

STAFF PAPER

November 2016

IASB® Meeting

Project	Conceptual Framework
Paper topic	Liability definition and supporting concepts—background information

CONTACTS Joan Brown jbrown@ifrs.org

This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (the Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB Update.

Overview of Agenda Papers 10B–10F

- 1 The Exposure Draft *Conceptual Framework for Financial Reporting* (the Exposure Draft) proposed that:
 - 4.24 A liability is a present obligation of the entity to transfer an economic resource as a result of past events.
- 2 Agenda Papers 10C–10E consider whether any changes are needed to this definition or the proposed supporting concepts. These papers include staff recommendations and questions for the Board. Changes are considered in the light of:
 - (a) feedback on the Exposure Draft;
 - (b) subsequent discussions with the Accounting Standards Advisory Forum (ASAF);
 - (c) matters arising during a staff exercise to test the proposed asset and liability definitions and supporting concepts; and
 - (d) tentative decisions the Board has already reached on:
 - i) its approach to defining liabilities and equity; and
 - ii) the definitions of an asset and a liability.

- 3 This paper (10B) and Agenda Paper 10F provide information to support Agenda Papers 10C–10E. They do not contain any staff recommendations or questions for the Board.

Agenda paper	Paper title
10B (this paper)	Liability definition and supporting concepts—background information
10C	Liability definition and supporting concepts—the ‘no practical ability to avoid’ criterion
10D	Liability definition and supporting concepts—reducing the risk of further changes
10E	Liability definition and supporting concepts—other topics
10F	<p>Testing the proposed asset and liability definitions—illustrative examples.</p> <p>As discussed at October 2016 IASB meeting. Reproduced for reference only at this meeting.</p>

Content of this paper

- 4 The background information in this paper includes a summary of the feedback on the proposed liability definition and supporting concepts, and a reminder of the tentative decisions that the Board has already reached, and further work that the staff have already performed, in the light of that feedback.
- 5 The Board has already reached tentative decisions on:
- (a) the approach to defining liabilities and equity (paragraphs 7–9); and
 - (b) some changes that affect the definitions of both an asset and a liability (paragraphs 10–12).
- 6 The staff have already performed further work on the concepts proposed to support the liability definition (paragraphs 13–22).

Background information

Approach to defining liabilities and equity

- 7 Some respondents to the Exposure Draft questioned the approach the Board is taking to define liabilities and equity. They suggested that the Board should:
- (a) make no changes to the liability definition and supporting concepts until it has completed its project on Financial Instruments with the Characteristics of Equity; or
 - (b) address the distinction between liabilities and equity in the *Conceptual Framework* project.
- 8 The Board discussed this feedback at its meeting in April 2016.¹ It tentatively decided:
- (a) to continue to follow the approach it had taken in developing the Exposure Draft, that is:
 - i) to develop no new concepts to address challenges that arise in classifying financial instruments with characteristics of both liabilities and equity as part of the *Conceptual Framework* project; and
 - ii) instead, to continue to develop concepts to address those challenges in the Financial Instruments with Characteristics of Equity research project, acknowledging that an outcome of that project might be a need to make further changes to the revised *Conceptual Framework*;
 - (b) to continue to develop concepts that address *other* problems in identifying liabilities, and add those concepts to the *Conceptual Framework*, as part of the *Conceptual Framework* project; and

¹ IASB meeting, April 2016, [Agenda Paper 10E Approach to redeliberations—Concepts for liabilities and equity](#).

- (c) to consider refinements to the proposals in the Exposure Draft in developing those concepts, to reduce the risk of adding to the *Conceptual Framework* new concepts that the Board may need to revisit as a result of future decisions on the classification of financial instruments.²
- 9 Possible refinements are considered in Agenda Paper 10D *Liability definition and supporting concepts—reducing the risk of further changes*.

Changes that affect the definitions of both an asset and a liability

- 10 The main change proposed in the Exposure Draft to the existing *Conceptual Framework* definitions would affect the definitions of both an asset and a liability. The Exposure Draft proposed replacing the requirement for ‘expected’ inflows (or outflows) of economic benefits with:
- (a) a requirement for the ‘potential to produce’ economic benefits in the definition of an economic resource; and
 - (b) a requirement for a ‘potential to require’ the transfer of an economic resource in the concepts supporting the definition of a liability.
- 11 Many respondents to the Exposure Draft expressed broad agreement with this change. However, some did not. Their main concern was that, in combination with proposed changes to the recognition concepts, replacing ‘expected’ with ‘potential to produce’ or ‘potential to require’ might result in more low-probability items being recognised in financial statements.
- 12 The Board discussed this feedback at its July 2016 meeting.³ It:

² [IASB Update, April 2016](#)

³ IASB meeting, July 2016, [Agenda Paper 10B Asset definition and supporting concepts](#) and [Agenda Paper 10C Recognition](#).

- (a) confirmed the Exposure Draft proposals:
 - i) to replace ‘expected’ with ‘potential to produce’ and ‘potential to require’ in the definitions and supporting concepts; and
 - ii) not to prescribe a ‘probability criterion’ in the *Conceptual Framework*.
- (b) tentatively decided to enhance the concepts proposed in the Exposure Draft to provide more direction on the recognition of assets and liabilities with a low probability of inflows or outflows of economic benefits, along lines suggested by staff at the July 2016 meeting.⁴

Concepts proposed to support the liability definition

Exposure Draft proposals

- 13 The Exposure Draft proposed several new concepts to support the definition of a liability. The most significant was the proposed description of a 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; in other words, the entity has received the economic benefits, or conducted the activities, that establish the extent of its obligation.

Summary of feedback

- 14 Many respondents broadly agreed with this description of a present obligation. Those respondents included most responding users of financial statements, regulators, standard-setters, accounting firms, and accountancy bodies, and most preparers of financial statements *except* banks. Most of the banks responding disagreed with the proposed description, expressing particular concern about the implications for the

⁴ [IASB Update, July 2016](#).

classification of claims as liabilities or as equity. Their concerns are discussed in Agenda Paper 10C *Liability definition and supporting concepts—the ‘no practical ability to avoid’ criterion*.

- 15 Even among respondents who broadly agreed with the proposed description of a present obligation, some expressed concerns that the description, or aspects of the accompanying guidance, would be difficult to interpret and implement. Their concerns are also discussed in Agenda Paper 10C.
- 16 A few respondents thought that the proposed description could be interpreted in unwelcome or inappropriate ways that are inconsistent with existing requirements. For example, they suggested that the proposed description could lead to conclusions that:
- (a) some entities have liabilities not only for levies chargeable for current-year operations, but also for levies expected to be charged for several (or many) future years’ operations if entities do not have the practical ability to withdraw from the relevant market quickly;
 - (b) liabilities arise for potential payments under long-term incentive plans as soon as the plans commence;
 - (c) entities have liabilities for future expenses that they will be compelled to incur, such as aircraft or other asset maintenance obligations. The enactment of a law could be the past event that leads to recognition of liabilities for all future payments required under the law that the entity lacks the practical ability to avoid;
 - (d) entities cannot have liabilities for future restructuring costs because the obligations to pay costs of a future restructuring do not arise from past activities;
 - (e) liabilities should be recognised for obligations arising from executory contracts; or
 - (f) deferred tax balances do not meet the definitions of assets and liabilities.

- 17 Some respondents suggested that, before the Board finalises the revised *Conceptual Framework*, it conduct further work to test the robustness and implications of the proposed definitions and supporting concepts. Those respondents were geographically diverse and included a regulator, accounting firms, standard-setters and preparers of financial statements. Specific further work suggested by respondents included:
- (a) a thorough analysis of how the proposed concepts can be reconciled to, or conflict with, existing Standards, and in particular:
 - i) how the proposed concepts fit with those in IAS 37;
 - ii) an explanation of why the Board has not identified some of the transactions listed in paragraph 16 as areas of inconsistency between existing requirements and the proposed concepts.
 - (b) a fuller analysis of the practical implications of the proposed descriptions (and related guidance) for a range of transactions.

Work already performed by the staff in response to the feedback

- 18 In response to these suggestions, the staff performed an exercise to test the proposed asset and liability definitions and supporting concepts. The staff prepared an analysis of:
- (a) the outcome of applying the proposed definitions of an asset and a liability, and supporting concepts, to a range of illustrative examples; and
 - (b) ways in which the definitions and supporting concepts could help the Board reach decisions in some of its current projects.

The analysis covered all the suggestions summarised in paragraph 17.

- 19 The Board discussed the staff analysis in October 2016. The analysis has been reproduced for reference at this meeting—Agenda Paper 10F *Testing the proposed asset and liability definitions—illustrative examples*.

- 20 The illustrative examples in the analysis address the specific concerns listed in paragraph 16. They explain why the staff suggest that, applying the proposed concepts:
- (a) levies will often—though not always—accumulate over the period for which they are charged (Examples 2.5(a)–(c) *Levies*);
 - (b) liabilities arise for potential payments under long-term incentive plans as employees provide their service, not when the plans commence (Example 2.4 *Long service leave*);
 - (c) entities would not identify liabilities for future aircraft maintenance costs (Example 2.8 *Refurbishment costs*);
 - (d) the announcement of a restructuring plan could remain a trigger for identifying liabilities for some restructuring costs (Examples 2.6(a)–(b) *Restructuring costs*);
 - (e) in many cases no liability would be recognised for obligations arising from executory contracts, unless the contracts were onerous (Example 3.1 *Executory purchase contract* and Example 3.2 *Executory sale contract*); and
 - (f) recognition of a deferred tax balance as a separate liability (or asset)—as required by existing IFRS Standards—rather than as part of the measurement of an underlying asset or liability, arguably meets the objectives of financial reporting. However, long-standing debates about whether deferred tax meets the definition of a liability are likely to continue. (Examples 2.9(a)–(b) *Deferred taxes*).
- 21 The staff also discussed the illustrative examples with participants at the World Standard-setters Meeting in September 2016 and, from these discussions, identified further matters for consideration by the Board. These matters concern the proposed description of a ‘past event’ and the lack of concepts on ‘existence uncertainty’. Both matters are discussed further in Agenda Paper 10E *Liability definition and supporting concepts—other topics*.

- 22 Finally, in response to some specific feedback on the Exposure Draft, the staff have considered possible refinements to the concepts supporting the liability definition. The staff discussed some possible refinements with the ASAF in July 2016. The feedback from ASAF members is included in the discussion of the relevant topics in Agenda Papers 10C–10E.