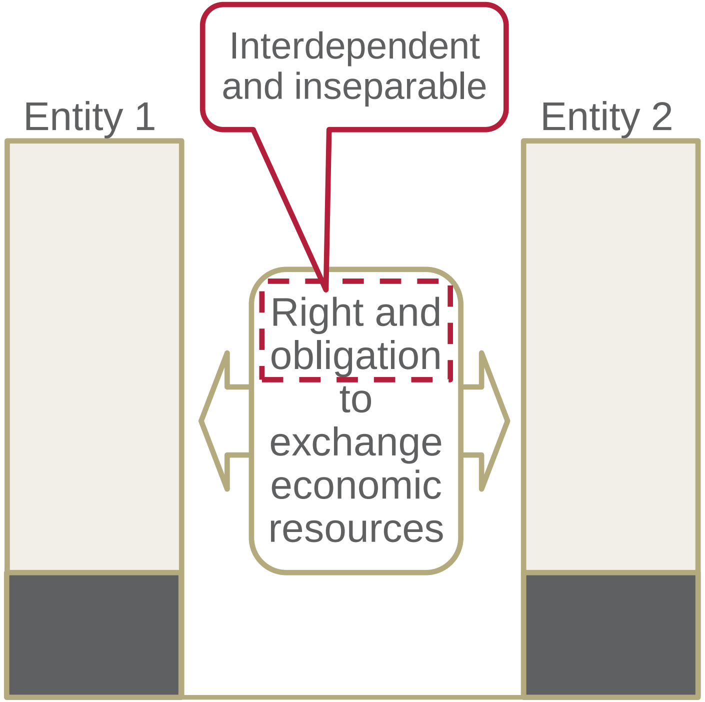
…if the entity has no practical ability to avoid that action.

Proposed concepts—executory contracts

4.41

Contract is equally unperformed:

- neither party has fulfilled any of its obligations; or
- both parties have fulfilled their obligations partially to an equal extent



- Combined right and obligation constitute:
  - a single asset (if terms are favourable); or
  - a single liability (if terms are unfavourable)
- Measurement based on historical cost will normally lead to measurement at zero unless the contract is onerous

Examples

Example 1—constructive obligation

Fact pattern

An entity is preparing financial statements at 31 December 20X0.

The entity has an informal practice of paying employees a bonus in January each year. Each employee receives a bonus based on his or her salary for the previous year.

The entity has no contractual obligation to pay bonuses, but management judge that withholding the bonuses would cause such damage to employee relationships that the costs of lost productivity would significantly exceed the cost of the bonuses.

Application of concepts

Criterion	Met?	Comment
Arisen from past events?	✓	Employer has received benefits (employee services) that establish extent of its obligation.
No practical ability to avoid?	✓	
Liability at 31 Dec 20X0?	✓	For bonus payable in January 20X1.

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Example 2—conditional obligation

Fact pattern

(Like example 2 in the Illustrative Examples accompanying IFRIC 21 Levies)

An entity is preparing financial statements at 31 December 20X0.

It will be required to pay a levy if it generates revenue in a particular market in 20X1. The levy will be calculated as a percentage of the entity's revenue in the relevant market in 20X0.

Withdrawing from that market would result in lost profits far in excess of the levy.

The entity generates revenue in the market throughout 20X0. In 20X1, it starts to generate revenue again on 3 January 20X1.

Application of concepts

Criterion	Met?	Comment
Arisen from past events?	✓	Event that establishes extent of obligation is revenue in 20X0.
No practical ability to avoid?	✓	
Liability at 31 Dec 20X0?	✓	Liability accumulates throughout 20X0.

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Example 3—restructuring costs

Fact pattern

An entity is preparing financial statements at 31 December 20X0.

The entity is required by law to make one-off payments to employees if it terminates their employment. The amount depends on the length of each employee's past service.

In the normal course of business, the entity rarely needs to make termination payments. However, as a result of a recent acquisition, it now has excess production capacity.

It has prepared, and announced, a detailed plan for closing one factory and terminating the employment of all employees at that factory.

Application of concepts

Criterion	Met?	Comment
Arisen from past events?	✓	Employer has received services that establish extent of obligation.
No practical ability to avoid?	✓	Not a result of, but evidenced by, plan.
Liability at 31 Dec 20X0?	✓	

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Example 4—legal requirement to fit smoke filters

Fact pattern

(Like example 6 in the guidance accompanying IAS 37 Provision, Contingent Liabilities and Contingent Assets)

An entity is preparing financial statements at 31 December 20X0.

Legislation enacted in 20X0 requires entities carrying out a particular type of manufacturing operation after 30 June 20X1 to have smoke filters in their factories.

The entity carries out that type of operation, but has not yet fitted smoke filters in its factory. Fitting smoke filters will be much less costly than alternative courses of action.

Application of concepts

Criterion	Met?	Comment
Arisen from past events?	×	Entity has not received or done anything that establishes extent of obligation.
No practical ability to avoid?	✓	
Liability at 31 Dec 20X0?	×	

Example 5—executory contract

Fact pattern

An entity earns revenue by providing repair services for a particular type of machinery.

The entity provides the services under 5-year fixed-fee contracts.

Customers pay service fees annually at the start of each year. The contracts are profitable.

Application of concepts

Event	Nature of obligation created	Obligation to transfer economic resource?
Signing of contract	Combined obligation and right to exchange services for fees.	✗ Obligation is to exchange resources, and exchange is not unfavourable.
Receipt of fee	Obligation to provide repairs during period covered by fee.	✓

Example 6—legal requirement to refurbish

Fact pattern

(Like example 11 in the guidance accompanying IAS 37 Provisions, Contingent Liabilities and Contingent Assets)

An airline is preparing financial statements at 31 December 20X0.

The airline is required by law to overhaul the engines in its aircraft once every three years. The next overhaul will be required in 20X1.

Application of concepts

Criterion	Met?	Comment
Transfer of economic resources?	×	Entity will receive enhancements to its assets in exchange for overhaul costs.
Arisen from past events?	n/a	Consumption of engines is the result of past use but …
No practical ability to avoid?	n/a	
Liability at 31 December 20X0?	×	...the loss is recognised as depreciation.

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Further information

- Exposure Draft *Conceptual Framework for Financial Reporting*
  http://go.ifrs.org/ED-CF-May2015
- Conceptual Framework website
  http://go.ifrs.org/Conceptual-Framework
- Submit a comment letter
  http://go.ifrs.org/comment_CF
- Snapshot
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