STAFF PAPER

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IASB Meeting

Project	**Conceptual Framework**
Paper topic	Liability definition and supporting concepts—reducing the risk of further changes

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Overview of paper

Purpose of paper

1. Paragraphs 4.24–4.39 of the Exposure Draft *Conceptual Framework for Financial Reporting* (the Exposure Draft) proposed a new definition of a liability and new concepts to support that definition.

2. This paper considers refinements to the proposals in the Exposure Draft to reduce the risk of adding to the *Conceptual Framework* new concepts that the Board may need to change as a result of future decisions on classifying financial instruments.

Staff recommendations

3. The staff recommend that the revised *Conceptual Framework* should omit two concepts proposed in the Exposure Draft that would apply in practice only to questions of how to distinguish between liabilities and equity claims:

   (a) a statement that, if an entity that prepares financial statements on a going concern basis, that entity does not have a liability for a transfer that would be required only on liquidation (in paragraph 4.33(b)); and

(b) a statement that an obligation of an entity to transfer its own equity claims to another party is not an obligation to transfer an economic resource (paragraph 4.30). That statement implies that an obligation for an entity to transfer its own equity instruments never constitutes a liability (even if the obligation requires the transfer of a variable number of equity instruments with a fixed total value), and is inconsistent with existing IFRS requirements.

4. The staff recommend that the revised *Conceptual Framework* should also omit the description of a present obligation proposed in paragraph 4.31 of the Exposure Draft. However, it should include the supporting discussion proposed in the Exposure Draft, which identifies both of the criteria in that description as necessary characteristics of a present obligation.

Background information

Previous Board decisions

5. As explained in Agenda Paper 10B *Liability definition and supporting concepts—background information*, the Board is addressing financial instrument classification in a separate project on Financial Instruments with Characteristics of Equity. The Board has decided that the concepts in the revised *Conceptual Framework* will not necessarily limit the range of possibilities explored in that project. Consequently, an outcome of that project might be a need to make further changes to the revised *Conceptual Framework*.

6. In April 2016, the Board decided to consider refinements to the proposals in the Exposure Draft to reduce the risk of adding to the *Conceptual Framework* new concepts that the Board may need to change as a result of decisions it makes in its Financial Instruments with Characteristics of Equity project.

Refinements recommended in Agenda Paper 10C

7. In paragraph 48 of Agenda Paper 10C *Liability definition and supporting concepts—the 'no practical ability to avoid' criterion*, the staff recommend that the Board should refine the concepts on the meaning of 'no practical ability to avoid' proposed in paragraph 4.32 of the Exposure Draft. The refined concepts should state that the factors considered in reaching a conclusion that an entity has no practical ability to avoid a transfer would depend on the type of transaction under consideration.

8. The revised *Conceptual Framework* would state that, for some types of transaction, an entity *may* have no practical ability to avoid a transfer if all avoiding actions would have economic consequences significantly more adverse than the transfer itself. But they would not suggest that economic factors would necessarily be the basis of the assessment.

9. This refinement could reduce the risk of inconsistencies between the revised *Conceptual Framework* and future decisions in the Financial Instruments with Characteristics of Equity project, because:

   (a) in that project, the Board is considering the classification of instruments that give the issuer an option to choose between an equity settlement outcome and a liability settlement outcome;

   (b) in reaching decisions, the Board might at some stage take the view that classification of some such instruments should depend on whether the issuing entity has the practical ability to exercise the equity settlement option; but

   (c) the factors that the Board specifies to assess whether an entity has the practical ability to exercise an equity settlement option within a financial instrument might be different from those identified in paragraph 4.32 of the Exposure Draft.

10. In October 2016, the Board tentatively decided that, under the 'Gamma' approach that it is developing in the Financial Instruments with Characteristics of Equity project, economic incentives that might influence the issuer's decision to exercise its rights

should not be considered when classifying a claim as either a liability or equity. Thus, under the Gamma approach, classification would be based on the substantive rights and obligations established by a contract, including obligations that are established indirectly through the terms of the contract.[1,2]

Further refinements considered in this paper

11. This paper discusses two further refinements that could reduce the risk of adding to the *Conceptual Framework* new concepts that the Board may need to change as a result of future decisions on classifying financial instruments. They would involve:

    (a) omitting new concepts that would apply only to classification of claims (paragraphs 13–22); and

    (b) discussing the necessary characteristics of a liability in a different way (paragraphs 23–31).

12. The appendix to this paper illustrates one way in which the staff recommendations in this paper could be drafted.

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[1] As discussed in Agenda Paper 10C, the phrase 'no practical ability to avoid' would identify whether an entity has a substantive obligation. Economic consequences may affect the assessment of whether a liability exists only if they are so significant that the entity has no practical ability to take a particular action. Mere economic incentives would not play a role in that assessment.

[2] In the Financial Instruments with Characteristics of Equity project, the Board has observed that an entity typically has the right to satisfy, in whole or in part, all claims against it, including ordinary shares, by transferring economic resources at some point in time. This could be for a variety of reasons, including because it is significantly economically favourable to do so. Equity classification is not intended to mean that economic resources will never be transferred to holders of equity claims. If there is no possibility of transferring economic resources, then the question is whether there is a claim at all. This is why it is useful to distinguish between:

(a) issues concerned with determining whether a claim exists or not; and

(b) issues concerned with determining whether an existing claim is classified as a liability or equity based on particular characteristics of the claim.

Possible refinement 1—Omitting new concepts that would apply only to classification of claims

Exposure Draft proposals

13. Two of the concepts that the Exposure Draft proposed to add to the *Conceptual Framework* would apply in practice only to questions of how to classify a claim, and not to any other questions that arise in identifying liabilities.

14. The first of those concepts was proposed in paragraph 4.33(b) of the Exposure Draft. This paragraph stated that if an entity prepares financial statements on a going concern basis, it has the practical ability to avoid a transfer that would be required only on the liquidation of the entity or on the cessation of trading. This statement implies that any present claim that would be settled only on liquidation is an equity claim. Such an outcome is inconsistent with two of the three approaches to classification being developed in the Financial Instruments with Characteristics of Equity project (the 'Beta' and 'Gamma' approaches). The Beta and Gamma approaches would both classify as a liability an obligation to transfer an amount that is independent of the entity's economic resources, even if the transfer is required only on liquidation of the entity.

15. The other proposal that would apply only to classification of claims was in paragraph 4.30 of the Exposure Draft:

> 4.30 An equity claim does not contain an obligation to transfer economic resources. Furthermore, an equity claim is not an economic resource for the issuer. It follows that an obligation of an entity to transfer its own equity claims to another party is not an obligation to transfer an economic resource.

16. As some respondents to the Exposure Draft observed, applying paragraph 4.30, an obligation for an entity to transfer its own equity instruments would never constitute a liability, even if the obligation required the transfer of a variable number of equity instruments with a fixed total value. Those respondents noted that such an outcome would be inconsistent with requirements in some existing Standards, and suggested

that the proposal was pre-judging the outcome of the Financial Instruments with Characteristics of Equity project.

17. Such an outcome would also be inconsistent with the Beta and Gamma approaches. Those approaches would both classify as a liability an obligation for an amount that is independent of the entity's economic resources, even if that obligation is satisfied by transferring equity claims.

Staff analysis

18. At the July 2016 meeting of the Accounting Standards Advisory Forum (ASAF), the staff asked ASAF members for their views on omitting these two concepts from the revised *Conceptual Framework*. One ASAF member explicitly agreed. No ASAF members objected to omitting the statement in paragraph 4.33(b) of the Exposure Draft that if an entity prepares financial statements on a going concern basis, it has the practical ability to avoid a transfer that would be required only on the liquidation of the entity or on the cessation of trading. However, several ASAF members expressed concerns about omitting paragraph 4.30, arguing that:

   (a) something is needed in the *Conceptual Framework* to prevent people from reading the proposed concepts to mean that an entity's obligations to transfer its own equity claims are (all) liabilities; and

   (b) the Board can revise paragraph 4.30 when it makes the other changes required as a result of its Financial Statements with Characteristics of Equity project.

19. The existing *Conceptual Framework* does not include any concepts similar to those proposed in paragraph 4.30 and 4.33(b) of the Exposure Draft. Omitting those paragraphs from the revised *Conceptual Framework* would not remove existing concepts, it would amount only to not adding new ones.

20. Furthermore, omitting paragraph 4.30 should not be read to mean that an entity's obligations to transfer its own equity claims are (all) liabilities. The Board could provide this reassurance by communicating clearly the scope and implications of the

Conceptual Framework project and how it interacts with the Financial Instruments with Characteristics of Equity project.

Staff recommendations

21. For the reasons in paragraphs 18–20, the staff recommend that the revised *Conceptual Framework* should omit two concepts proposed in the Exposure Draft that would apply in practice only to questions of how to distinguish between liabilities and equity claims:

    (a) a statement that, if an entity that prepares financial statements on a going concern basis, that entity does not have a liability for a transfer that would be required only on liquidation (in paragraph 4.33(b)); and

    (b) a statement that an obligation of an entity to transfer its own equity claims to another party is not an obligation to transfer an economic resource (paragraph 4.30). That statement implies that an obligation for an entity to transfer its own equity instruments never constitutes a liability (even if the obligation requires the transfer of a variable number of equity instruments with a fixed total value), and is inconsistent with existing IFRS requirements.

22. The drafting illustration in the appendix to this paper illustrates the effect of omitting those two concepts.

Question 1—omitting new concepts that would apply only to classification
Do you agree with the staff recommendation in 21?

Possible refinement 2—Discussing the necessary characteristics of a liability in a different way

Exposure Draft proposals

23. Paragraph 4.31 of the Exposure Draft proposed that an entity has a present obligation to transfer an economic resource (in other words, a liability) if:

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

    (b) the obligation has arisen from past events.

24. The two criteria in the description were then explained further in paragraphs 4.32–4.39 of the Exposure Draft.

25. Written in this way, the two criteria identified in the description could be interpreted not only as *necessary* characteristics of a liability, but also as *sufficient* characteristics. In other words, paragraph 4.31 could be interpreted to mean that any claim against the entity that meets these two criteria would be a liability; it could not be an equity claim.

Possible refinement

26. The description of a liability proposed in the Exposure Draft was developed to help identify when any claim meeting the definition of a liability arises, not whether any claim meeting the specified conditions at that time necessarily constitutes a liability.

27. The staff think that this aim could still be achieved if the revised *Conceptual Framework* omitted the description of a present obligation (paragraph 4.31 of the Exposure Draft) but kept the supporting discussion, which identifies both of the criteria in that definition as necessary (but not necessarily sufficient) characteristics of a present obligation.

28. This format would be more consistent with the format of the existing *Conceptual Framework*, which has a paragraph discussing each of the terms within the existing

definition (present obligation, past events etc). It describes the term 'present obligation' as an 'essential characteristic' of a liability.[3]

Feedback from ASAF

29. The staff discussed this suggestion with the ASAF in July 2016. A few ASAF members said they agreed with the change. A few ASAF members questioned aspects of illustrative drafting included in the ASAF paper. In particular, they questioned a new paragraph that suggested linking the liability definition to the supporting concepts by listing the essential characteristics in summary form. One ASAF member thought that this list of essential characteristics seemed to be competing with the definition and elevating the status of particular concepts. This was not the intention. So the drafting illustrated in the appendix to this paper does not include a summary list of essential characteristics.

Staff recommendations

30. The staff recommend that the revised *Conceptual Framework* should omit the description of a present obligation proposed in paragraph 4.31 of the Exposure Draft. However, it should include the supporting discussion proposed in the Exposure Draft, which identifies both of the criteria in that description as necessary characteristics of a present obligation.

31. The drafting illustration in the appendix to this paper illustrates one way in which these changes could be put into effect.

Question 2—discussing the necessary characteristics of a liability in a different way
Do you agree with the staff recommendation in paragraph 30?

[3] Existing *Conceptual Framework*, paragraph 4.15.

APPENDIX—Drafting illustration—possible refinements to concepts supporting the liability definition

A1. This appendix illustrates one way in which the staff recommendations in this paper and Agenda Papers 10C and 10E *Liability definition and supporting concepts—other topics* could be drafted in the revised *Conceptual Framework*. The exact words would be chosen when the revised *Conceptual Framework* is being drafted. The Board is not asked to approve the drafting at this stage.

A2. The original text is from the Exposure Draft. The suggested additions and deletions are marked. Some paragraphs have been re-ordered. The re-ordering is not marked, but the paragraphs keep the numbers they had in the Exposure Draft.

Definition of a liability

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

4.25 If one party has an obligation to transfer an economic resource (a liability), it follows that another party (or parties) has a right to receive that economic resource (an asset). The party (or parties) could be a specific person or entity, a group of people or entities, or society at large.

4.26 A requirement for one party to recognise a liability (or asset) and measure it at a specified amount does not imply that the other party must recognise the corresponding asset (or liability) or measure it at the same amount. Applying different recognition criteria or measurement requirements to the liability (or asset) of one party and the corresponding asset (or liability) of the other party may sometimes be an outcome of decisions intended to meet the objective of financial reporting.

~~Obligation to transfer~~Transfer of an economic resource

4.27 An entity's obligation to transfer an economic resource must have the potential to require the entity to transfer an economic resource to another party. It need not be certain, or even probable, that the entity will be required to transfer an economic resource, but the obligation must already exist and there must be at least one circumstance in which it will require the entity to transfer an economic resource. One example of such an obligation is an obligation to stand ready to transfer an economic resource if an uncertain future event occurs.

4.28 Obligations to transfer an economic resource include, for example, obligations to:

(a) pay cash;

(b) transfer other assets;

(c) exchange economic resources with another party on unfavourable terms (see paragraphs 4.40–4.42);

(d) provide services; or

(e) issue another obligation that will oblige the entity to transfer an economic resource.

4.29 Instead of fulfilling an obligation to transfer an economic resource, entities sometimes:

(a) settle the obligation by negotiating a release from the obligation;

(b) transfer the obligation to a third party; or

(c) replace the obligation with another obligation to transfer an economic resource.

~~4.30 An equity claim does not contain an obligation to transfer economic resources. Furthermore, an equity claim is not an economic resource for the issuer. It follows that an obligation of an entity to transfer its own equity claims to another party is not an obligation to transfer an economic resource.~~

This paragraph would apply in practice only to questions of how to distinguish between liabilities and equity claims. As discussed in paragraphs 13–20 of this paper.

If the Board wanted to retain the statement that an equity claim is not an economic resource for the issuer, we could move it to the concepts supporting the definition of an asset.

~~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.~~

Omitted to avoid implying that any claim with these characteristics is necessarily a liability (as opposed to an equity claim). The two criteria in the description continue to be discussed below as necessary characteristics of a liability. As discussed in paragraphs 23–28 of this paper.

~~No practical ability to avoid the transfer~~Obligation

4.34 An obligation compels an entity to do something. Obligations can arise in various ways. Many obligations are legally enforceable as a consequence of a contract, legislation or similar means. Obligations can also arise, however, from an entity's customary practices, published policies or specific statements if ~~that require the transfer of an economic resource. If~~ the entity has no practical ability to act in a manner inconsistent with those practices, policies or statements~~, the entity has an obligation~~. The obligation that arises in such situations is often described as a constructive obligation.

New introduction needed in absence of paragraph 4.31.

4.32 The factors used to assess whether an entity has the practical ability to avoid a transfer may depend on the type of transaction under consideration. For some types of transaction, an ~~An~~ entity may have ~~has~~ no practical ability to avoid a transfer if~~, for example, the transaction is legally enforceable or,~~ any action ~~necessary~~ that it could take to avoid the transfer would cause significant business disruption or would have economic consequences significantly more adverse than the transfer itself. To conclude that an entity has no practical ability to avoid a transfer, it would never be ~~It is not~~ sufficient that the management of the entity intends to make the transfer or that the transfer is probable.

To reflect the changes recommended in Agenda Paper 10C and also discussed in paragraphs 7–9 of this paper.

4.35 In some situations, the requirement for an entity to transfer an economic resource may be expressed as being conditional on a particular future action by the entity, such as conducting particular activities or exercising particular options within a contract. The entity has an obligation if it has no practical ability to avoid that action.

4.33 If an entity prepares financial statements on a going concern basis, the entity~~:~~

~~(a)~~ has no practical ability to avoid a transfer that could be avoided only by liquidating the entity or ceasing trading; ~~but~~

~~(b) has the practical ability to avoid (and hence does not have a liability for) a transfer that would be required only on the liquidation of the entity or on the cessation of trading.~~

> Would apply in practice only to questions of how to distinguish between liabilities and equity claims. As discussed in paragraphs 13–20 of this paper.

Present obligation as a result of past events

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

> To reflect changes recommended in Topic 1 of Agenda Paper 10E.

4.36A The enactment of a law (or the introduction of some other enforcement mechanism, policy or practice, or the making of a statement) is not in itself sufficient to give an entity a present obligation. The entity must have conducted an activity to which a present law (or other present enforcement mechanism, policy, practice or statement) applies.

4.37 An event establishes the extent of an obligation if it specifies either the amount of the future transfer or the basis for determining that amount. For example, an insurer may enter into a contract to provide insurance coverage in return for a single premium. When the insurer receives the premium, it has an obligation to provide insurance coverage because:

(a) although the amount of any future transfer still depends on whether an insured event occurs, the insurer has no practical

> The main purpose of this paragraph was to explain the meaning of 'establishes the extent'. It would need to be amended as a consequence of the changes to paragraph 4.36. It could possibly be deleted. The staff have not yet considered whether or how to amend or delete or this paragraph.

ability to avoid transferring an economic resource if an insured event occurs; and

(b) the insurer has received the premium that establishes that it must provide coverage to the extent specified by the contract, and this provides the basis for determining the amount of any future transfer.

4.38 A present obligation can exist at the end of the reporting period even if the transfer of economic resources cannot be enforced until some point in the future. For example, a financial liability may not require a payment to be made until a future date. The payment cannot be enforced until that future date, but the liability exists now. Similarly, a contractual obligation for the entity to perform work at a future date cannot be enforced by the counterparty until that future date, but the obligation arising from the contract exists now if the counterparty has already paid for the work (see paragraphs 4.40–4.42).

4.39 An entity does not have a present obligation for the costs that will arise if it will receive benefits, or conduct activities, in future (for example, the costs of future operations); ~~the extent of the future transfer will not be determined by reference to benefits that~~ the entity has not yet received benefits, or conducted activities that will or may require it to transfer an economic resource that it would not otherwise have had to transfer ~~that it has conducted, in the past~~. If the entity has entered into a contract that is still executory, the entity may have a present right and obligation to exchange economic resources in the future (see paragraphs 4.40–4.42).

As a consequence of changes to paragraph 4.36.

4.39A In some cases, there might be uncertainty about past events. For example, if another party claims that an entity has committed an act of wrongdoing and should compensate the other party for that act, it might be uncertain whether that act occurred, whether the entity committed it or how the law applies. Until the uncertainty about the past events is resolved—for example by a court ruling—it is uncertain whether a liability exists. Paragraph 5.16 discusses recognition of liabilities whose existence is uncertain.

To implement the staff recommendation in Topic 6 of Agenda Paper 10E.