AASB Staff Issues Paper on IASB Conceptual Framework Developments (Draft IASB Discussion Paper)

Definitions of the Elements of Financial Statements

Introduction

1 This AASB Staff Issues Paper, together with AASB Agenda Paper 14.3, provides the focus for the Board's non-deliberative high-level 'educational' session at the forthcoming AASB meeting on the latest publicly available Draft IASB Discussion Paper (DP) on Conceptual Framework, as reflected in IFRS Staff Papers issued in April 2013.

2 Extracts from the Draft IASB DP covering the definitions of the elements of financial statements are provided in AASB Agenda Papers 14.4 and 14.5. Each of those papers is a copy of an IFRS Staff Paper.

3 This paper includes the AASB staff's questions that AASB members will be asked to discuss regarding the above-mentioned extracts from the Draft IASB DP. Board members' tentative leanings on these questions would be welcome.

Background on the selected questions asked in this paper

4 The questions asked of AASB members in this paper focus on the key issues, as AASB staff see them, affecting the IASB's draft discussion of the definitions of the elements of financial statements. Board members' views on them will inform staff in identifying key concerns to raise in an initial draft of the AASB's submission on the IASB DP and in discussions with AOSSG and ASAF members.

5 Some of the questions in this paper (Questions 1, 2, 4, 7 and 8) are closely related to questions asked of IASB members in the attached IFRS Staff Papers (AASB Agenda Papers 14.4 and 14.5). Other questions in this paper raise issues not raised in the IFRS Staff Papers (Questions 3, 5 and 6). Some questions asked of IASB members in the attached IFRS Staff Papers (namely, those in paragraph 63 of AASB Agenda Paper 14.4 and paragraphs 95 and 98 of AASB Agenda Paper 14.5), are not raised in this paper because AASB staff think they do not relate to key issues or they relate to issues that have yet to be developed sufficiently (e.g. analysis of the 'unit of account' topic, to which the draft IASB question in paragraph 63 of AASB Agenda Paper 14.4 relates). Any IASB questions on the definitions of the elements of financial statements that are not included in this paper could be addressed in AASB Staff Papers for future Board meetings.

6 At the Board meeting session, AASB staff will give a PowerPoint-based verbal presentation on the parts of the draft IASB DP covered by AASB Agenda Papers 14.4 and 14.5. (Copies of the PowerPoint slides will be tabled at the Board meeting.)

7 This paper includes views of AASB staff on the issues discussed. Consistent with the introductory nature of this Board meeting's discussion, those AASB staff views are tentative in nature.

Proposed Definitions of an Asset and a Liability

8 Except for their references to past events, the proposed revised definitions of an asset and a liability are agreed with by AASB staff. Those revised definitions in paragraph 14 of IFRS Staff Paper 10B(a) for the IASB's April 2013 meeting (AASB Agenda Paper 14.4) are:

> "An asset (of an entity) is a present economic resource controlled by the entity as a result of past events"; and
>
> "A liability (of an entity) is a present obligation of the entity to transfer an economic resource as a result of past events."

9 Accordingly, AASB staff agree with amending the existing definitions of an asset and a liability to indicate that those elements are, respectively, a resource and an obligation, rather than (in both cases) inflows or outflows of economic benefits expected to arise from the element. AASB staff also agree with removing "expected" from the definitions of an asset and a liability, to remove any connotations of a likelihood threshold for the existence of the element (see paragraph 38(a) of AASB Agenda Paper 14.4).

10 In relation to the comment in paragraph 16(b) of AASB Agenda Paper 14.4 that the proposed change to the definitions of an asset and a liability "would … show more clearly the parallel between [them]", AASB staff note that those definitions would not be mirror images of each other, nor should they be. This is because, although each liability involves a present relationship with another party or group of parties (i.e. is an asset, in the form of a right, held by another party or group), the converse does not apply to each asset. That is, many non-monetary assets (e.g. property, plant and equipment and various intangible assets) do not involve a present relationship with another party or group of parties (i.e. there are no corresponding liabilities of others in respect of them).

Question for Board members

Q1 What are your tentative leanings on the IASB's preliminary views to:

(a) amend the existing definitions of an asset and a liability to indicate that those elements are, respectively, a resource and an obligation; and

(b) remove "expected" from the definitions of an asset and a liability?

Past Event

11 Consistent with the related comment in the AASB's submission on the IPSASB's Conceptual Framework ED *Elements and Recognition in Financial Statements* (dated 15 May 2013), AASB staff disagree with the IASB's preliminary view to retain a reference to 'past events' in the definitions of an asset and a liability. In relation to the definition of an asset, the AASB's submission said:

"The AASB considers that every asset of a reporting entity that qualifies for recognition is the result of a past event.[4] However, the AASB considers that *identification* of a past event of the reporting entity should not be necessary for an asset to qualify for recognition (and, consequently, should not be an essential characteristic of an asset). This is because the AASB agrees with the arguments in paragraph 2.46 of the IPSASB's Consultation Paper (CP) *Elements and Recognition in Financial Statements* (December 2010: see quote below), albeit in the context of recognition criteria for an asset rather than the definition of an asset (because a past event would be one way of associating an asset with a particular reporting entity). Paragraph 2.46 of the IPSASB's Consultation Paper (CP) said:

> "Those who contend that a past transaction or event is not a necessary condition for an asset point out the following:
>
> (a) Past transactions or events may have resulted in assets that no longer exist; and
>
> (b) The inability to identify a past transaction or event may lead to non-recognition of an asset. Many place undue emphasis on identifying the past event that gave rise to an asset. Although this may be helpful, it may be a distraction and lead to debates about which event is the triggering event instead of focusing on whether the rights to benefits exist at the reporting date."

Although the AASB thinks a past event should not be an essential characteristic of an asset, it would support:

(a) emphasising the importance of a past event of the reporting entity as an indicator that an asset of the reporting entity would, subject to meeting other recognition criteria, qualify for recognition; while

(b) noting that the existence of a past event does not guarantee that an asset continues to qualify for recognition.

4 Note that these AASB views refer to assets that qualify for recognition, rather than items that meet the definition of an asset, because, as mentioned above, the AASB considers that factors (such as a past event) that associate an item with an entity should ideally be treated as recognition considerations."

12 AASB staff note that paragraphs 19(a) and 19(c) of AASB Agenda Paper 14.4 seem inconsistent regarding whether it is necessary for a past event to be identified in order to identify an asset or a liability. Paragraph 19(c) provides the reason for including a reference to 'past event' in the definitions of an asset and a liability. However, paragraph 19(a), with which we agree, says:

> "… to determine whether an asset or liability exists, the key question is whether the entity has an economic resource or obligation at the reporting date. To answer this question, it is not necessary to identify precisely which past event brought the resource under the entity's control or imposed the obligation on the entity."

13 See also paragraph 38(a) below regarding possible problems with focusing on past events, in the context of liability identification.

Question for Board members

Q2 What are your tentative leanings on the IASB's preliminary views to retain the reference to 'past events' in the definitions of an asset and a liability?

Definition of a Liability: Meaning of 'Present Obligation'

14 The IFRS Staff Paper 10C(a) *Additional guidance to support the asset and liability definitions* (AASB Agenda Paper 14.5) discusses whether 'constructive obligations' should, in concept, be identified as liabilities. 'Constructive obligations' are not explicitly referred to in the current IASB Conceptual Framework, and AASB Agenda Paper 14.5 (paragraph 37) refers to the definition of constructive obligation in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, namely:

> "A *constructive obligation* is an obligation that derives from an entity's actions where:
>
> (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
>
> (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities." (IAS 37, paragraph 10)

15 AASB Agenda Paper 14.5 notes problems in practice with applying the notion of constructive obligations in various IFRSs, such as difficulties in:

(a) judging whether, and to what extent, an entity's past practices, policies or statements are sufficient to have created a valid expectation among other parties that the entity will accept certain responsibilities; and

(b) distinguishing constructive obligations from situations in which an entity is economically compelled to take a particular course of action in the future.

16 Two of the more significant aspects of this issue discussed in AASB Agenda Paper 14.5 are:

(a) whether to limit liabilities to obligations that are enforceable by legal or equivalent means (thus effectively excluding 'constructive obligations' from the concept of a liability); and

(b) possible approaches to 'obligations' whose outcome depends on future events.

17 The following discussion reflects the implicit assumption in AASB Agenda Papers 14.4 and 14.5 that factors associating an element with an entity are addressed

in the definition of that element, rather than being addressed in the recognition criteria. AASB staff note that, in its submission on the IPSASB's Conceptual Framework ED *Elements and Recognition in Financial Statements*, the AASB argued that factors associating an element with an entity ideally should be addressed in the recognition criteria.

Whether to exclude 'constructive obligations' from the concept of a liability

18 The IASB's preliminary view in AASB Agenda Paper 14.5 (paragraph 59) is that the Conceptual Framework should not limit liabilities to obligations that are enforceable by legal or equivalent means (therefore, a 'constructive obligation' should in concept qualify as a liability). The IASB's preliminary view is also that guidance should be added to help distinguish constructive obligations from economic compulsion, and should indicate that, for an entity to have a constructive obligation:

(a) the entity must have a duty or responsibility to another party (e.g. economic compulsion to act in the best interests of the entity or its shareholders is insufficient);

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

(c) as a result of the entity's past actions, the other party can reasonably rely on the entity to discharge its duty or responsibility (AASB Agenda Paper 14.5, paragraph 47).

19 While AASB staff broadly agree with (a) – (c), we think this guidance on a constructive obligation should also clarify that, as a result of the other party being entitled to reasonably rely on the entity to discharge its duty or responsibility [see (c) above], the entity has little or no discretion to avoid a transfer of economic resources. This is because AASB staff think:

(a) having little or no discretion to avoid a transfer of economic resources should be identified as an essential characteristic of a liability (see discussion in paragraphs 21 – 22 and 29 below); and

(b) it seems possible to meet the conditions in (a) – (c) above without having little or no discretion to avoid a transfer.

20 AASB staff do not suggest adding to the guidance on a constructive obligation a condition that the other party has the power to compel the entity to discharge its duty or responsibility, because that power would, in effect, make the obligation enforceable by legal or equivalent means and therefore not a constructive obligation.

21 In his forthcoming AASB Occasional Paper on Liabilities[1], Warren McGregor supports including ‘constructive obligations’ in the concept of a liability and that an entity has a present obligation when there is either a mechanism to enforce a transfer of economic resources against the entity or the entity has, through its own actions, effectively removed its discretion to avoid a transfer. AASB staff generally agree with those views, subject to whether the concept of a constructive obligation can effectively be distinguished from economic compulsion to transfer economic resources. We think that making such a distinction effectively is a huge challenge. As the comments in paragraphs 38(b) and 40 – 47 below indicate, the approaches to defining a liability that are considered by the IASB and treat constructive obligations as liabilities do not seem likely to make that distinction effectively.

22 Similarly to the forthcoming Occasional Paper by Warren McGregor, the IPSASB’s Conceptual Framework ED *Elements and Recognition in Financial Statements* proposed that a present obligation is “a … requirement, which an entity has little or no realistic alternative to avoid” (November 2012, paragraph 3.2). The AASB’s submission on that ED did not specifically indicate whether the Board agrees with that view, focusing instead on its preference that such notions are addressed in the recognition criteria for liabilities, rather than the definition of a liability.

23 The questions for Board members on whether constructive obligations should be included in the concept of a liability are set out under paragraph 30 below (Question 3), after a discussion of the AASB staff’s tentative view on the definition of a liability that would provide the most useful information to users; and under paragraph 49 below (Question 4), after a discussion of whether, in effect, that definition needs to be modified because of concerns about whether the concept of a constructive obligation can effectively be distinguished from economic compulsion to transfer economic resources.

Possible approaches to ‘obligations’ whose outcome depends on future events

24 AASB Agenda Paper 14.5 notes that, when the outcome of an entity’s ‘obligations’ depends on future events beyond the entity’s control, the entity has an unconditional obligation to stand ready to transfer economic resources if the specified future event occurs, and that obligation is a liability (paragraphs 63 – 64). AASB Agenda Paper 14.5 notes that the more contentious issue is whether a present obligation exists if the eventual need to transfer economic resources depends on the entity’s own future actions.

25 AASB Agenda Paper 14.5 discusses three possible approaches to whether a present obligation arises from a requirement to transfer an economic resource that depends on the entity’s future actions:

<u>Approach 1:</u> A present obligation must be unconditional

<u>Approach 2:</u> A present obligation arises when the entity receives benefits for which it accepts a responsibility to transfer an economic resource

[1] AASB Occasional Paper No. 1, *Liabilities – the neglected element: a conceptual analysis of the financial reporting of liabilities* (which is in the process of finalisation for publication in the near future).

Approach 3: Focus on past events instead of future events

26 A simple example illustrating the potential differences between these approaches is 'Example 7: Variable lease payments' in paragraph 66 of AASB Agenda Paper 14.5, reproduced below:

> "A lease agreement for a retail unit in a shopping mall requires a lessee to pay a variable rental of 1% of its monthly sales. The lease commences on the last day of the entity's reporting period. The first variable payment will be calculated by reference to sales in the first month in the next reporting period."
>
> AASB Agenda Paper 14.5 says that, at the reporting date:
>
> (a) under Approach 1, a present obligation **does not exist** because the lessee could avoid making sales from the leased retail unit (Table 1, paragraph 68);
>
> (b) under Approach 2, a present obligation **does not exist** because the retailer has not yet started to receive the benefits from the sales that will give rise to a responsibility to pay a variable lease rental, in the absence of fixed lease payments (Table 2, paragraph 73)[2]; and
>
> (c) under Approach 3, a present obligation **exists** because, as a result of the past receipt of a right-of-use asset, the lessee will have to pay to the lessor 1% of any sales it makes during the remaining lease period (Table 3, paragraph 75).

AASB Staff's Introductory Comments

27 AASB Agenda Paper 14.5 does not appear to clearly explain the relationship between the significance of the conditionality of an obligation and whether constructive obligations should be encompassed by the definition of a liability. This is because it is unclear to AASB staff whether, under all three of these approaches, at least some constructive obligations would qualify as a liability. This is discussed further in relation to Approach 1 (see paragraph 33 below).

28 AASB staff think the appropriate choice among these Approaches should depend on the underlying principle for a present obligation (liability), which in turn should reflect the objective for identifying liabilities (i.e. the reason for distinguishing liabilities from other expected transfers of economic benefits to other parties, such as employee benefits in relation to services expected to be received from employees in future periods).

29 AASB staff tentatively think the objective for identifying liabilities is to determine those obligations involving potential future transfers of economic resources that presently exist and presently constrain the entity's future use of economic resources.

2 However, AASB staff understand that the IASB's latest thinking on Approach 2 may be to focus on whether the entity has a practical ability to avoid a future transfer of economic resources through its future actions (if a past event has occurred) and that, in the 'variable lease payments' example: (a) a present obligation would exist to the extent that the retailer does not have the practical ability to avoid making future sales; and (b) in most circumstances, the retailer will not have the practical ability to avoid making *any* sales.

AASB staff also tentatively think an entity is presently constrained in its use of economic resources if it has little or no discretion to avoid a transfer of economic resources. Any significant degree of discretion regarding whether to make a future transfer of economic resources would seem not to presently constrain the entity. Therefore, AASB staff tentatively think that, if factors associating an obligation with an entity are addressed in the definition of a liability[3], the concept of a present obligation (and related guidance) that would support the IASB's preliminary view regarding the definition of a liability (see paragraph 18 above) and provide the most useful information for users should be along the following lines:

> "A present obligation is a future transfer of economic resources to an external party that the entity:
>
> (a) is expected by that party to make; and
>
> (b) has little or no discretion to avoid.
>
> In relation to criterion (b), an entity would have little or no discretion to avoid a transfer if there is a mechanism for an external party to enforce that transfer. However, such a mechanism would not be essential for criterion (b) to be met."

30 AASB staff tentatively think economic compulsion to transfer economic resources as a result of a past event should not of itself be sufficient for a present obligation to exist. This is because an entity might have a range of unavoidable transfers of economic benefits arising from carrying on activities, such as staff retraining to ensure continued compliance with industry regulation[4] and investing in economic resources that need future maintenance, repairs and replacement: it seems unlikely that adopting economic compulsion as a source of a liability would enable present obligations to be distinguished from future obligations.

Question for Board members

Q3 What are your tentative leanings on the AASB staff's tentative views that:

(a) the definition of a present obligation that would provide the most useful information for users:

(i) is a future transfer of economic resources to an external party that the entity is expected by that party to make and has little or no discretion to avoid; and

(ii) consequently, should include constructive obligations[5]; and

(b) economic compulsion to transfer economic resources as a result of a past event should not of itself be sufficient for a present obligation to exist?

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3 As is mentioned in paragraph 17 above, the AASB has previously expressed a view that, ideally, such factors should be addressed in the recognition criteria instead.

4 See Example 7 of the Guidance on Implementing IAS 37.

5 Note that Question 4 asks Board members for their tentative leanings on whether the 'ideal' concept of a performance obligation should be modified in view of concerns about economic compulsion.

Description and Discussion of the Three 'Approaches' to Identifying Performance Obligations

Approach 1

31 Under Approach 1 referred to in paragraph 25 above, a present obligation must be unconditional. That is, the obligation is not a 'present obligation' (i.e. a liability) if the entity can avoid a transfer of economic resources through its future actions. This is because, in that case, the entity would have a conditional obligation, i.e. the future transfer is conditional on a future action that the entity could (at least in theory, i.e. regardless of its economic consequences) avoid taking.

32 AASB staff think unconditional obligations would include obligations to make transfers of economic resources that other parties cannot presently enforce, but that become presently enforceable after the passage of time (i.e. their enforceability is not conditional upon the occurrence of any uncertain future event).

AASB staff analysis of Approach 1

33 In AASB Agenda Paper 14.5, in the analysis of the eight examples of potential obligations set out in Table 1 under paragraph 68[6], none of the potential obligations is described as a present obligation under Approach 1 because the entity can avoid a future transfer of economic resources by taking particular actions, or avoiding taking particular actions[7]. Based on that analysis, it would appear that, under Approach 1, no constructive obligations would qualify as a present obligation. AASB staff considered whether another example of a potential obligation (i.e. one not included in AASB Agenda Paper 14.5) that seems to be a constructive obligation might qualify as a present obligation under Approach 1. To this end, AASB staff considered an example of a publicly announced commitment to rehabilitate a mine site that is not enforceable against the entity by legal or equivalent means, but that the entity considers it has little discretion to avoid fulfilling[8] (as a result of an announced policy, its past practices of conducting such rehabilitation, and agitation by environmental groups). AASB staff think that, for the same reasons as those given in Table 1 under paragraph 68 of AASB Agenda Paper 14.5, the constructive obligation to rehabilitate a mine site would not qualify as a present obligation under Approach 1 (i.e. it would not be unconditional, because the entity has the ability not to honour its commitment, even if the

6 AASB staff understand that the IASB's latest tentative thinking might be to remove Example 6 ('Emissions trading scheme') from the examples analysed under each of the three Approaches, and to discuss emission trading schemes separately in the DP, noting that the outcome of the IASB's research project on emission trading schemes on identifying whether and when present obligations arise from those schemes might depend on factors not considered in the DP.

7 AASB staff observe that, although AASB Agenda Paper 14.5 does not mention 'going concern' in relation to Approach 1, it seems implicit that the entity could avoid the future transfer of economic resources while remaining a going concern. This is mentioned in this footnote because there would seem little point, in financial statements prepared on a going concern basis (as assumed in paragraph 4.1 of the IASB Conceptual Framework), to take into account an entity's ability to avoid a future transfer of economic resources by ceasing to be a going concern. AASB staff also note that, in relation to Approach 2, paragraph 72(c) of AASB Agenda Paper 14.5 similarly says an indication that an entity has accepted a responsibility to transfer an economic resource is that "the entity cannot avoid the future actions if it remains a going concern".

8 Here, for simplicity, the reference to 'fulfilling' includes transferring the obligation to another party that will fulfil the promise, in return for the entity paying consideration to that transferee.

consequences of that 'breach of commitment' might be more costly than the cost of honouring the commitment). On balance, AASB staff think no constructive obligations would qualify as present obligations under Approach 1.

34 Because AASB staff tentatively think a present obligation should be defined as a future transfer of economic resources to an external party that the entity is expected by that party to make and has little or no discretion to avoid, AASB staff tentatively think constructive obligations should be encompassed by the definition of a liability, subject to whether the concept of a constructive obligation can effectively be distinguished from economic compulsion to transfer economic resources (which, as mentioned in paragraph 21 above, we think is a huge challenge). (If the concept of a present obligation were limited to future transfers the entity has *no* discretion to avoid, it would seem to align with Approach 1 and therefore apparently exclude constructive obligations.) Therefore, AASB staff tentatively disagree with treating Approach 1 as the conceptual ideal for defining a liability.

<u>Approach 2</u>

35 AASB Agenda Paper 14.5 describes Approach 2 as identifying a present obligation "at the earlier of the two following times:

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

(b) when the entity receives benefits in exchange for which it accepts a responsibility to transfer an economic resource" (paragraph 71).

36 AASB staff understand the latest thinking of the IASB might be to amend Approach 2 to identify a present obligation as an obligation that:

(a) has arisen from past events (effectively replacing with a broader criterion the trigger event of having received economic benefits, which is discussed in paragraphs 70 – 73 of AASB Agenda Paper 14.5); and

(b) the entity has no practical ability to avoid through its future actions (effectively retaining the criterion in paragraph 72(a) of AASB Agenda Paper 14.5). AASB staff understand the latest thinking of the IASB might be that an entity does not have the practical ability to avoid making a future transfer of economic resources if it can only avoid that transfer by ceasing or significantly curtailing operations or leaving specific markets.

The following discussion focuses on what AASB staff understand the IASB's latest thinking to be.

<u>AASB staff analysis of Approach 2</u>

37 As AASB staff understand the latest thinking of the IASB, Approach 2's notion of an entity having no practical ability to avoid a transfer of economic resources through its future actions seems closest of the three Approaches to the AASB staff's tentative view (noted in paragraph 29 above) that the most useful notion of a present obligation

should be based on a future transfer of economic resources that the entity has little or no discretion to avoid.

38 However, in relation to Approach 2, AASB staff are concerned that:

(a) a reference to 'past events' would be a potential distraction from identifying the present economic phenomenon that constitutes a liability (present obligation) of the entity. For example, multiple 'past events' may have occurred that potentially give rise to a present obligation. To assess whether one, or a combination, of those past events gives rise to a present obligation, it would be necessary to identify the essential characteristics of an entity's present financial condition that give rise to a present obligation. Past events are not part of an entity's present financial condition. Viewed in that light, it would seem that the past events should not be regarded as an essential characteristic of a present obligation. This point is illustrated in Table 2 under paragraph 73 of AASB Agenda Paper 14.5, in Example 1. In that example ('employee bonus with vesting conditions'), the first 'reason' sentence does not seem to determine whether a present obligation exists. The pertinent reason sentence seems to be the second one, i.e. the one saying that the employer has no practical ability to terminate the employment contracts before the end of the vesting period (and thus avoid paying the bonus); and

(b) there is a significant risk that 'having no practical ability to avoid a future transfer of economic resources' would be indistinct from being economically compelled to make such a future transfer. This concern seems to be evidenced by the apparently broad interpretation of 'having no practical ability to either stop earning revenue, exit a market or cease an activity' used in AASB Agenda Paper 14.5 in Examples 2, 3 and 4 in Table 2 under paragraph 73.

<u>Approach 3</u>

39 Approach 3 focuses on past events instead of future events. That is, a present obligation is identified if any event has occurred that will oblige the entity to transfer economic resources to another party on more onerous terms than would have been required without that past event. Such a present obligation would include an obligation to transfer economic resources that is conditional on the occurrence or non-occurrence of a future event (AASB Agenda Paper 14.5, paragraph 74).

40 AASB staff understand that the IASB's latest tentative thinking on Approach 3 might be that a present obligation arises when the entity no longer has *complete* discretion to avoid a future transfer of economic resources. In contrast, under Approach 1, an entity has no discretion to avoid a future transfer; and under Approach 2 an entity has no practical ability to avoid a future transfer.

<u>*AASB staff analysis of Approach 3*</u>

41 For the reasons given in paragraph 40 above, it seems to AASB staff that Approach 3 (reflecting the AASB staff's understanding of the IASB's latest thinking) takes a much broader view of a present obligation than the other two Approaches, notwithstanding that, like the other Approaches, it requires a past event to have occurred. AASB staff

have strong concerns that if no longer having complete discretion to avoid a future transfer gives rise to a present obligation if a past event has occurred, almost any form of economic compulsion could potentially give rise to a present obligation. This is particularly so in view of the apparently broad notion of past event in AASB Agenda Paper 14.5. Therefore, AASB staff think there is a much greater risk under Approach 3 than under Approach 2 that the notion of a present obligation would be indistinct from being economically compelled to make a future transfer of economic resources.

42 As noted in paragraph 18 above, an IASB preliminary view in AASB Agenda Paper 14.5 is that guidance should be added to help distinguish constructive obligations (which the IASB supports including in the definition of a liability) from economic compulsion—implicitly, it seems the IASB does not propose encompassing economic compulsion in the definition of a liability.

43 Another concern of AASB staff with Approach 3, as described above, is that interpretation of that Approach seems potentially to be significantly subjective. For example, in relation to Table 3 under paragraph 75 of AASB Agenda Paper 14.5, the analysis of Example 7 seems to treat entry into a contract as a past event—this seems potentially inconsistent with the analysis of Example 5, which does not identify the passing of legislation for a levy as a past event.

44 For the reasons in paragraphs 41 – 43 above, AASB staff tentatively strongly disagree with adopting Approach 3 to when a present obligation arises.

Summary and Overview

45 As noted above, AASB Agenda Paper 14.5 includes a preliminary view of the IASB that constructive obligations should be encompassed by the definition of a liability. Apparently consistent therewith, *IASB Update* for the IASB's April 2013 meeting indicates the IASB tentatively decided that Approach 1 (discussed in paragraphs 31 – 34 above) should not be adopted. With one important proviso, AASB staff tentatively agree with those tentative preliminary views of the IASB. That proviso is that the concept of a constructive obligation can effectively be distinguished from economic compulsion to transfer economic resources.

46 Of the two Approaches compatible with the tentative preliminary views of the IASB (i.e. Approaches 2 and 3), Approach 2 seems closest to reflecting the AASB staff's tentative views on the ideal concept of a present obligation noted in paragraph 29 above. However, under both of Approaches 2 and 3 as described in paragraphs 35 – 36 and 39 – 40 (respectively) above, there seems to be significant and unacceptable risk that having 'no practical ability to avoid a future transfer of economic resources' or 'an absence of a complete discretion to avoid a future transfer of economic resources' would be indistinct from being economically compelled to make such a future transfer. Opening the door to treating economic compulsion as sufficient of itself for a present obligation to exist is, tentatively, a greater concern to AASB staff than the limitation of Approach 1 in meeting the objective for a liability argued in paragraphs 33 – 34 above. Therefore, AASB staff tentatively lean toward Approach 1 as the preferred Approach to whether a liability arises from a requirement to transfer an economic resource that depends on the entity's future actions, and

excluding constructive obligations from the concept of a present obligation, in the absence of a more robust way of distinguishing constructive obligations from circumstances in which an entity is economically compelled to make future transfers of economic resources. AASB staff concede that adopting such an approach would seem to omit useful information about such commitments as an entity's contractual commitments to pay unvested employee benefits arising from employee services received before the reporting date (such as unvested long service leave) and publicly announced commitments to rehabilitate mine sites that are not enforceable against the entity by legal or equivalent means.

47 One of the issues for discussion at the forthcoming AASB meeting is whether Board members think the concept of a constructive obligation can effectively be distinguished from economic compulsion to transfer economic resources by adopting a different notion of a constructive obligation [see Question 4(b) under paragraph 49 below].

48 AASB staff note the apparent ambiguity of the IFRS Staff Paper (AASB Agenda Paper 14.5) regarding an entity's ability to avoid transfers of economic resources in satisfaction of an 'obligation' by closing its business while remaining a going concern. Paragraph 77(b) of AASB Agenda Paper 14.5 says that, whichever of the three Approaches is applied, a present obligation would not include "losses that an entity expects to incur if it chooses to stay in business, but will avoid if it closes the business". It also says "Even though financial reporting generally presumes that an entity is a going concern, that fact does not mean that the entity is obliged to remain in business. A future loss is not a present obligation to transfer an economic resource." However, in applying Approach 3 to the eight examples, AASB Agenda Paper 14.5 identifies only Example 5 as not involving a present obligation, even though in all eight examples, the entity would not be required to transfer economic resources if it ceased operating the business. For the purposes of this issues paper, AASB staff assume the analysis of Approach 3 in Table 3 faithfully represents that Approach, and that if that analysis is inconsistent with paragraph 77(b), the latter should be disregarded for the time being. AASB staff will check the DP when it is published to determine whether this ambiguity has been resolved. It seems important that this ambiguity is resolved, because paragraph 77(b) seems similar to the policy in IAS 37 that:

> "It is only those obligations arising from past events existing independently of an entity's future actions (that is, the future conduct of its business) that are recognised as provisions. … [If an] entity can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure …" (paragraph 19).

49 The clarity of the IASB's proposed guidance on the characteristics of a present obligation would be enhanced if it were clear how the proposed Approaches relate to the principles in IAS 37.

Question for Board members

Q4 What are your tentative leanings on the AASB staff's tentative views that:

(a) under both of Approaches 2 and 3 as described in paragraphs 35 – 36 and 39 – 40 above, there seems to be significant and unacceptable risk of identifying present obligations when the entity is economically compelled to make a future transfer; and

(b) on balance, constructive obligations should be excluded from the concept of a present obligation, in the absence of a more robust way of distinguishing constructive obligations from circumstances in which an entity is economically compelled to make future transfers of economic resources? Any suggestions for a possibly more robust way of making that distinction would be welcome.

Uncertainty

50 In relation to the role of uncertainty, AASB staff agree with the IASB's draft preliminary view to distinguish, in principle, 'existence uncertainty' and 'outcome uncertainty' (AASB Agenda Paper 14.4, paragraphs 22 – 39).

51 AASB staff agree with the IASB's preliminary view in paragraph 38(b) of AASB Agenda Paper 14.4 that "The Conceptual Framework should not set a probability threshold to determine whether an asset or liability exists …" (in the rare cases in which it is uncertain whether an asset or a liability exists). However, regarding existence uncertainty affecting a (possible) asset or liability, AASB staff think the IASB Conceptual Framework should indicate that an entity uses judgement in assessing (in light of available evidence) whether the asset or liability exists. AASB staff think it is important to clarify that the IASB's preliminary view that the Conceptual Framework should not set a probability threshold to determine whether an asset or liability exists does not mean that the mere possibility of the existence of an asset or a liability would cause the asset or liability to be treated as existing and, subject to any recognition criteria, recognised by the entity (particularly because of the IASB's preliminary view to delete the reference to probability from the recognition criteria for the elements of financial statements: see paragraphs 8 – 12 of AASB Agenda Paper 14.3). The above-mentioned exercise of judgement should not be regarded as a probability assessment, in the same way that exercising judgement about 'which asset?' or 'which liability?' exists and the appropriate unit of account to apply would not accurately be described as a probability assessment.

52 See paragraphs 8 – 12 of AASB Agenda Paper 14.3 for a discussion of the role of probability in recognition criteria.

Questions for Board members

Q5 What are your tentative leanings on the IASB's preliminary view to distinguish, in principle, 'existence uncertainty' and 'outcome uncertainty'?

Q6 What are your tentative leanings on whether the IASB should clarify that the mere possibility of the existence of an asset or a liability should not cause the asset or liability to be treated as existing and, subject to any recognition criteria, recognised by the entity?

Definitions of Income and Expenses

53 The IASB's preliminary view is that the definitions of income and expenses in the IASB Conceptual Framework should not be substantially amended (AASB Agenda Paper 14.4, paragraph 48). The key issue affecting that conclusion is whether gains and losses should (unlike their treatment in the existing IASB Conceptual Framework) be defined as separate elements from revenue and expenses (i.e. whether revenue and gains, and expenses and losses, should be defined as separate elements). This issue is discussed briefly in paragraph 54 below.

Are gains and losses separate elements from revenue and expenses?

54 AASB staff agree with the IASB's preliminary view in paragraph 48 of AASB Agenda Paper 14.4 that any definition of 'ordinary activities' (which would be necessary to distinguish gains and losses from revenue and expenses) should not be developed in the Conceptual Framework project, and accordingly that the Conceptual Framework should not define gains and losses as separate elements of financial statements.

Questions for Board members

Q7 What are your tentative leanings on the IASB's preliminary view not to define gains and losses as separate elements from other components of income and expenses?

Q8 What are your tentative leanings regarding whether there are any significant reasons to amend the definitions of income and expenses in the IASB Conceptual Framework?