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**Liabilities – the neglected element:  
a conceptual analysis of the  
financial reporting of liabilities**

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# **Liabilities – the neglected element: a conceptual analysis of the financial reporting of liabilities**

## **Synopsis**

This Paper presents a conceptual analysis of the principal issues concerning the financial reporting of liabilities. The objective of the analysis is to develop a series of inter-related proposals that, if implemented, have the potential to significantly improve the quality of reported information about liabilities.

The Paper presents a Liability definition and advocates a consistent approach to recognition and measurement across all liability types that, if applied in practice, would produce a more complete representation of a reporting entity's liabilities and better reflect the economic burdens those liabilities represent than is presently the case.

This Paper advocates that:

- (a) liabilities be defined broadly, in the sense they are not limited to those that are considered to be legally enforceable;
- (b) meeting the liability definition would be sufficient for an item to be recognised in the financial statements (that is, the Paper advocates that there be no separate recognition criteria); and
- (c) liabilities would be measured at current value on initial recognition and in most cases at current value in subsequent reporting periods.



# 1. Why an Occasional Paper on liabilities?

- 1.1 The definition, recognition, measurement and disclosure of information about liabilities has been a challenging and until relatively recently, somewhat neglected subject area for accounting standard setters and others involved in the development of financial reporting. Historically, standard setters and others have focussed most of their attention on assets. Why that has been the case is open to conjecture, but I suspect it has something to do with the complexities of the issues arising from the nature of some liabilities and the consequent implications for their measurement, and the sometimes counter-intuitive effects of measuring liabilities on a current value basis.
- 1.2 Unlike most assets, liabilities will often arise without an exchange transaction having taken place; for example, litigation liabilities, asset retirement liabilities, taxation liabilities, social policy liabilities and liabilities arising from the receipt of government grants. There is no commensurate inflow (or more precisely ‘exchange proceeds’) relating to these liabilities. This contrasts, for example, with a conventional loan liability where the reporting entity receives proceeds (the loan amount) from the lender in exchange for the promise to repay the loan, or an insurance contract liability where the insurer receives proceeds (the premium) from the insured as compensation for accepting the risk of loss from the insured. Assessing whether, and identifying when, an obligation arises in relation to ‘non-exchange’ liabilities and consequently measuring them is sometimes highly problematic.
- 1.3 The absence of a ‘cost’ for non-exchange liabilities demands that an alternative measurement basis be applied, but which basis: fair value; fulfilment value<sup>1</sup>; nominal expected future cash outflows; discounted expected future cash outflows; the value of a ‘related’ asset, for example a grant received; or some other basis? Indeed, some might contend that because these liabilities are ‘costless’, they should be measured at zero (for example, government grants), or their recognition should be delayed until most of the uncertainties relating to their measurement have been resolved (for example, litigation liabilities)<sup>2</sup>.
- 1.4 If liabilities are measured on a current value basis, whether or not they result from exchange transactions, other challenges and controversies arise. How should the cash outflows expected to be required to transfer, settle or fulfil the liability be estimated?

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1 Fulfilment value is a current value measure of a liability that uses the reporting entity’s estimates of future cash flows and a risk adjustment, and is based on the premise that the entity intends to fulfil the liability rather than settle it with the counterparty or transfer it to a third party. The notion of fulfilment value is currently being developed by the International Accounting Standards Board (IASB) and the United States Financial Accounting Standards Board (FASB). It is explained more fully in Chapter 4.

2 Another point of distinction between assets and liabilities that may help explain why standard setters and others have historically focused their attention on accounting for assets is that for most assets it will be clear whether the definition and recognition criteria are met. This is because most assets can be sold (even if active markets do not exist), whereas liabilities can often exist without either an identifiable counterparty or other evidence that a present obligation exists.



Should the cash flows be risk-adjusted? Should the adjustment be for all risks, including own credit risk? How should risk be taken into account?

- 1.5 Adjusting for risk by increasing the discount rate when valuing assets is intuitive but many find it difficult to conceptualise that when using the discount rate to adjust for risk in valuing liabilities the discount rate is reduced. Furthermore, adjusting for changes in credit risk when valuing liabilities seems to many to produce counterintuitive results, such as recognising a gain when an entity's credit standing deteriorates. These are difficult issues and their resolution often raises significant controversy.
- 1.6 Over time, standard setters have addressed some of these issues and standards cover many of the broad areas referred to above. However, many issues remain unresolved and conclusions reached thus far on others are often inconsistent and lack conceptual rigour.
- 1.7 This Paper endeavours to address the main issues concerning the definition, recognition and measurement of liabilities. It also addresses specific disclosure issues arising out of that analysis. In doing so, it draws on the most recent work of the standard setters in these areas.
- 1.8 I hope the Paper will contribute to the ongoing debate of these issues by standard setters. In particular, I hope it will encourage resolution of the issues in a conceptually consistent manner.



## 2. What is a liability and when does it arise?

### Defining a liability

2.1 The conceptual frameworks of a number of standard-setting bodies contain liability definitions. In some cases, those definitions apply to both private and public sector entities. Generally speaking, the definitions are broadly similar. Yet debate continues apace about the adequacy of the definitions. Fuelling the debate is practice (supported by accounting standards) that sometimes reports an item as a liability that demonstrably does not meet the extant definition; for example, an item of revenue that is not recognised in the profit or loss statement in the current reporting period but is deferred and recognised as revenue in the profit or loss statement in future reporting periods. And practice that sometimes fails to recognise an item as a liability even though demonstrably it meets the extant definition; for example, certain so-called ‘contingent liabilities’.

2.2 The IASB and the International Public Sector Accounting Standards Board (IPSASB) have been discussing the liability definition as part of their respective conceptual framework projects<sup>3</sup>. The IASB is seeking to revise the existing definition to better deal with observed deficiencies in practice and to reflect developments in thinking about the concept of liabilities emerging from standards level projects, such as the Review of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (the Liabilities project)<sup>4</sup> and the Review of IAS 18 *Revenue*. The definition in the IASB’s existing Conceptual Framework for Financial Reporting (Conceptual Framework) is:

*A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.*<sup>5</sup>

2.3 The IPSASB, whilst acknowledging and being informed by the definitions in the existing conceptual frameworks, is endeavouring to establish a definition that is able to deal effectively with transactions and events unique to certain public sector entities, such as certain non-exchange transactions. The definition tentatively agreed by the IPSASB is:

*A liability is a present obligation that arises from a past event where there is little or no realistic alternative to avoid an outflow of service potential or economic benefits from the entity.*<sup>6</sup>

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3 The IASB’s conceptual framework project was initially a joint project with the US Financial Accounting Standards Board (FASB). Work on the project was deferred in 2010. It has since been reactivated by the IASB in its own right. Most of the references to the project in this Paper are to the joint deliberations of the IASB and FASB because the boards made tentative decisions on the asset and liability definitions after extensive debate. The IASB’s reactivated project is at an early stage, with the Board having issued a Discussion Paper “*A Review of the Conceptual Framework for Financial Reporting*” in July 2013. It is hoped this Paper will help inform the IASB’s deliberations throughout the course of the reactivated project.

4 This project was deferred by the IASB in 2010 and is now categorised as a research project.

5 IASB *Conceptual Framework for Financial Reporting*, paragraph 4.4(b)



- 2.4 Extant liability definitions typically identify three characteristics:
- (a) an obligation;
  - (b) an expected outflow or sacrifice of economic benefits; and
  - (c) a past transaction or other past event that has given rise to the obligation.
- 2.5 The IASB and FASB effectively combined these elements into one expression by using the term ‘present economic obligation’. The definition tentatively agreed by the IASB and FASB is:
- A liability of an entity is a present economic obligation for which the entity is the obligor.*<sup>7</sup>
- 2.6 Although there seems to have been a coalescing around what is considered to be the essence of a liability; that is, a present economic obligation, debate continues around what precisely that phrase means and how it should be applied in classifying particular transactions and other events.

### **Liabilities or claims?**

- 2.7 It can be argued that the concept of liabilities in financial reporting is in fact an artificial construct since at any point in time there may be a spectrum of claims against the assets of an entity; any distinction between those characterised as liabilities and those characterised as equity is by nature arbitrary<sup>8</sup>. However, users of financial statements have consistently claimed that there is information value in making such a distinction<sup>9</sup>. The key point of distinction between the various claims that is of particular interest to users is that for some claims the entity has little or no discretion to avoid transferring resources in settlement or fulfilment of the claim; it has a present obligation to do so. Information about such claims is particularly important to users in assessing the liquidity and solvency of an entity. It is also important, in the case of for-profit entities, for investors in assessing the timing and amount of future returns on their investments and, in the case of not-for-profit entities, for stakeholders and other users in assessing the capacity of an entity to provide goods and services in the future.
- 2.8 Even if the argument can be sustained that there is little value in distinguishing between different types of claims, there is still a need to distinguish between those events that give rise to a claim and those that do not. Users of financial statements will want to know, for example, whether an event has created a claim on the entity’s assets or simply reflects a risk that the entity confronts in carrying out its activities.

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6 IPSASB Conceptual Framework Project Exposure Draft 2 *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Elements and Recognition in Financial Statements*, November 2012, paragraph 3.1.

7 IASB & FASB Project Update, 15 March 2010. Accessible at [http://www.fasb.org/project/cf\\_phase-b.shtml](http://www.fasb.org/project/cf_phase-b.shtml) (May 2013).

8 Indeed, it would arguably be consistent with entity theory, on which modern financial reporting is based, not to make such a distinction.

9 See, for example, Barth M, Hodder L and Stubben S, *Fair Value Accounting for Liabilities and Own Credit Risk*, *The Accounting Review*, Vol. 83, No. 3, 2008, pp. 629-664, and Barth M, Hodder L, and Stubben S, *Financial reporting for employee stock options: liabilities or equity?*, *Review of Accounting Studies*, Volume 18 Number 3, 13 June 2013.

## Present economic obligation

- 2.9 The existence of a present economic obligation has generally provided a workable concept for distinguishing between different types of claims and between those transactions and other events that create claims and those that do not. However, difficulties continue to exist in classifying transactions and other events that are ‘at the margin’.
- 2.10 Difficulties in classifying claims as liabilities or equity can often stem from the fact that, under the existing classification system, equity is treated as a residual. In other words, liabilities are defined positively in accounting standards and conceptual frameworks (as are assets) and equity is defined as a residual. The absence of a generic definition of equity has meant that the focus is, by necessity, on whether the claim gives rise to a present obligation to transfer resources in the future even if the claim also has features in common with other claims that would typically be classified as equity.
- 2.11 The IASB faced this particular conundrum when it addressed certain types of puttable instruments that require entities to transfer resources to the holders of the instruments when put back to the entity but which also give the holders a residual interest in the net assets of the entity. The IASB decided that in such cases the right to put the instrument back to the entity is not the dominant feature of the instrument which should drive its classification as a liability or equity. For example, the feature may exist only as a means of retaining the entity’s shareholding within a family group, or to enable an external party to supply the entity with goods or services, or it may only have effect on liquidation of the entity. In other words, the instruments are more in the nature of equity instruments even though they give rise to a present economic obligation for the entity<sup>10</sup>.
- 2.12 The limitations of the existing approach of focussing on the existence of a present economic obligation in distinguishing between liabilities and equity, and the anomalous outcomes that sometimes result from that focus, led the IASB to undertake a project entitled *Financial Instruments with Characteristics of Equity*, which involved considering various approaches to directly classifying financial instruments as equity instruments<sup>11</sup>. It also led the IASB and FASB to consider the merits of a claims approach in its conceptual framework project<sup>12</sup>, that is, an approach that defines only two balance sheet elements; assets and claims, rather than three; assets, liabilities and equity. I believe the issues of whether or not to distinguish between different types of claims and, if so, how to distinguish between different types of claims are worthy of

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10 Consequently, in February 2008, the IASB amended IAS 32 *Financial Instruments: Presentation* to introduce a limited scope exception to the requirement to classify puttable financial instruments as liabilities. An alternative way to deal with this conundrum, which was considered but rejected by the IASB, is to bifurcate the instrument and account separately for the liability and equity components.

11 The project, which was deferred in 2010, was undertaken jointly with the FASB as part of the boards’ Memorandum of Understanding (MOU). See FASB website, accessible at [http://www.fasb.org/project/fi\\_with\\_characteristics\\_of\\_equity.shtml](http://www.fasb.org/project/fi_with_characteristics_of_equity.shtml) (May 2013).

12 See IASB Board Agenda Paper 3, Phase B: Elements and Recognition – Claims Approach, Board meeting February 2007, accessible at <http://www.ifrs.org/NR/rdonlyres/B5E8C3F9-2C7B-471F-830D-98A660A93CF1/0/CF0702b03obs.pdf>



further analysis. However, they are not the focus of this Paper and consequently will not be considered further. Accordingly, this Paper assumes that the IASB and IPSASB will continue to distinguish between liabilities and equity and will continue to define liabilities directly with equity defined as a residual<sup>13</sup>.

## Enforceability

- 2.13 In their conceptual framework project, the IASB and FASB endeavoured to articulate more clearly the notion of a present economic obligation. To that end, they tentatively defined an economic obligation as “an unconditional promise or other requirement to provide or forgo economic resources, including through risk protection” and explained that an entity is obligated if it is required to bear the economic obligation and that requirement is enforceable by legal or equivalent means<sup>14</sup>.
- 2.14 The IPSASB has also endeavoured to provide a clearer articulation of a present obligation. It has tentatively defined a present obligation as “a legal or non-legal binding requirement, which an entity has little or no realistic alternative to avoid, that requires an entity to deliver services or economic benefits to another party”<sup>15</sup>.
- 2.15 These developments are welcomed because they are genuine attempts to clarify what is arguably the most problematic and controversial issue relating to the existence of a liability; is enforceability an essential characteristic of a present economic obligation? The IASB and FASB tentatively answered ‘yes’. The IPSASB has tentatively answered ‘no’.
- 2.16 The IASB’s and FASB’s motivation in answering the question in the affirmative is understandable since many of the controversies in practice relating to whether a liability exists that they and other standard setters have had to address arise in circumstances where there is no enforceable obligation. For example, some commentators contend that an entity is presently obligated if it is compelled economically to transfer resources in the future. An example is where an entity issues preference shares for which it has no contractual obligation to pay the specified coupon rate each period, but if it fails to do so the rate payable to the preference shareholders in the future will increase at a prohibitively expensive accelerating rate.

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13 It is interesting to note that the IPSASB has proposed in its conceptual framework project that there should be two additional elements in the financial statements of not-for-profit public sector entities. The elements are deferred inflows and deferred outflows. A deferred inflow is defined as “an inflow of service potential or economic benefits provided to the entity for use in a specified future reporting period that results from a non-exchange transaction and increases net assets”. A deferred outflow is defined as “an outflow of service potential or economic benefits provided to another entity or party for use in a specified future reporting period that results from a non-exchange transaction and decreases net assets”. Although this tentative decision does not impact the discussion of liabilities in this Paper, since deferred inflows and deferred outflows are not identified as liabilities and assets, I find it difficult to comprehend the economic meaning that could be attributed to these ‘elements’. See IPSASB Conceptual Framework Project Exposure Draft 2, op. cit. paragraphs 5.1-5.2.

14 IASB & FASB Project Update, 15 March 2010, IFRS Foundation website. The Update refers to the existence of a mechanism to enforce the economic obligation against the entity and notes that “the Board also agreed that laws and regulations are examples of mechanisms and are not, by themselves, present obligations”.

15 IPSASB Conceptual Framework Project Exposure Draft 2, op. cit. paragraph 3.2.



These commentators reason that because the entity effectively has no choice in economic terms but to pay the coupon rate, it has a present obligation to do so. However, this argument is a slippery slope and could be applied to many circumstances where an entity is economically compelled to transfer resources in the future. For example, an entity could be considered to be economically compelled to transfer resources to its employees and other essential suppliers in the future because failure to do so will mean that it cannot continue in business. The characteristic of enforceability provides a clear basis for excluding these types of items from being identified as liabilities.

- 2.17 However, the implications of the IASB's and FASB's tentative decision are profound. For example, in many jurisdictions certain types of employee benefits accrue as service is provided by employees but payment is deferred until specified vesting conditions are met (in Australia, long-service leave accrues from the date employment commences but does not vest until completion of a specified continuous period of employment). Cessation of employment before vesting occurs will generally result in forfeiture of the accrued benefits because there is no mechanism for the employees to force the entity to pay them.
- 2.18 Applying the IASB's and FASB's tentative decisions in their conceptual framework project to this scenario, a liability would not exist until the vesting date because the 'claim' against the employer is not 'enforceable by legal or equivalent means' until that date. Most commentators would be surprised, and indeed probably alarmed, by this outcome. Practice, supported by official pronouncements in many jurisdictions (including IAS 19 *Employee Benefits* and IPSAS 25 *Employee Benefits*), has for some considerable time been to recognise a liability as service is provided by the employees. Supporters of current practice would reason that an exchange transaction takes place as the employees provide service and, in the process, the entity incurs a constructive obligation to pay the benefits in the future<sup>16</sup>.
- 2.19 The tentative decision of the IASB and FASB to specify enforceability as a characteristic of a present economic obligation highlights the dilemma facing standard setters in this area of financial reporting. A narrow definition of a liability may be more effective in excluding from reported liabilities those transactions and other events that do not give rise to an economic burden for the entity than would a broader definition. This should enhance comparability of financial reporting. However, it may also exclude from reported liabilities those economic burdens arising from past transactions and other past events for which an entity can be obligated other than by legal enforceability or equivalent means. Excluding these economic burdens from the balance sheet would deprive users of relevant information.
- 2.20 This concern would appear to be at the heart of the IPSASB's tentative decision to answer in the negative the question: is enforceability an essential characteristic of a present economic obligation? In the public sector, the incidence of events giving rise to obligations for which the transfer of resources by an entity in the future will effectively be unavoidable but will not be enforceable by legal or equivalent means

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<sup>16</sup> This issue is discussed in more detail in paragraphs 2.88 to 2.91.



will be much greater than in the private sector. A decision by the New Zealand Government to support its citizens in the wake of the catastrophic earthquake that hit Christchurch in February 2011 illustrates the point. After the earthquake, and before the end of the reporting period, the Government announced that it would make offers to homeowners to purchase their land and property in badly affected areas in view of the fact that local insurers would be unable to meet all of the claims from policyholders. Formal offers were made to homeowners after the end of the reporting period. Although this commitment by the Government was not enforceable as at the end of the reporting period, the Government had no realistic alternative to avoid the promised outflow of resources. Failure to report this commitment as a liability in the period in which the commitment was made would have excluded from the Government's financial statements a material economic burden that it could not realistically avoid and would have deprived users of its financial statements of important information in assessing the financial performance of the Government during the reporting period and its financial position at the end of the period<sup>17</sup>.

### **Constructive obligation**

2.21 The definition of liabilities in many of the existing conceptual frameworks would seem to go beyond obligations that are enforceable by legal or equivalent means. For example, the IASB's conceptual framework states:

Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement ... Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. If, for example, an entity decides as a matter of policy to rectify faults in its products even when these become apparent after the warranty period has expired, the amounts that are expected to be expended in respect of goods already sold are liabilities.<sup>18</sup>

2.22 Similarly, the United States Governmental Accounting Standards Board's conceptual framework states:

Sometimes a liability will be created, not because it is legally enforceable, but because of a government's actions, or conduct. In these cases, social, moral or economic consequences leave the government little or no discretion to avoid the sacrifice of resources.<sup>19</sup>

2.23 At a standards level, standard setters have endeavoured to encapsulate this aspect of a liability that extends beyond 'legal enforceability' by developing the concept of a 'constructive obligation'. However, the concept has proven to be troublesome.

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17 Disclosure of the commitment would not be a substitute for recognition. Failure to recognise the liability would result in the financial statements not faithfully representing the government's financial position at the end of the reporting period or its financial performance during the reporting period.

18 IASB Conceptual Framework, op. cit. paragraph 4.15.

19 Governmental Accounting Standards Board, Concepts Statement 4 *Elements of Financial Statements*, June 2007, paragraph 19.



2.24 A constructive obligation is defined in IAS 37 and IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets* as:

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.”<sup>20</sup>

2.25 In its Liabilities project, the IASB tentatively agreed to retain the notion of constructive obligation. However, it both narrowed the concept and included cautionary language in applying the concept. It would seem that this was an acknowledgement of the difficulty of applying the concept in practice and a response to some of the outcomes of applying the broader concept, for example in the area of restructurings<sup>21</sup>. The Board agreed that the definition of constructive obligation should be changed to limit the circumstances in which a constructive obligation might exist. The Board stated that “... an entity might have a constructive obligation, but only if:

- (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated that it will accept specific responsibilities;
- (b) it has indicated its acceptance of those responsibilities to the parties that will benefit from their performance or suffer harm from their non-performance; and
- (c) as a result, the entity has created a valid expectation among those parties that they can reasonably rely on it to discharge its responsibilities”<sup>22</sup>.

2.26 The proposed narrowing of the concept of constructive obligation from that set out in IAS 37 has resulted from a number of specific wording changes. The change from ‘certain’ responsibilities to ‘specific’ responsibilities provides a sharper focus on the nature of an obligation. The clarification that the parties to whom the responsibilities are owed are those parties “that will benefit from their performance or suffer harm from their non-performance” reinforces that there must be an economic burden. And, the inclusion of additional wording to the effect that the entity's past actions have created a valid expectation that “parties can reasonably rely on it” to discharge its

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20 IASB, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, paragraph 10; and IPSASB, IPSAS 19 *Provisions, Contingent Liabilities and Contingent Assets*, paragraph 18.

21 The IASB tentatively decided to remove the requirements in IAS 37 relating to the recognition of liabilities for restructurings because of concern that the requirements do not focus on the specific obligations that arise in a restructuring situation, for example, an obligation to pay employee termination benefits. An effect of the current requirements has been that, in certain circumstances, liabilities for restructurings have been recognised before the reporting entity is actually constructively obligated.

22 IASB website International Financial Reporting Standard [X], *Liabilities*, Working Draft, 19 February 2010, paragraph 12. See <http://www.ifrs.org/NR/rdonlyres/3C00FC6B-F8E3-4826-82B4-3580989B31EA/0/IFRSLiabilitiesWorkingDraftFeb10.pdf>



responsibilities, clarifies that the responsibility only exists if the parties in question have the expectation, created by the entity, that they can reasonably rely on the entity to meet its responsibilities.

- 2.27 It is interesting to note that the IASB's tentative decision to retain a broader notion of an obligation (albeit a narrower notion of constructive obligation) in this standards-level project on liabilities is at odds with the tentative view of the IASB and FASB in their conceptual framework project.
- 2.28 A similar decision was made by the IASB in its Insurance Contracts project in relation to accounting for so-called 'with-profits' or 'participating' insurance contracts. In Exposure Draft ED/2010/8 *Insurance Contracts*, the IASB proposed that the expected future cash flows relating to the participating feature of these contracts should be included in the measurement of the insurance contract liability even though there may be no legal obligation to pay those amounts<sup>23</sup>.
- 2.29 The IASB's apparent inconsistent decisions may be simply a matter of the timing of the respective discussions. Alternatively, perhaps it reflects a view that, at a standards level, a broader notion is required to capture events that severely limit the ability of an entity to avoid the outflow of resources – failure to recognise these 'obligations' as liabilities may be inconsistent with higher levels of the conceptual framework because it would mean excluding information that is relevant to financial statement users and can be faithfully represented.
- 2.30 It is likely the IASB and FASB were motivated by the following two related factors when they made the tentative decision in their conceptual framework project that for a liability to exist an obligation must be enforceable by legal or equivalent means:
- (a) a belief that a narrower definition of an obligation is desirable because of the abuses in practice that had occurred under the extant definitions, and
  - (b) a belief that most of the 'additional' obligations that would be captured under the constructive obligation notion would in fact be enforceable obligations, and clarifying that point would address the narrow interpretation of 'legal obligations' under the existing literature that gave rise to the perceived need for the notion of constructive obligations to capture these additional obligations.
- 2.31 I suspect the IASB and FASB took comfort in this reasoning because they were viewing their deliberations through the prism of the legal systems of jurisdictions in which contracts, both express and implied, play a central role and, in a number of them, are supported by the legal notion of promissory estoppel<sup>24</sup>. It may be that when

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23 IASB, Exposure Draft ED/2010/8 *Insurance Contracts*, July 2010, paragraph BC70. The IASB has retained this approach in the 2013 re-exposure draft. See IASB, Exposure Draft ED/2013/7 *Insurance Contracts*, July 2013, paragraph 17.

24 The Free Dictionary defines 'promissory estoppel' as follows: *In the law of contracts, the doctrine that provides that if a party changes his or her position substantially either by acting or forbearing from acting in reliance upon a gratuitous promise, then that party can enforce the promise although the essential elements of a contract are not present.* Accessible at <http://www.thefreedictionary.com/>



the IASB subsequently paused to consider the broader implications of ‘enforceability’ in the context of its standards-level projects, it found the notion to be unduly limiting. This may particularly have been the case when the Board considered the impact in jurisdictions where there is less reliance on formal contracts in business dealings and more on so-called ‘business customs’ or ‘religious strictures’.

- 2.32 I believe the IASB’s recent tentative decisions at a standards level in its Liabilities and Insurance Contracts projects are appropriate and that it should rethink its tentative decision in the joint conceptual framework project with the FASB. In this context, I support the tentative decision of the IPSASB not to specify enforceability as an essential characteristic of a liability. In my view, limiting the meaning of present economic obligation to only those situations where the obligation is enforceable by legal or equivalent means would potentially exclude from an entity’s financial statements economic burdens that it has little or no discretion to avoid. This would deprive users of the financial statements of relevant information for assessing the performance and financial position of an entity.
- 2.33 I acknowledge that in jurisdictions where the doctrine of promissory estoppel exists it has the effect of expanding the notion of enforceable obligations beyond that which might be commonly understood. However, even in those jurisdictions, the notion of enforceable by legal or equivalent means may be unduly limiting. For example, I am not convinced that the doctrine of promissory estoppel could be applied to rationalise the recognition of liabilities for unvested accrued employee benefits, expected future benefit payments under insurance contracts with participating features, and commitments that a government through its own actions has little or no discretion to avoid. In jurisdictions where the doctrine of promissory estoppel does not exist, the notion of enforceable by legal or equivalent means is even more limiting. In these jurisdictions an obligation may not be ‘enforceable’ as such, but the entity may nonetheless have little or no discretion to avoid a transfer of economic resources; for example, because the existence of religious strictures or particular business customs mean that it is understood by both the reporting entity and the counterparty that promises made by an entity will be honoured.

### **Definition of a liability**

- 2.34 Consistent with the views expressed in paragraphs 2.32 and 2.33, my preferred definition of a liability is:
- A liability of an entity is a present economic burden for which the entity is obligated.
- 2.35 ‘A present economic burden’ exists when an event has occurred that could require the transfer of economic resources from the entity to another party or parties who will either benefit from the transfer of resources or suffer from the entity’s failure to transfer the resources. The event is an unconditional promise or other requirement to transfer resources. It is not necessary that there be a particular level of certainty that resources will be transferred for an economic burden to exist, merely that the event could require a transfer. As will be discussed in Chapter 3, uncertainties relating to



the timing and amount of resources ultimately transferred would be taken into account in measuring the liability.

- 2.36 An entity is ‘obligated’ in relation to an economic burden when there is either a mechanism to enforce the burden against the entity or the entity’s discretion to avoid the economic burden has effectively been removed, either through its own actions or otherwise.
- 2.37 The operation of the law, for example, through contracts, statutes and regulations, is the mechanism by which an entity would typically be obligated<sup>25</sup>. However, an entity can also be obligated by virtue of its own actions or otherwise; that is, an entity can be constructively rather than legally obligated.
- 2.38 I agree with the IASB’s most recent articulation of the concept of constructive obligation in the Liabilities project (as stated in paragraph 2.25). Because of the difficulty of applying the concept in practice and the risk of misapplication, I believe it is essential the concept be clearly articulated. In this regard, I believe the proposed amended wording is an improvement on the existing wording in IAS 37/IPSAS 19 because it makes clearer that an economic burden must exist and clarifies how an entity can become obligated.
- 2.39 The definition of a liability I have set out above is a mirror image of the asset definition tentatively agreed by the IASB and FASB in their conceptual framework project. The boards tentatively agreed that:
- An asset of an entity is a present economic resource to which the entity has a right or other access that others do not have.<sup>26</sup>
- 2.40 The proposed asset definition, with which I largely agree<sup>27</sup>, focuses on the existence of an economic resource and links that resource to the entity that has exclusive access to the resource. The liability definition I have set out focusses on the existence of an economic burden which is linked to the entity that is obligated to bear it. I believe it is important that the definitions of the two basic elements of the financial statements are mirror images of one another because, at least in the case of liabilities, they will be two sides of the one coin; that is, one entity’s liability will be another entity’s asset.
- 2.41 Of course, as noted earlier, articulating a broader concept of a liability is one thing, having that concept applied consistently in practice is another thing entirely. The following section discusses situations where the application of the concept may prove problematic.

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25 In this context, ‘legally enforceable’ should be read as encompassing equitable obligations, which are obligations based on ethical or moral considerations. In many jurisdictions there is a separate body of law relating to or valid in equity, as distinct from common law or statute law, See The Free Dictionary at <http://www.thefreedictionary.com>

26 IASB & FASB Project Update, 15 March 2010. Accessible at [http://www.fasb.org/project/cf\\_phase-b.shtml](http://www.fasb.org/project/cf_phase-b.shtml) (June 2013).

27 Consistently with my view of the IASB’s and FASB’s tentative definition of a liability, I would not limit the definition of assets to only those situations where the right or other access is enforceable by legal or equivalent means.

## Identifying when an entity is obligated

- 2.42 In many situations in practice it will be readily apparent that an entity is obligated to transfer resources. That would be the case if the entity has entered into a contract and made an unconditional promise to transfer resources. The resultant liability might be characterised as a financial liability if, for example, it constitutes an unconditional promise to transfer cash or another financial instrument in exchange for goods or services. Alternatively, it might be characterised as a performance obligation if it is an unconditional promise to transfer goods or services (for example, in exchange for cash or other assets).
- 2.43 It would also be the case that it is clear that an entity is obligated to transfer resources if the entity is required by law or regulation to transfer resources and it is evident from the facts and circumstances that the operation of the law or regulation applies. For example, an entity may have breached the law and be required to pay a fine; it may have unequivocally damaged the environment and be legally required to repair the damage; or it may have clearly reached the required threshold to pay taxes or levies.
- 2.44 However, sometimes it will not be clear that an event has occurred that obligates the entity or it may not be clear which of a number of events obligates the entity. In the remainder of this Chapter, the liability definition set out in paragraph 2.34 is applied to a range of transactions and other events where establishing the existence or non-existence of a liability has proven to be problematic.

## Non-exchange transactions

### Social benefits

- 2.45 Public sector entities will often be parties to non-exchange transactions. A common type of such transactions involves the provision of ‘social benefits’. They include transfer payments such as old-age pensions and unemployment benefits.
- 2.46 An issue that presents itself at the outset when considering whether governments or their agencies are obligated for future resource transfers such as social benefit payments is the sovereign power of governments that enables them to change the law. This power has some similarities with the ability of an entity to avoid some future transfers of resources by ceasing to operate as a going concern.
- 2.47 The response of standard setters to the argument that such abilities mean that the particular entities have the discretion to avoid future resource flows and therefore would not be obligated for those possible future resource flows, has been that the accounting for transactions and other events must reflect conditions that exist at the reporting date. If a law has been enacted (or substantively enacted), or an entity is constructively obligated, and the entity is a going concern at the reporting date, it must account for the effect of laws that exist or actions it has undertaken as at the reporting date. I agree with that long held financial reporting axiom. Omitting information from the financial statements on the basis that circumstances that exist today may change in the future would severely limit the capacity of those financial statements to



portray the financial position of an entity at reporting date or faithfully reflect its performance during the period<sup>28</sup>.

- 2.48 The critical issue in assessing whether a public sector entity is obligated for particular social benefits is identifying the obligating event. For example, if a government has enacted legislation that commits it to pay benefits to any person who has been unemployed for a minimum of four weeks and who has financial assets less than currency units (CU) 50,000, would the government become obligated when the legislation was enacted (or substantively enacted), when a person meets the qualifying conditions, when the person presents for payment, or at some other time?
- 2.49 Some might reason that upon enactment of the legislation the government has an unconditional obligation to stand ready to pay unemployment benefits to those persons who qualify. Measurement of the liability would take into account the uncertainties related to the amount and timing of the payments. However, the mere existence of a law does not obligate an entity that is required to comply with it for resource transfers that it may have to make in the future in compliance with the law. For example, the requirement for an entity to comply with occupational health and safety laws does not mean that it has an obligation to stand ready to make payments for any possible future breaches of the law.
- 2.50 Applying the definition of a liability set out in paragraph 2.34, for a liability to exist there must exist presently both an economic burden and an obligation to bear that burden. Enactment of the unemployment legislation is not an event that creates an economic burden for the government. At that date, there is no unconditional promise or requirement to transfer resources, even though it may be highly likely that people will qualify for benefit payments in the future. Only when people meet the conditions for receipt of the benefits is the government obligated by law to transfer resources to particular parties who will benefit from the transfer or suffer from failure to make the transfer, and then only in respect of the benefit that is payable for the period of past unemployment.
- 2.51 Similarly, an expressed intention by a government to transfer resources to other parties, whether as a result of a budgetary policy, an election promise or a statement of intent does not of itself create an economic burden for the government. Unless the promise is accompanied by other actions of the government that have effectively removed its discretion to avoid the transfer<sup>29</sup>, an economic burden will not arise and

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28 There is also a practical dimension to this issue; namely which future events would or should be taken into account and on what basis? For example, notwithstanding that a government can and will change the laws of the jurisdiction in the future, on what basis would that ability be incorporated into a current assessment of whether the government is presently obligated? Might that be always, because it is theoretically possible for the government to change the law to avoid the transfer of resources in the future? Might that be sometimes, when it is considered highly likely that the government will have the political will and practical ability to change the law? Might that be sometimes, when it is considered more likely than not that the government will have the political will and practical ability to change the law?

29 For example, in the case of the New Zealand Government's decision to support its citizens when the Christchurch earthquake devastated the city, it did not merely state its intention to provide assistance but publicly announced that it would be making formal offers to homeowners to purchase their land and



the government will not be obligated to bear that economic burden until the other parties meet specified entitlement conditions or eligibility criteria.

- 2.52 These situations can be contrasted with an entity that enters into a contract to provide risk protection. In this case the obligating event is entering into the contract. A present economic burden exists at that point because the entity has made an unconditional promise to provide risk protection and will transfer resources (that is, services) to other parties as it provides that protection even if an insured event fails to occur during the protection period. Because the present economic burden is the unconditional promise to stand ready to compensate policyholders if an insured event occurs, the liability would be measured by reference to those events and their associated probabilities<sup>30</sup>.

### Levies

- 2.53 An entity may be liable to pay levies to a government or its agencies for participating in a particular market. In most cases the event that gives rise to a liability will be clearly evident. For example, an entity may be required to pay a levy on a proportionate basis by reference to the revenues it generates in a specific market. A present economic burden for which the entity is obligated arises as the entity generates revenue; that is, the event that gives rise to a liability is the earning of revenue. Accordingly, a liability will arise progressively during the reporting period as revenue is earned. Alternatively, an entity may be liable to pay a levy if it is operating in a specific market at a point in time, for example the end of a calendar year. The amount of the levy may be based on revenue generated during the calendar year or the previous calendar year. The event that obligates the entity in relation to the economic burden (that is, the levy) is being in business at the end of the year. Accordingly, a liability would arise at the end of the calendar year, not progressively during the current or previous year.
- 2.54 In some situations a levy may be payable only if an entity reaches a specified threshold. For example, if the entity generates revenue of CU 100 million during the calendar year it will be required to pay CU 1 million. If it generates revenue less than CU 100 million during the calendar year, for example CU 99.99 million, it will pay nothing. Is the event that obligates the entity reaching the threshold or is it something else?

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property. See paragraph 2.20. Similarly, a government may through its actions create a constructive obligation to pay vested employee benefits. See paragraphs 2.88 to 2.91.

- 30 This example can be contrasted with so-called 'self-insurance', whereby an entity undertakes to self-fund losses from insurable events rather than pay a third party to bear the risk. In this case, the self-insurer does not have a present economic burden since it has not made an unconditional promise to transfer resources to other entities in the event that losses arise. It has merely made a business decision that it will bear the risk of such losses rather than pay a third party to do so. If an entity, such as a government, decides to 'self-insure' losses that third parties suffer, in the sense that it decides on a case-by-case basis whether it will compensate those suffering the loss, the entity is not obligated and a liability does not arise until its actions (for example, public statements) leave it with little or no discretion to avoid a transfer of resources.



- 2.55 In my view the event that obligates the entity in relation to the economic burden (the levy) is reaching the revenue threshold<sup>31</sup>. Before this point the entity has discretion to avoid the outflow of resources; for example, it could change its business model, it could exit the industry or it could reduce the level of business activity if it were approaching the threshold towards the end of the calendar year<sup>32</sup>.
- 2.56 Some will find this answer discomfoting because the total amount of the levy would be recognised at a point in time even though the levy is based on business activity taking place throughout the whole of the calendar year. They would be concerned about interim financial statements potentially reporting no levy when revenues that contributed to attracting the levy are reported in those financial statements. Expressed differently, they would be concerned that the costs incurred in generating the revenue during the reporting periods are not being matched with the revenues earned during those periods.
- 2.57 These concerns are understandable but they are not persuasive. The fact that the entity is carrying on business during the calendar year and may be required to pay a levy if a specified threshold is met does not obligate the entity, even if it is highly likely that the threshold will be met. Unlike an insurance contract, there is no unconditional obligation to stand ready to transfer economic resources if a future event occurs. The unconditional obligation only arises if and when the threshold is met. Similarly, there is no constructive obligation; the entity has discretion to avoid the resource transfer<sup>33</sup>.

### Government grants

- 2.58 When an entity becomes entitled to receive a grant from a government or its agencies but is not required to directly transfer assets to the grantor in exchange, a non-exchange transaction has occurred. The question arises; upon recognition of the asset by the recipient of the grant: does a present economic burden exist for which the entity is obligated? Prima facie, the answer would appear to be ‘no’. The entity is not required to compensate the grantor and the transaction would therefore appear to be akin to a gift. However, grants made by governments normally have attaching conditions; for example, a requirement for the assets to be deployed in a particular way, such as the construction of a facility or subsidisation of a workforce, with failure to do so resulting in a requirement to return the grant. In such situations there is a requirement for the entity to transfer resources, either to the parties benefitting from the deployment of the resources, which might be characterised as a performance obligation, or to the grantor in the event that the conditions of the grant are not met, which might be characterised as a refund obligation. The critical question in this, and in the other situations discussed below, is: what is the obligating event – the

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31 There may be debate around when an entity might actually reach the threshold. For example, if enforceable contracts are in place at the end of an interim reporting period and those contracts will be met before the end of the calendar year has the threshold been reached substantively by the end of the interim period?

32 The IASB’s Interpretations Committee recently reached the same conclusion. See IFRIC Interpretation, IFRIC 21 *Levies*, May 2013, paragraph 12.

33 This can be contrasted with the example of unvested employee benefits, discussed in paragraphs 2.17 to 2.18 and 2.88 to 2.91.



establishment of a right to the grant (thereby giving the entity control over the grant) or the failure to comply with the conditions attaching to the grant?

- 2.59 The answer to the above question can have significant implications for performance reporting as well as liability recognition since it may lead to ‘day one’ income recognition, something that is anathema to many standard setters, regulators, practitioners and preparers of financial statements. That would clearly be the case if the obligating event were considered to be failure to comply with the attaching conditions since no liability would be recognised until non-compliance occurred.
- 2.60 In my view, where conditions relating to the use of the grant are attached to the grant, the obligating event is the establishment of a right to the grant by the entity. That event imposes an economic burden on the entity because receipt of the grant could require the transfer of economic resources from the entity, either by deploying the grant or returning it to the grantor.
- 2.61 But through which means is the entity obligated? As noted earlier in this Chapter, I believe an entity is obligated in relation to an economic burden when there is either a mechanism to enforce that burden against the entity or the entity’s discretion to avoid the economic burden has, through its own actions or otherwise, effectively been removed. In the case at hand, on obtaining control of the grant the entity is not required to deploy the grant nor would anything typically have been done to remove its discretion to avoid deploying the grant. However, the event would give rise to an unconditional obligation to stand ready to return the grant if the entity does not meet the conditions attaching to the grant. In my view, the requirement to refund the grant in the event of non-compliance obligates the entity<sup>34</sup>. This distinction is important because I believe measurement of the liability, which is discussed in Chapter 4, should be consistent with the nature of the obligating event<sup>35,36</sup>.

### Emission trading schemes

- 2.62 Emission trading schemes involve the transfer of emission rights from a government or its agent to emitting entities. These rights are a form of government grant. As with other types of government grant, the controversial financial reporting issues are

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34 The obligation to stand ready to refund the grant is an unconditional obligation that the entity cannot avoid. There is also a conditional obligation to repay the grant if the entity does not meet the conditions attaching to the grant. The entity can avoid this obligation through its own actions by complying with the conditions attaching to the grant. In the event that the entity breaches the conditions and must repay the grant the unconditional stand ready obligation is replaced by an unconditional obligation to repay the grant.

35 In Chapter 4, I express the view that all liabilities should be measured at initial recognition on a current value basis and most liabilities should be measured subsequently on a current value basis. Applying a current value measurement to the liability arising from a government grant will result in the uncertainties relating to the amount and timing of any refunds being captured in the measurement of the refund liability. This may result in a day one gain being recognised.

36 The recognition of income (and liabilities) resulting from contributions of assets to not-for-profit entities is currently being considered by the Australian Accounting Standards Board (AASB) in its project on the review of AASB 1004 *Contributions*. The Board is proposing to require any performance obligations arising on recognition of the contribution to be measured at fair value (giving rise to the possibility of a day one gain), with subsequent recognition of income as performance occurs being based on the principles set out in the IASB’s forthcoming standard on Revenue from Contracts with Customers.



whether a liability arises on receipt of the grant and, if it does, how the liability should be measured.

- 2.63 Focussing only on the perspective of the emitting entity and, in that context, only on the issue of liability recognition, the analysis set out in paragraphs 2.58 to 2.61 relating to government grants with attaching conditions would seem to apply. In my view, receipt of emission rights on entry into an emissions trading scheme is the obligating event. An economic burden is imposed on the entity at that point because it could be required to transfer resources in the future; by polluting and having to pay for the pollution with emission rights, by incurring costs to reduce emissions, or by exiting the business and having to return the rights to the government. However, as with the general case, I also believe that receipt of the emission rights does not impose a requirement on the entity to only use the rights in payment for subsequent acts of pollution, nor does it require the entity to incur costs to reduce emissions. In other words, the entity retains discretion to avoid these outflows of resources. On the other hand, receipt of the emission rights does impose an unconditional obligation to return the rights if the entity exits the scheme<sup>37</sup>. Again, measurement of the liability should be based on the nature of this obligation.
- 2.64 It should be noted that this discussion has assumed the entity would be required under the conditions attaching to receipt of the emission rights to return the rights to the government or its agent in the event it exits the scheme. If the scheme does not impose that condition, in my view no liability arises on receipt of the emission rights.

### **Liability incurrence or asset impairment?**

- 2.65 The emissions trading scheme example is a good example of the confusion that sometimes arises between the existence of a liability and asset impairment. The introduction of an emissions trading scheme changes the economic environment in which a polluting entity operates by imposing another cost of doing business; if the entity does not exit the business it must either incur costs in reducing emissions, for example, by modernising its plant, or pay the cost of continuing to pollute, that is, use emission rights granted to it by the government or obtained in the market. The emission rights granted to the entity by the government compensate the entity for this cost imposition but are set at a level that requires the entity either to incur costs to reduce its emissions or acquire additional emission rights in the market to pay for 'excess' emissions. The net economic impact of the emissions trading scheme on the entity is to reduce the entity's value. This reduction in entity value would typically be only partially reflected in the financial statements through the impairment of non-financial assets because the financial statements would not reflect the entity's value; not all of the entity's non-financial assets would be recognised (most intangible assets

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37 A liability relating to emissions does of course arise when the entity emits. However, even in this context identifying the obligating event(s) might be problematic. For example, the obligating event for a local government's refuse management activities is arguably when the refuse is dumped not when the pollutants are released into the atmosphere, because at that point the local government will have little or no discretion to avoid the transfer of economic benefits (emission rights).



- would typically be unrecognised) and those non-financial assets that are recognised would often not be measured at their current value.
- 2.66 Some of those who argue for day one recognition of a liability equal to the value of the emission rights received from the government do so because of the failure of the existing financial reporting model to capture all of the value change. They find it incongruous that a ‘day one’ gain would be recognised if the liability is measured at an amount less than the value of the emission rights transferred when the entity’s economic value has declined. I agree that this outcome appears anomalous; however, it derives from the failure of the financial reporting model to reflect fully the impact of the change in the economic environment in which the entity operates. In my view, it is inappropriate to recognise an amount characterised as a liability that does not meet the definition of a liability in order to compensate for the inability of the financial reporting model to reflect the full reduction in the value of the entity’s assets.
- 2.67 Of course, this is not the first time accounting practices have evolved that have used liability recognition as a means of compensating for the failure of asset accounting to reflect the economics of transactions and other events. A notable example is accounting for future repairs and maintenance costs. A practice evolved over many years whereby the anticipated future costs of repairs and maintenance would be accrued (recognised as a liability) so as to reflect the deterioration in (consumption of) operating assets that was not being captured by periodic depreciation expenses. The rationale supporting this approach was that this deterioration occurs period by period and should therefore be reflected in profit or loss period by period, rather than being recognised in profit or loss when the repairs and maintenance actually take place. A commonly cited example is the periodic maintenance required on jet engines.
- 2.68 Provisions for repairs and maintenance are not liabilities. It may be highly likely that an entity will incur repairs and maintenance costs in the future but it will not be presently obligated to do so; that is, there will be no legal or constructive obligation to incur the costs. In the jet engine example, although the airline may be required by air safety regulations to undertake a major overhaul of the engines after operating for a specified number of hours, they will not be obligated to incur the costs of the overhaul before the threshold number of hours has been reached. Until then, the airline could for example either decommission or sell the plane or the engine<sup>38</sup>. If it were to sell the plane or the engine, the price received would reflect the amount of time the engine had been operating since the last major overhaul. And therein lays the key to this conundrum. The event that should be captured by the financial reporting model is the consumption of economic benefits that occurs as the jet engine is operated, not the expected future transactions that will restore those benefits. The problem with the financial reporting model that led to this practice was the failure of the depreciation methodology to capture the different rates of consumption of economic benefits that may occur with assets that comprise major components, because depreciation was

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38 Of course, the airline may be otherwise obligated if it has sold forward airline tickets during this period. In this case, it would have a performance obligation relating to the provision of air transport services which it would satisfy with its own planes or by acquiring the services from other airlines.



determined at the whole-of-asset level. By allocating an asset's carrying amount to its major components and depreciating those components over their useful lives, depreciation better reflects the consumption of benefits during the period and avoids the temptation to create 'catch-up' provisions. Moreover, when the restoration of the benefits takes place, the costs are capitalised to the component asset to reflect the acquisition of a resource that will provide future economic benefits, that is, an asset<sup>39</sup>.

## Refraining from acting

- 2.69 Entities sometimes enter into agreements that require them to refrain from acting in a particular way. A common type of these agreements is a 'non-compete' agreement, whereby an entity sells an asset or a business and enters into a legal undertaking with the purchaser not to compete with them in respect of a particular geographic area and/or for a particular period of time. The vendor will recognise the proceeds of sale and the disposition of the asset or business, but should it also recognise a liability in respect of the 'non-compete' agreement?
- 2.70 The 'non-compete' agreement obligates the entity to refrain from competing but does it impose a present economic burden on the entity? In the context of the definition of liabilities set out in paragraph 2.34, a present economic burden is considered to exist when an event has occurred that could require the transfer of economic resources from the entity to another party or parties who will either benefit from the transfer of resources or suffer from the entity's failure to transfer the resources. A 'non-compete' agreement inhibits an entity from generating economic resources in the future from the sale of goods and services but does it obligate an entity to transfer economic resources to another party or parties? Similar to emissions trading schemes, this issue has both asset measurement and liability recognition dimensions.
- 2.71 When an entity sells an asset or a business subject to a 'non-compete' agreement, the compensation it receives would reflect the fact that it would also have sold some of its goodwill, which may comprise purchased goodwill and internally generated goodwill. The full impact of the economics of the transaction would not be reflected in the financial statements of the seller because internally generated goodwill would not have been recognised as an asset under the existing financial reporting model<sup>40</sup>. The financial effect of the existence of the 'non-compete' agreement on the value of the entity would only be fully revealed in the event of the sale of the remaining business, where the price paid by the acquirer would be adjusted for the restriction on the acquiree's activities and would be reflected in an amount of purchased goodwill lower than it would have been absent the 'non-compete' agreement.
- 2.72 The 'non-compete' agreement also creates an unconditional obligation for the entity to stand ready to compensate the counterparty in the event the entity breaches the 'non-compete' agreement. Measurement of the liability would be based on the

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39 Component depreciation was introduced into IFRS literature in 2003 when the IASB amended IAS 16 *Property, Plant and Equipment*. Before the revised standard became effective, the use of repairs and maintenance provisions was widespread. They are still used in many non-IFRS jurisdictions.

40 Accordingly, the amount of the purchase consideration attributable to internally generated goodwill transferred would be shown as a gain.



accompanying conditional obligation, that is, to pay compensation to the counterparty in the event the entity breaches the ‘non-compete’ agreement, and would reflect the likelihood of that event occurring<sup>41</sup>. If the entity subsequently breaches the ‘non-compete’ agreement an unconditional obligation to pay compensation to the counterparty would replace the unconditional stand ready obligation.

## ‘Regulatory liabilities’

- 2.73 In some jurisdictions standard setters have decided that the existence of regulatory mechanisms governing the pricing of particular goods or services can result in certain transactions or events giving rise to what have been termed ‘regulatory assets’ and ‘regulatory liabilities’<sup>42</sup>. This accounting is most commonly applied in the utility industries, that is, industries providing so-called ‘essential services’, such as water and power.
- 2.74 The standard setters that have endorsed the recognition of these ‘assets’ and ‘liabilities’ have reasoned that price regulation can, in certain circumstances, create rights to resource flows from customers and obligations to transfer resources to customers. With respect to liabilities, they reason that price regulation can create a present obligation for an entity to ‘refund’ excess amounts charged to customers in the past by reducing the rates they will charge the customers in the future. For example, an entity realises a gain on an asset the depreciation of which it has been recovering from customers through past regulated service charges, and the regulator requires the entity to ‘refund’ the prior excess service charges. In this case, some would argue that the entity should defer the gain in the current period (that is, recognise a ‘liability’) and recognise that gain in future periods when the future service charges are reduced.
- 2.75 Some see regulated entities as being similarly placed to entities that have entered into ‘non-compete’ agreements, in the sense that they are constrained by the regulatory mechanism from acting freely in generating future resource inflows. They reason that, as with non-compete agreements, although regulation affects the value of the regulated entity<sup>43</sup>, it does not create regulatory assets and liabilities.
- 2.76 Others argue that particular forms of regulatory mechanism constitute a ‘compact’ between the regulator and the regulated entities that effectively creates enforceable rights and obligations.
- 2.77 I support the former view. Mechanisms that regulate the pricing of goods and services do not, in my view, create regulatory assets and liabilities. In the example referred to above, the realisation of a gain on the asset is not an event that creates a present economic burden; it does not give rise to an unconditional promise or other

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41 Given that it is within the entity’s control to avoid breaching the agreement, the likelihood of a breach occurring would normally be assessed to be low and would result in the liability normally being measured at an insignificant amount.

42 The United States and Canada are the two jurisdictions most commonly associated with this accounting practice, although it has been employed in other jurisdictions, for example, Brazil and India.

43 The existence of the regulatory mechanism may in fact enhance the value of the entity by ‘guaranteeing’ a minimum rate of return on its capital investment. This intangible asset would not be recognised under the existing financial reporting model except in the event of a business combination.



requirement to transfer resources to customers in the future. If the entity provides regulated goods or services to customers in future periods it will be required to charge a lower rate, but that requirement constitutes a restriction on the entity's capacity to freely set its rates and generate resource inflows. In other words, the regulatory mechanism imposes an opportunity cost on the entity, not an obligation to transfer resource flows to customers in the future. The entity retains discretion to provide the goods and services in the future; for example, it may change its business model or it may exit the industry<sup>44</sup>. Indeed the market for the entity's goods and services may change, resulting in its customer base severely contracting; for example, if it is providing power, customers may shift to alternative self-generating energy sources.

- 2.78 In the example in paragraph 2.74, in substance two distinct economic events occur and should be accounted for separately. The entity has sold an asset in the current reporting period and should recognise the gain on sale; comprehensive income and net assets of the entity are higher in that period as a result of the transaction. In future periods, if and when the lower rates are charged to customers as required by the regulator, revenue will be reported that will be lower than it may have been absent the regulatory mechanism; comprehensive income and net assets likewise may be lower. Recognising a regulatory liability on sale of the asset and subsequently 'allocating' that liability to the profit or loss statements of future periods when the lower rates are charged to customers, fails to reflect the economics of these transactions. In my view, the recognition of regulatory assets and liabilities is driven by a desire to remove the potential lumpiness in reported amounts of revenue resulting from the lagged effect of the required adjustments to the rates charged to customers. The result is smoother reported profits.
- 2.79 Of course, if the regulatory mechanism imposes a contractual or statutory obligation on the entity to transfer resources to customers in the future because they have been 'overcharged' in the past, then a liability should be recognised in accordance with the relevant standard (for example, IFRS 9 *Financial Instruments*). I understand that this is rarely, if ever, the case.

## Performance obligations

- 2.80 In recent years, certain types of liabilities have been characterised as 'performance obligations'<sup>45</sup>. These are liabilities for which the reporting entity is obligated to transfer goods or services to another party<sup>46</sup>.

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44 As noted in footnote 39, the entity may be otherwise obligated if it has entered into forward sale transactions.

45 The nomenclature seems to have emanated from the joint IASB/FASB project on Revenue from Contracts with Customers, which was commenced in June 2002.

46 The IASB has defined 'performance obligation' as: "a promise in a contract with a customer to transfer a good or a service to the customer". See IASB Exposure Draft ED/2011/6 *Revenue from Contracts with Customers*, Appendix A Defined terms, page 51. The IPSASB has defined 'performance obligation' as: "an obligation in a contract or other binding arrangement between a public sector entity and an external party to transfer a resource to that other party". See IPSASB Conceptual Framework Exposure Draft 2, op. cit., paragraph BC25.



- 2.81 It is not entirely clear why this characterisation was introduced to the literature. The essential characteristics of a liability are clearly present for these transactions; there is a present economic burden in that an event has occurred (entering into an enforceable agreement) that could require the transfer of economic resources (goods or services) to another party or parties who will either benefit from the transfer of resources or suffer from the entity's failure to transfer the resources, and the entity is obligated in relation to the economic burden by virtue of having been a party to the enforceable agreement.
- 2.82 The characterisation appears to have been developed because standard setters have for some time been concerned that liability recognition and measurement in the context of income generating activities has been driven more by criteria associated with the timing of income (or revenue) recognition rather than by reference to whether a liability has been incurred or satisfied. In other words, it has been, in a sense, the tail wagging the dog. This seems incongruous given that 'income' (and 'revenue' as a subset of income) has been defined in the extant conceptual frameworks by reference to changes in assets and liabilities<sup>47</sup>. Revenue recognition literature has typically focussed on criteria such as the transfer of significant risks and rewards of ownership, reliable measurement, and uncertainties related to ultimate cash collection. This focus has at times resulted in amounts being recognised as deferred revenue (and presented as liabilities in the statement of financial position) even though the entity has no further obligation to deliver goods or services.
- 2.83 The IASB's project on Revenue from Contracts with Customers is proposing to shift the focus onto assets and liabilities. Under the proposed model, a contract liability (performance obligation) would be recognised when an entity receives customer consideration in advance of the delivery of goods or services<sup>48</sup>. Under this model, it is not a matter of 'deferring revenue'; rather, it is a matter of identifying the event that triggers recognition of the contractual obligation to provide goods or services in the future. Consistent with the conceptual definition of income (and thus of revenue), revenue is recognised as the liability is extinguished through specific acts of performance, rather than, for example, merely through the passage of time as may be the case under existing models<sup>49</sup>.

## Leases and service concession arrangements

- 2.84 The IASB and the IPSASB have recently relied on the notion of performance obligation to justify the recognition of a liability in circumstances I believe do not give rise to a present economic burden for which the entity is obligated. In the exposure draft on service concession arrangements that preceded IPSAS 32 *Service Concession*

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47 The IPSASB is proposing to define revenue by reference to changes in assets and liabilities and decreases in deferred inflows. See IPSASB Conceptual Framework Exposure Draft 2, op. cit., paragraph 4.1.

48 The proposed model acknowledges that rights and obligations arise at contract inception (i.e. the reporting entity's rights to receive consideration from the customer and its obligations to transfer goods or services to customers), but delays the recognition of a (net) contract asset or liability until performance of either party occurs. A net contract asset will in fact often exist at contract inception (see footnote 80). In addition, the rights and obligations could be recognised 'gross' at contract inception.

49 However, in some arrangements, the passage of time may be a faithful proxy for when multiple specific acts of performance occur.



*Arrangements: Grantor*, the IPSASB proposed that a liability should be recognised by the grantor (government) when it grants a right to the operator of a service concession asset to charge users of that asset<sup>50</sup>. The rationale provided in the exposure draft was that the grantor has a performance obligation because it has an obligation to continue to provide the asset to the operator during the life of the concession arrangement<sup>51</sup>. Similarly, the IASB, together with the FASB, proposed in their original joint exposure draft on leases that in certain circumstances a lessor should recognise a liability when it transfers a right of use to a lessee, on the grounds that the lessor has an obligation to continue to provide the asset to the lessee during the term of the lease<sup>52</sup>. It would seem in both cases that the boards have misapplied the concept of a performance obligation as that notion has been articulated to date in the IASB's project on Revenue from Contracts with Customers.

- 2.85 I believe both of these transactions involve exchanges. In the case of the service concession arrangement, the grantor has transferred a right to the operator to charge customers for the use of the asset, in exchange for the concession asset. The operator controls the right to charge; the grantor controls the concession asset. The grantor does not have a present economic burden; it has already provided resources to the operator, the right to charge. It is not obligated to transfer further resources to the operator. The grantor should recognise the asset it now controls as income (or revenue). Because the transferred right will not previously have been recognised in the grantor government's statement of financial position, this will result in a 'day one' gain. IPSAS 32, by requiring the grantor to recognise a liability, requires the 'day one' gain to be spread over the term of the concession arrangement.
- 2.86 Similarly, when a lessor enters into a lease, it exchanges a right to use the underlying leased asset for an unconditional right to receive consideration in the form of cash or other assets. The lessee recognises a right to use the asset and an unconditional obligation to pay the lessor for that right of use. The lessor does not have a present economic burden as a result of the transaction; it has exchanged one asset for another. It is not obligated to transfer further resources to the lessee. It should recognise the unconditional right as income (or revenue) and the carrying amount of the transferred asset as an expense<sup>53</sup>. This may result in a 'day one' gain. The 2010 leases exposure

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50 IPSASB Exposure Draft 43 *Service Concession Arrangements: Grantor*, 2010.

51 In the final standard, the accounting was retained but the rationale included in ED 43 was removed in response to criticisms from constituents. The rationale for liability recognition is not clear to me. Paragraph AG47 of IPSAS 32 states: "When the grantor compensates the operator for the service concession asset and service provision by granting the operator the right to earn revenue from third-party users of the service concession asset, the operator is granted the right to earn revenue over the period of the service concession arrangement. Likewise, the grantor earns the benefit associated with the asset received in the service concession arrangement in exchange for the right granted to the operator over the period of the arrangement. Accordingly, the revenue is not recognised immediately...". The Basis for Conclusions to IPSAS 32 does not explain why the deferred revenue meets the definition of a liability nor how revenue is 'earned' over the period of the concession arrangement. It would seem that the IPSASB has removed the descriptor 'performance obligation' from the standard but has retained the concept as the rationale for delaying the recognition of revenue from the exchange transaction.

52 IASB Exposure Draft ED/2010/9 *Leases*, 2010. This proposal was not included in the revised exposure draft. See IASB Exposure Draft ED/2013/6, *Leases*, 2013.

53 The lessor may have a residual interest in the underlying asset, which it would recognise separately.



draft, by proposing that the lessor recognises a performance obligation liability, would have prohibited the lessor from recognising any 'day one' gain; the lease revenue and expense (amortisation of the leased property) would be recognised over the term of the lease as the lessor continues to provide the lessee with access to the asset.

- 2.87 In both of these cases, the accounting is contrary to the principles embodied in the IASB's ED/2011/6 *Revenue from Contracts with Customers*. Under the proposed principles, the exchange transactions would result in the recognition of contract revenue on day one. No performance obligation would be recognised; the grantor/lessor does not have an obligation to transfer goods or services to the operator/lessee in the future. The acts of performance that created revenue were the transfer of the right to charge customers by the grantor and the transfer of the right of use by the lessor, not the ongoing 'provision' of the transferred assets.

### **Unvested employee benefits**

- 2.88 In paragraphs 2.17 and 2.18 the vexed issue of accounting for unvested employee benefits was identified. These are situations where employee compensation for past services is deferred until a future event occurs, such as the completion of a specified period of service. As noted in paragraph 2.18, accounting standards in many jurisdictions have required entities to recognise a liability as service is provided by the employees. The conceptual question that arises in these situations is: does a present economic burden for which the entity is obligated exist during the vesting period when the obligation is not enforceable against the entity by legal or equivalent means?
- 2.89 *Prima facie*, the unvested employee benefits example and the minimum threshold levy example discussed in paragraphs 2.53 to 2.57 appear to be comparable. If the future event does not occur, for example, an employee leaves before completion of the specified period of service (the threshold is not met), the entity would not be required to pay the compensation. Accordingly, a liability would not arise until the future event occurs (the threshold is met).
- 2.90 However, in the case of unvested employee benefits, although a contractual or statutory obligation would not exist, a constructive obligation would arise as the employee provided the services. As services are provided by an employee an exchange transaction occurs; the entity receives services from the employee and, in exchange, promises to compensate them for those services. Typically, the compensation will comprise of current payments for which the entity will be legally obligated, and deferred payments, some of which they will typically be legally obligated to pay, such as annual leave and sick leave, and some for which they will not be legally obligated to pay at date of exchange, such as defined benefit pensions and long-service leave. Although ostensibly the entity has discretion to avoid deferred payments that are dependent upon the occurrence of future events and for which they are not legally obligated to pay, for example by dismissing the employees before they complete the required period of service, they will through their actions (for example, past practices, published policies, specific current statements, etc.) create valid expectations on the part of their employees that they will honour their promise to



compensate them for services provided. This obligation will be reinforced by the expectations of employee representative bodies and the community in general.

- 2.91 Accordingly, in my view the issue is one of measurement not existence. A liability arises at the point of exchange and should be measured using a measurement basis that reflects the uncertainties surrounding the timing and amount of the deferred payments, including the likelihood that payments will not be made to some employees.

## **Litigation liabilities**

- 2.92 One of the most problematic areas in liability recognition is identifying when an entity is obligated as a result of legal action that is possible, threatened, pending or in progress against an entity. The relevant question to ask is: has an event occurred that obligates the entity?
- 2.93 Often a number of different events will occur in the process of an entity becoming involved in legal action. Take the case of a pharmaceutical company that has developed a new drug for the treatment of heart disease. The company knows, based on past experience, that some users of the drug will suffer side effects that cause pain and suffering and possibly even death. Is the sale of the drug to a customer the event that obligates the entity or is it another event, for example, becoming aware that a customer has suffered an injury? At the point of sale, the entity knows that it is highly likely some customers will bring an action against it in the future but it does not know which customers or when the actions might be commenced.
- 2.94 To answer this question, we need to ask a further question: does a present economic burden exist at the point of sale? To answer 'yes' we would need to satisfy ourselves that by entering into a transaction an entity has either made an unconditional promise to transfer resources to customers in the future or another 'requirement' exists that leaves the entity with little or no discretion to avoid the transfer of resources to the customers in the future.
- 2.95 At the point of sale, no such promise has been made by the pharmaceutical company. However, if a law exists in the jurisdiction in which the company conducts its business that imposes a duty on it to provide a good that is safe for consumption, and failure to do so would leave it with little or no discretion to avoid the adverse consequences that may result, then arguably an unconditional obligation to stand ready to transfer resources to customers arises at the point of sale.
- 2.96 Those that hold the view that an obligation arises at the point of sale in these circumstances believe that the issue is one of estimation uncertainty not existence uncertainty. In their view, if the pharmaceutical company has a legal obligation to sell a good that is fit for purpose, sale of a defective good would constitute a breach of the law and would give rise to an unconditional obligation to stand ready to compensate customers who subsequently suffer injuries. The fact that the company cannot identify which of the sales will eventually give rise to injuries is not relevant to the issue of the existence of a liability, it is relevant only to measurement of the liability. Consistently with this view, measurement of the liability at initial recognition would take into account the likelihood that customers would suffer injuries, the



- likelihood that claims would be brought, the likelihood that the actions would be successful, etc. and the estimates would be risk adjusted (see Chapter 4 for discussion of current value measurements that capture the relevant risks and uncertainties).
- 2.97 An alternative view is that an economic burden is imposed on an entity by the law only when the customer has been shown to have suffered an injury from a defective good or service. In this view, the obligating event is detection of the breach of the law. Prior to this point, including the point of sale, the possibility that an entity would be required to compensate customers for injury caused by the use of its products or services is a business risk not a liability<sup>54</sup>.
- 2.98 In this view, at what point would a liability arise? When a customer notifies the pharmaceutical company that they have suffered side effects? When the company has been advised that legal action will be taken? When legal action commences? When the dispute has been resolved either by the court or via settlement with the claimant?
- 2.99 Arguably, the answer is the earliest point at which the entity judges, based on all relevant facts and circumstances, that the customer has been injured as a result of consuming the product or service and that the law applies to that event. At this point, an economic burden exists and the entity is obligated in relation to that burden by the operation of the law.
- 2.100 However, identifying that point may be very difficult. The entity would need to be satisfied that the claim is valid, that is, that an injury occurred and the good or service caused the injury. It would also need to be satisfied that the law applies. The entity may need to consider a range of evidence, including its own previous experience, experiences of other entities, expert opinions, and the claimant's information, in making these judgements. The more challenging the circumstances, the more likely the point at which the entity judges that a liability exists would be later in the litigation process.
- 2.101 Some have claimed that the latest point in the process that a liability should be recognised is when litigation commences. They reason that beyond this point the company no longer has any discretion to avoid the transfer of resources to claimants because it is now in the hands of the court. However, although commencement of litigation may be relevant evidence that a valid claim exists, it does not establish that fact. Nonetheless, an argument could be made that upon commencement of proceedings a liability arises in respect of costs the entity will incur in defending the claim. This is because once litigation commences the entity's discretion to avoid incurring these costs has effectively been removed. Measurement of the liability would reflect the likelihood of early settlement, amongst other things.
- 2.102 The view that a liability arises at the point of sale when an entity has a legal duty to provide goods or services that are fit for sale is intuitively appealing and one to which I subscribe, at a conceptual level. The overarching question is: does a present

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54 Those who hold this view reason that the economic effect of this risk would be reflected in the company's value, and would impact the amount attributable to goodwill and/ or an identifiable intangible asset recognised in the event of a business combination.



economic burden for which an entity is obligated arise when an entity breaches the law by selling a defective good or providing a defective service, or when, based on all relevant facts and circumstances, the entity assesses that a customer has suffered an injury as a result of consuming the defective good or service? In other words: is the event that obligates the entity the breach of the law or detection of the breach?

- 2.103 At a conceptual level it is difficult to argue that an obligation does not arise at the point an entity breaches the law. From that point, the entity has little or no discretion to avoid the transfer of resources to customers who suffer an injury and seek compensation for their suffering. However, this conclusion has broad implications that could prove very difficult and potentially very costly to apply in practice. All entities have an obligation to comply with the law. At any point in time they may have knowingly or unwittingly broken the law. For example, entities must comply with occupational health and safety laws, traffic laws, parking laws and environmental protection laws. If the existence of liabilities were to be based on the ‘breach of the law view’, at each reporting date entities would be required to assess: the range of laws to which they are exposed; the likelihood that they have broken the laws; the likelihood that the breaches will be detected; the likelihood that any legal actions taken by authorities or injured parties will be successful; the timing of such detections, actions and ultimate payments; the amounts of any payments; and, the timing and amounts of any costs incurred in dealing with the claims.
- 2.104 In my view, standard setters should acknowledge that at a conceptual level a stand ready obligation arises when an entity breaches the law and before the breach has been detected. However, at the accounting standards level I believe standard setters would be justified on cost/benefit grounds in delaying the point of recognition until an entity assesses on the balance of probabilities that it has broken the law.

## Options

- 2.105 Existing literature is clear that an option written by an entity that conveys a right to the option holder to exchange resources with the entity at a specified price is a liability of the entity<sup>55</sup>. What is perhaps not clear to some is why this is so. After all, an option (other than an option settled in the entity’s equity instruments) conveys a right to the option holder to require the entity to transfer resources to it, not an obligation on the option holder to do so. If the option holder fails to exercise the right, the entity will not be required to transfer the specified resources to the option holder.
- 2.106 From a reporting entity’s perspective, a written option contains an unconditional promise to transfer resources to the option holder in the event the option holder exercises their contractual right to require the transfer of resources. It is the unconditional promise that is the present economic burden and the entity is obligated in respect of that burden by the option contract<sup>56</sup>. An option contract comprises two

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55 See for example IAS 32 *Financial Instruments: Presentation*, paragraph AG17

56 In the same way, a purchased option gives the option holder a right to acquire the underlying. This right is the unconditional promise made by the option writer and is the present economic resource that would be recognised as an asset by the option holder. The underlying would only be recognised as an asset by the option holder if and when the option is exercised.



components; an **unconditional** obligation to stand ready to transfer resources to the counterparty if and when the counterparty chooses to exercise the option, and a **conditional** obligation to transfer resources if the counterparty exercises the option. The former component gives rise to a liability on entering the contract and requires performance on the part of the option writer during the term of the contract (much like an insurance contract). The latter component may give rise to a different liability in the future if and when the counterparty exercises the option.

## Existence versus measurement

- 2.107 This Chapter has been concerned with what has been termed the ‘existence’ question; that is, does a liability exist as a result of a transaction or other event? A separate question, which will be addressed in Chapter 4, is: if a liability exists at the reporting date, how should it be measured? Although these are separate questions and, logically, should normally be addressed sequentially, sometimes addressing the measurement of a possible liability will shed light on whether an economic burden presently exists.
- 2.108 When the IASB revised its business combinations standard in 2008 it had to deal with a liability recognition inconsistency created by the requirements of IAS 37. IAS 37 prohibits the recognition of contingent liabilities<sup>57</sup>. However, IFRS 3 *Business Combinations* requires, with limited exceptions, the assets and liabilities of the acquiree to be measured at their acquisition date fair values. The IASB had to include in IFRS 3 an exception to the recognition principle in IAS 37 in order to require any ‘contingent liabilities’ that are present obligations and that have acquisition date fair values that can be measured reliably to be recognised as liabilities of the acquiree<sup>58</sup>.
- 2.109 The IASB’s experience with IFRS 3 highlighted the power of the fair value measurement basis as a means of identifying the potential existence of liabilities (and assets) that have a separate existence but that are not recognised in the statement of financial position. Asking the question: “If the entity were sold, would market participant buyers discount the price they would be prepared to pay for the entity because of the existence of an unrecognised present economic burden?”, could, if answered in the affirmative, provide grounds for investigating further whether a liability exists or whether the price adjustment merely reflects general business risks facing the entity.

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57 A ‘contingent liability’ is defined in IAS 37 as:

- (a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- (b) a present obligation that arises from past events but is not recognised because:
  - (i) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
  - (ii) The amount of the obligation cannot be measured with sufficient reliability.

IASB IAS 37, op. cit., paragraph 10.

58 See IFRS 3, paragraph 23. The IASB had planned to remove this inconsistency in its Liabilities project.



2.110 However, before discussing the measurement of liabilities the Paper addresses liability recognition, which to this point in the development of accounting concepts and standards has typically been seen as a discrete event.



## 3. When should a liability be recognised?

- 3.1 In Chapter 2, a definition of a liability was presented and applied to a number of transactions and other events that have proven to be problematic to standard setters and practitioners. The focus of the Chapter was on existence – has a transaction or other event occurred that has given rise to a liability? This is sometimes referred to in the literature as ‘existence uncertainty’.
- 3.2 This Chapter explores the issue of when, having resolved that a liability does exist, it should be recognised in the statement of financial position. Specifically, it addresses the question of whether additional criteria should be satisfied before recognition is required.

### Recognition criteria

- 3.3 Historically, conceptual frameworks developed by standard-setting bodies have specified additional criteria that an item must meet in order to be recognised in the financial statements<sup>59</sup>. The IASB’s Conceptual Framework specifies that an item that meets the definition of an element should be recognised if:
- (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and
  - (b) the item has a cost or value that can be measured with reliability<sup>60</sup>.
- 3.4 These criteria are common to most of the frameworks. They impose a probability threshold relating to the likelihood of resources being transferred to or from the entity, and a requirement that the item can be measured reliably.
- 3.5 Standard setters and practitioners have interpreted the probability recognition criterion in various ways. For example, IAS 37/IPSAS 19 state that: “...for the purpose of this Standard, an outflow of resources ... is regarded as probable if the event is more likely than not to occur...”<sup>61</sup>. In practice in the United States, unless the literature states otherwise, ‘probable’ is understood to be at a much higher level of likelihood, for example, 90 per cent or more<sup>62</sup>. The reliable measurement recognition criterion builds on the qualitative characteristic of ‘reliability’ which is a concept common to all of the conceptual frameworks.

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59 See for example United Kingdom Accounting Standards Board *Statement of Principles*, Australian Accounting Standards Board *Statement of Accounting Concepts No. 4 Elements of the Financial Statements*, Financial Accounting Standards Board *Concepts Statement No. 5 Recognition and Measurement in the Financial Statements of Business Enterprises*, and Canadian Institute of Chartered Accountants *Financial Statement Concepts*.

60 IASB *Conceptual Framework*, paragraph 4.38

61 IASB, IAS 37 op. cit. paragraph 23 and IPSASB, IPSAS 19 op. cit. paragraph 31.

62 *Statement of Financial Accounting Standards No. 5 Accounting for Contingencies*, issued by the FASB requires an estimated loss from a loss contingency to be recognised in income if it is *probable* that a liability has been incurred. Practitioners apply this as a very high recognition threshold.



- 3.6 However, the existing conceptual frameworks were developed many years ago and standard setters' thinking in the area of recognition appears to have evolved. For example, the recognition of financial instruments under IAS 39 *Financial Instruments: Recognition and Measurement* and IFRS 9 is not dependent on those items meeting either a probability threshold or a measurement reliability criterion. If an instrument falls within the scope of the standards it must be recognised initially at fair value. Accordingly, for a financial liability to be recognised in the statement of financial position, it is sufficient for an item to merely meet the definition of a financial liability.
- 3.7 Of particular relevance to this Paper is the IASB's Liabilities project. In the exposure draft *Proposed Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits*, the IASB proposed that a non-financial liability should be recognised when:
- (a) the definition of a liability has been satisfied, and
  - (b) the non-financial liability can be measured reliably.
- 3.8 Consistently with the recognition of financial instruments, there would be no requirement for a non-financial liability to meet a probability threshold relating to the outflow of resources in order to be recognised in the statement of financial position. Although the IASB rationalised this proposed change to IAS 37 by focussing on the nature of the obligation that should be the subject of the measurement, (for example, in the case of warranties and guarantees by focussing on the unconditional stand ready obligation rather than on the conditional obligation), the implications of the proposed change would be much broader.
- 3.9 I agree with the direction of these developments. In my view, there should be only one criterion for the recognition of a liability; that the item meets the definition of a liability. I believe that both the probability recognition criterion and the reliable measurement criterion contained in a number of existing conceptual frameworks and in the existing IAS 37/IPSAS 19 are unnecessary and have the potential to impair the quality of financial reporting. This is discussed below.

## Probability criterion

- 3.10 I believe the motivation for including this criterion in the IASB's Conceptual Framework was to not require an entity to recognise (or perhaps to prevent an entity from recognising) an item as a liability unless there was a reasonable likelihood of resources being transferred from the entity to another party<sup>63</sup>. This concern can be dealt with in two ways. First, by making clear in the definition of a liability that for a present economic burden to exist there must be a possibility that resources will be transferred from the entity to another party. Secondly, where measurement uncertainty exists in relation to the liability, require the liability to be measured in a way that captures that uncertainty, for example, at its fair value or entity-specific

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63 For an asset, I believe the motivation was to prevent entities recognising an asset unless there is a reasonable likelihood that resources would flow to the entity.



value<sup>64</sup>. Thus, although a liability would be required to be recognised even if the likelihood of having to transfer resources to other parties is low (assuming the amount would be material), the amount recognised would reflect that expectation.

- 3.11 Of more significance is the potential loss of relevant information when the recognition of liabilities is constrained by a probability threshold. For example, under IAS 37/IPSAS 19 material non-financial liabilities would be omitted from the statement of financial position if an entity determines that the outflow of resources relating to an item that meets the definition of a liability is not more likely than not to occur. Expressed another way, if the probability of the outflow occurring is 50 per cent or less the liability must not be recognised. If it is more than 50 per cent, the liability must be recognised. To take this to its extreme, a liability with a 50 per cent probability of outflows occurring is not recognised, but one with a 50.01 per cent probability of outflows occurring is recognised. In my view, this ‘cliff-edge’ accounting has no conceptual rationale. Indeed, it is contrary to the higher levels of the conceptual framework since the omission of material liabilities and expenses from an entity’s financial statements would deprive users of relevant information for assessing the performance and financial position of an entity.

### **Reliable measurement**

- 3.12 Although the reliable measurement recognition criterion is, in my view, less egregious than the probability recognition criterion, again, I believe it is unnecessary and has the potential to impair the quality of financial reporting. In my view it should always be possible to derive a measurement which, to use the terminology in the IASB’s revised Conceptual Framework, faithfully represents a liability.
- 3.13 As will be discussed in more detail in the Chapter 4, I believe a liability should be recognised initially at a current value that captures the economic characteristics of the liability. If the liability results from an arm’s-length exchange transaction, this value should normally be readily determinable; either by reference to the current value of the resources expected to be transferred to the counterparty in satisfying the liability, or by reference to the current value of the assets received in exchange. The timing and amount of the resource flows will often be clearly evident from the terms of the contract on which the transaction is based. If there is significant uncertainty about the amount and/or timing of the future resource flows, for example because of the existence of contingent payments, then I believe reliable estimates can be made using appropriate valuation methodologies. In this respect, it is salient to refer to the earlier observation that there is no reliable measurement recognition criterion for financial liabilities in the IFRS and IPSAS financial instruments literature. This is the case, notwithstanding that the measurement of certain financial liabilities, particularly derivatives, could involve significant uncertainties relating to the amount and timing of future resource flows. Typically, the measurements would be level 3 fair value measurements (as described in IFRS 13 *Fair Value Measurement*) and would involve the use of valuation methodologies. Similarly, the IASB is not proposing to include a

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64 These measurement bases (and others) will be discussed in Chapter 4.



- reliable measurement recognition criterion for the recognition of insurance liabilities even though measurement of these liabilities may involve significant uncertainties<sup>65</sup>.
- 3.14 I see no reason why the same approach should not be applied to liabilities arising from non-exchange transactions. Where the liabilities involve significant uncertainties relating to the amount and/or timing of resource flows, representationally faithful measures should be achievable using appropriate valuation methodologies.
- 3.15 The standards-level decisions of the IASB and IPSASB regarding financial liabilities and the IASB's tentative decisions regarding liabilities arising from insurance contracts, and my view that representationally faithful measures of liabilities should always be achievable, would appear to be consistent with Chapter 3 of the IASB's conceptual framework and Section 3 of the IPSASB's conceptual framework dealing with qualitative characteristics of useful financial information. In the discussion of the meaning of faithful representation, the IASB's conceptual framework states that a representation of an unobservable price or value, that is, an estimate "...can be faithful if the amount is described clearly and accurately as being an estimate, the nature and limitations of the estimating process are explained, and no errors have been made in selecting and applying an appropriate process for developing the estimate"<sup>66</sup>. Similarly, the IPSASB's conceptual framework states that: "In some cases...the accuracy of an estimate of the value or cost of an item or the effectiveness of a service delivery program may not be able to be determined. In these cases, the estimate will be free from material error if the amount is clearly described as an estimate, the nature and limitations of the estimation process are explained, and no material errors have been identified in selecting and applying an appropriate process for developing the estimate"<sup>67</sup>.
- 3.16 These statements are important additions to the conceptual frameworks because they make clear that an estimate of an economic phenomenon that involves significant uncertainty can be a faithful representation of that economic phenomenon even if, for example, the estimate is one of a number of possible estimates within a range. This is contrary to a commonly held view that for an estimate of an amount to be reliable, that estimate must be verifiable or precise. This view stemmed from a misunderstanding of the meaning of the term 'reliability' in the IASB's previous conceptual framework and had been compounded by failure of the previous framework to convey clearly the meaning of reliability. The IASB replaced reliability with 'faithful representation' in the revised conceptual framework in order to more clearly convey the intended meaning<sup>68</sup>. It also identified verifiability as an enhancing qualitative characteristic

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65 See IASB, Exposure Draft ED/2013/7 *Insurance Contracts*, op. cit.

66 See IASB *Conceptual Framework*, paragraph QC15

67 IPSASB *The Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities*, 2013, paragraph 3.16.

68 See IASB *Basis for Conclusions on Chapter 3: Qualitative characteristics of useful financial information*. The IPSASB subsequently decided to use the same expression in its conceptual framework.



rather than, as in the previous framework, an aspect of reliability (representational faithfulness)<sup>69</sup>.

- 3.17 The IASB's and IPSASB's discussion of faithful representation seems to imply a shift away from the position originally taken in the IASB's conceptual framework that reliable measurement should be a constraint on recognition of the elements. Although the IASB is yet to reconsider the section of the conceptual framework dealing with recognition of the elements, I believe the revisions to the qualitative characteristics section imply the removal of the reliable measurement criterion.
- 3.18 The reliable measurement criterion is like an on/off switch. If an element can be reliably measured, assuming any other recognition criteria are met, it must be recognised. If the element cannot be reliably measured it must not be recognised. This concerns me, because it can lead to the omission from the financial statements of relevant information. Like the probability recognition criterion, being in a sense a bright line, it can also encourage opportunistic behaviour<sup>70</sup>.
- 3.19 Chapter 3 of the IASB's revised Conceptual Framework seems to give pre-eminence to the qualitative characteristic of 'relevance'. Although it states that information must be both relevant and faithfully represented if it is to be useful, its explanation of how these fundamental qualitative characteristics should be applied suggests that the process of recognising an element in the financial statements should not be a discrete exercise. Paragraph QC18 of Chapter 3 explains the process as follows:
- First, identify an economic phenomenon that has the potential to be useful to users of the reporting entity's financial information. Second, identify the type of information about that phenomenon that would be most relevant if it is available and can be faithfully represented. Third, determine whether that information is available and can be faithfully represented. If so, the process of satisfying the fundamental qualitative characteristics ends at that point. If not, the process is repeated with the next most relevant type of information<sup>71</sup>.
- 3.20 If this process is applied to the recognition of liabilities in the financial statements, it seems that having been satisfied of the existence of a present economic burden for which the reporting entity is obligated (the economic phenomenon), information about that economic phenomenon should be reported in the financial statements, even if it is not the most relevant information that potentially could be reported. In other words, an iterative process should be followed using alternative measures until information that is relevant and representationally faithful is identified. For example, assume that

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69 See IASB *Conceptual Framework*, paragraphs QC19 & QC26. The IPSASB also identified verifiability as a separate qualitative characteristic rather than an aspect of representational faithfulness.

70 I have found it anomalous that standard setters' concerns about reliable measurement at both a conceptual and standards level are put to one side when setting standards for business combinations. Granted an exchange transaction occurs, but the standards require the acquired assets and liabilities to be measured separately at fair value. This is so even when, absent a business combination, some of the assets and liabilities would not be recognised at all because they could not be reliably measured and others, although previously recognised, would not subsequently have been measured at fair value because their fair value could not be reliably measured.

71 IASB *Conceptual Framework*, paragraph QC18



the most relevant measure of a particular liability is its fair value, but that an estimate of fair value is not considered to be representationally faithful because of the inability to establish market participants' estimates of key inputs to the valuation process. The next most relevant measure might be a current value determined using entity-specific estimates of future resource flows. If a representationally faithful estimate of that measure can be determined, then that amount would be reported in the financial statements.

- 3.21 My view that there should not be a separate reliable measurement recognition criterion should not be interpreted as implying that I attach diminished importance to the qualitative characteristic of faithful representation. To the contrary, I support the position taken in Chapter 3 of the IASB's revised conceptual framework and Section 3 of the IPSASB's conceptual framework that, for information to be useful to the users of the financial statements, it must be both relevant and faithfully represented. My point is that concerns about reliable measurement or faithful representation arise from uncertainties relating to the amount and timing of future resource transfers, and I believe these concerns can be overcome by selection of an appropriate measurement basis and disclosure of appropriate information related to the measurement process, rather than by not recognising a liability at all<sup>72</sup>. The next two Chapters of this Paper address these measurement and disclosure issues respectively.

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72 It would appear that my view is supported by the IPSASB. In its exposure draft on elements and recognition in financial statements, the IPSASB has proposed that an element should be recognised in the financial statements if the definition of the element is satisfied and an appropriate measurement basis exists, such that the measurement of the element is "sufficiently relevant and faithfully representative". In other words, the IPSASB is not proposing recognition thresholds but rather views recognition as a process of overcoming 'existence uncertainty' and 'measurement uncertainty'. See IPSASB Conceptual Framework Project Exposure Draft 2, *op. cit.* Section 7.



## 4. How should liabilities be measured?

- 4.1 This Chapter explores the vexed issue of measurement. As noted in Chapter 1 of this Paper, measurement of liabilities has been a neglected area of study by standard setters and academics until relatively recently; and the thinking is still evolving.
- 4.2 Standard setters often address measurement at two discrete points in the reporting process; at initial recognition of an element in the financial statements, and in subsequent reporting of information about that element. Standards dealing with the recognition and measurement of financial instruments provide a good example of this. For example, in IFRS 9, financial assets and financial liabilities are required to be measured on one basis at initial recognition; that is, fair value<sup>73</sup>, and on one of two principal measurement bases subsequent to initial recognition; that is, fair value or amortised cost<sup>74</sup>. For ease of comparison with existing requirements, a similar approach is adopted here.

### Measurement at initial recognition

- 4.3 Standard setters have struggled to articulate a consistent and conceptually defensible model for the initial measurement of liabilities. Prima facie, this seems surprising since the challenge does not appear to be all that difficult; for example it might appear to be simply a case of identifying the liability and either measuring it at the value of the proceeds received in exchange, or if the obligation arises from an event other than an exchange, at a value that provides a faithful representation of the economic burden undertaken by the entity. For some transactions, the challenge will indeed be relatively simple; the obligation would be readily identifiable, for example, a promise to repay a loan, and the amount received in exchange for taking on the obligation would be readily determinable, for example, the proceeds received from the lender<sup>75</sup>. However, in other cases identifying and measuring the liability would be problematic. This is particularly true of transactions that are income (or revenue) generating and non-exchange transactions.

### Identifying and measuring the liability

- 4.4 When an entity receives a payment from customers in exchange for a promise to deliver goods or services in the future, has a liability arisen? If it has, what is the nature of the obligation and at what amount should the liability be measured? For example, is the obligation to refund the amount received if the goods or services are not provided? And is the measure of that liability the amount received? Alternatively,

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73 Although the measurement **basis** is fair value, if the financial asset or financial liability is to be measured subsequently on a cost basis, fair value is to be adjusted by directly attributable transaction costs.

74 'Amortised cost' seems to be an incongruous term when applied to liabilities. I will return to this measurement basis later in this Chapter.

75 Even this simple transaction may not be so simple. For example, the transaction may not be at arm's-length, in which case the proceeds received may not be a faithful representation of the economic burden undertaken.



is the obligation to provide the goods and services promised under the contract? And is the measure of that liability the amount the entity expects to incur in the future to provide the goods or services, for example, the cost of materials, labour, services, (or the present value of that amount), or possibly the amount the entity would be required to pay to a third party to be relieved of the obligation? If the liability is measured at initial recognition at the amount of consideration received, there would be no 'day one' income (gain) or expense (loss). If the liability were measured at the amount the entity expects to incur in the future to provide the goods and services (or the present value of that amount), or at some other amount representing the current value of the economic burden, for example, exit price, there may be a 'day one' gain or loss. What is the correct characterisation of the obligation and what is the correct basis for measuring it?

- 4.5 Characterisation of an obligation should be driven by the nature of the transaction or other event that has given rise to the obligation. For example, if an entity has entered into a contract to supply computers to a customer, it has undertaken an obligation to provide goods. If an entity has entered into a contract to provide compensation to a policyholder in the event of a loss, it has undertaken an obligation to provide insurance services. If an entity has received a government grant with conditions attaching and failure to meet those conditions would require the entity to refund the grant, the entity has a refund obligation.
- 4.6 Of course, contracts, whether express or implied, are rarely so simple, and the accounting model needs to be robust enough to capture the various features of contracts. For example, a contract for the supply of goods may confer to the customer a right of return. This right represents a promise by the entity to stand ready to accept a returned product. An amount separate from that attributable to the entity's obligation to provide goods and services should be recognised for the refund liability<sup>76</sup>. Similarly, an insurance policy will typically provide the policyholder with a right to cancel the policy before the end of the term<sup>77</sup>.
- 4.7 Standard setters may be prepared to agree on the identification and characterisation of obligations arising from exchange and non-exchange transactions. And the resulting liabilities may be broadly consistent with the definition of liabilities presented in this Paper and with the definitions expounded in their own literature. However, agreement is not reached so readily on the measurement of the obligations. Once again, this is particularly true of transactions that are income-generating (or revenue-generating), but it does not only apply to them.

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76 The IASB's Exposure Draft on Revenue from Contracts with Customers proposes that a portion of the transaction price be allocated to the refund liability representing the customer's right of return. See IASB Exposure Draft ED/2011/6 *Revenue from Contracts with Customers*, November 2011, paragraph 57.

77 The IASB's Exposure Draft ED/2013/7 *Insurance Contracts* (July 2013) proposes that expected contract lapses be included in the measurement of the insurance contracts liability rather than being reported separately. See IASB ED/2013/7, paragraphs 22 and B63.

## Liability or ‘deferred income’?

- 4.8 When an entity enters into a contract to provide goods and services it will typically incur costs to obtain the contract. These ‘contract origination costs’ may include professional fees, commissions, and government charges, and the entity will normally endeavour to price the goods and services to recover those costs. Acquisition of contracts is a value-creating activity by an entity (assuming the contracts are not onerous), and that value may be observable in the market place – that is, the contracts may be transferrable to a third party at a price. In other words, when an entity acquires a contract it creates an asset.
- 4.9 Assets arising from the acquisition of contracts are typically not recognised in the financial statements because the contracts are considered to be executory; that is they are considered to be equally proportionately unperformed in that the reporting entity is yet to provide to the customer the goods and services identified in the contract, and the customer is yet to pay for the goods and services<sup>78</sup>. However, this ‘convention’ may be challengeable on the grounds that the entity has provided at least one service; namely a selling service. For example, in many retail settings an entity may provide ‘retail access’ services (including the services of making products accessible to customers through widely dispersed retail outlets, assembling a range of products that customers can peruse, and product advice at point of sale) for which it incurs costs. In addition, a successful bidder for a construction contract often performs a service in developing initial designs as part of the bidding process; the customer obtains the benefit of that service upon entering into the contract.
- 4.10 Irrespective of whether an asset should be recognised at the point of contract origination because a service has been provided by the entity (and the entity has been or will be compensated for that service), or because the entity has created something of value, if the customer performs (pays) before the entity performs, an asset must be recognised by the entity. The question in both scenarios is: what is the credit entry? Has income (or revenue) arisen, does a liability exist in respect of the contract acquisition asset, or have both arisen?
- 4.11 As noted earlier in this Paper, standard setters have found answering this question troublesome because the implication of not recognising a liability, or recognising a liability measured at an amount less than the measured amount of the corresponding asset, is that ‘day one’ income (or revenue) would be recognised. Standard setters have shown a distinct aversion to recognising income (or revenue) at initial recognition of assets and liabilities arising from a contract with a customer, probably because of their concerns about opportunistic behaviour by preparers. Not surprisingly, a conceptual rationale for the accounting is rarely, if ever, provided<sup>79</sup>.

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78 Exceptions to the non-recognition of ‘contract acquisition assets’ include the recognition of intangible assets arising from contractual rights in a business combination, and specialised industry accounting, for example, the recognition of contract acquisition costs as assets in the insurance industry.

79 The IASB and FASB joint exposure draft on Revenue from Contracts with Customers is no exception. The exposure draft is based on measurement of the rights and obligations arising under contracts; that is, the reporting entity’s rights to receive consideration from the customer and its obligations to transfer goods or services to customers. If the measure of the rights exceeds the measure of the remaining performance



- 4.12 Failure to recognise income (or revenue) in these circumstances will result in the accounting not reflecting the economics of these transactions. Income and net assets would be understated. If the transaction results in the recognition of a liability (whether separately or in measuring a net contract position), as it would under the proposals in the IASB's ED/2011/6 on revenue recognition, the liability would be mismeasured. The measured amount (the transaction amount under the IASB's ED/2011/6 on revenue recognition) would in fact comprise two components, a liability and deferred income. The latter item would not possess the essential characteristics of a liability and the measured amount would not therefore be a faithful representation of the liability.
- 4.13 As was observed in Chapter 3 of this Paper, in the IASB's revised conceptual framework and the IPSASB's newly issued conceptual framework, faithful representation is identified as a qualitative characteristic of useful information<sup>80</sup>. For information to be useful it must faithfully represent the economic phenomena that it purports to represent. Faithful representations have three characteristics; they are complete, neutral and free from error. In Chapter 3 the observation was made that current requirements for the recognition and measurement of liabilities would not always produce representations of liabilities that possess the characteristic of completeness<sup>81</sup>. The approach presented in Chapter 3 could overcome that deficiency.
- 4.14 The proposal in the IASB's ED/2011/6 on revenue recognition of including deferred income in the measurement of performance obligations, which proposal largely reflects current practice, results in representations of liabilities that do not possess the characteristic of neutrality. A neutral depiction of a performance obligation (and of revenue resulting from satisfaction of a performance obligation) is one that is not "... slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users"<sup>82</sup>. In my view, by including in the measured amount of a liability a component of revenue (or income) and then including in subsequent measured amounts of revenue reductions in that liability that are revenue (or income) of a prior reporting period, the depictions of liabilities and revenues are effectively being slanted to increase the likelihood that users will receive information about an entity's revenue generating activities less favourably in one period and more favourably in another. When standard setters knowingly prescribe such measurements

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obligations, a contract asset exists and revenue is recognised. The boards noted that a contract asset could often exist at contract inception, because the transaction price often includes amounts that enable an entity to recover its costs to obtain a contract. However, they decided that an asset and revenue should not be recognised at inception, and they achieved this outcome by proposing that performance obligations should be measured at the same amount as the rights in the contract. The reason given in the exposure draft was the difficulty in objectively measuring the value of the performance obligation. In other words, the rationale is pragmatic not conceptual. See IASB Exposure Draft ED/2011/6 *Revenue from Contracts with Customers*, op cit. paragraphs BC18-26

80 IASB Conceptual Framework op. cit. paragraph QC12-16, and IPSASB *The Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities*, op. cit. paragraph 3.10-3.16

81 See paragraphs 3.9-3.18.

82 IASB *Conceptual Framework*, paragraph QC14. A similar notion is included in the IPSASB's conceptual framework. See IPSASB, *ibid*, paragraphs 3.13-3.14.



they are biasing the depictions of the economic phenomena the measurements are purporting to represent and are effectively injecting a degree of prudence or conservatism into the measurements. This is all the more disappointing when standard setters actively exhort others to avoid doing just that<sup>83</sup>.

- 4.15 When standard setters deviate from accounting that reflects the economics of transactions and other events, they often find themselves having to take compensatory action to prevent the financial statements from conveying information that is not a faithful representation of the impact of those transactions and other events on the entity's financial position and performance. These actions often involve additional rules and add to the complexity of the accounting standards and the consequent financial reporting. They can also result in the recognition of other (compensatory) items that also do not meet the definition of an element of the financial statements.
- 4.16 In the case at hand, failure to recognise income at the inception of the contract would have meant that an entity would recognise as an expense the costs it had incurred in originating a contract but not the offsetting income. This accounting could lead to the anomalous situation of an entity originating valuable contracts but reporting that it has suffered a loss in the period of origination. To prevent this occurring, standard setters have sometimes required entities to defer the costs, and to recognise those costs as expenses over some future period when the deferred income is recognised as income<sup>84</sup>. The accounting seems to be a misguided application of the 'matching principle', which sits rather incongruously alongside extant conceptual frameworks which either purposely do not identify matching as a concept or principle or, if they do, make it clear that it should not be used to justify the recognition of deferred debits or credits that do not meet the definitions of assets or liabilities<sup>85</sup>.

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83 The IASB's *Framework*, which was superseded by its *Conceptual Framework* in 2010, contained the following exhortation about the use of 'prudence' in making accounting estimates: "Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because financial statements would not be neutral and, therefore, not have the quality of reliability" (paragraph 37). The IASB excluded prudence from the qualitative characteristics in its recent revision of the *Framework*, noting that "Chapter 3 does not include prudence or conservatism as an aspect of faithful representation because including either would be inconsistent with neutrality". (IASB *Conceptual Framework*, paragraph BC3.27.) The IPSASB has taken a similar view in its conceptual framework, noting that "the notion of prudence is also reflected in the explanation of neutrality as a component of faithful representation, and the acknowledgement of the need to exercise caution in dealing with uncertainty. Therefore, like substance over form, prudence is not identified as a separate qualitative characteristic because its intent and influence in identifying information that is included in GPFs is already embedded in the notion of faithful representation." IPSASB *ibid*, paragraph BC3.17.

84 The IASB's ED/2013/7 on insurance contracts contains similar proposals to those contained in its ED/2011/6 on revenue recognition. ED/2013/7 proposes that day one gains on insurance contracts not be permitted but that contract acquisition costs can effectively be deferred by treating them as part of the measurement of the insurance contracts liability. See IASB Exposure Draft ED/2013/7 *Insurance Contracts*, July 2013, paragraphs 22 and B66(c).

85 For example, the IASB's *Conceptual Framework* states: "... application of the matching concept does not allow the recognition of items in the balance sheet which do not meet the definitions of assets or liabilities." IASB *Conceptual Framework*, *op. cit.* paragraph 4.50.



- 4.17 To me, this is a clear case of two wrongs not making a right. Deferred income is presented as though it is a liability, which it is not, for the reasons discussed above. Deferred expense is presented as though it is an asset, which it is not. There is no right to a resource represented by these costs. Take the simple case of an entity that receives full payment from the customer at contract origination. Compensation for the incurred contract origination costs has been received by the entity. What is the resource represented by the ‘asset’ that the entity will benefit from in the future?
- 4.18 The origination of a contract may indeed create an asset, but that is something quite different to the ‘asset’ implied by deferring contract acquisition costs. When an entity originates contracts with customers it can create a valuable right related to repeat business with the customer. This is known as a customer relationship intangible asset and its value would not necessarily be related to the amount of contract acquisition costs an entity might incur. These assets are typically only recognised in the context of business combinations<sup>86</sup>.
- 4.19 Earlier in the Paper it was noted that complexity can result when standard setters create rules to avoid anomalous outcomes. Requiring contract acquisition costs to be deferred because day one recognition of income (or revenue) is prohibited leaves standard setters having to address the question of which costs should be deferred. Recourse to a principle is not possible since the costs do not represent an asset. So the standard setter has to decide whether to limit the guidance to a general rule, for example, incremental costs incurred in obtaining the contract, or provide a list of the costs that can be deferred. This will typically lead to endless debates with neither the standard setter nor its constituents being totally satisfied with the outcome, and the strong prospect that the decision will need to be revisited in the future<sup>87</sup>.
- 4.20 In addition, requiring the presentation of deferred expenses as assets and deferred income as liabilities presents the standard setter with another conundrum; on what basis should the deferred expenses and deferred revenue be recognised in profit or loss in future periods? Since the ‘asset’ does not represent a present economic resource from which benefits could flow to the entity in the future and the ‘liability’ does not

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86 Of course, revenue (or other income) might arise at contract origination even if a customer relationship intangible is not created. This would occur when the liability to customers is measured at an amount less than the measured amount of the related assets. For example, it is readily acknowledged in the insurance industry that there are certain niche markets in which an insurer can earn ‘excess profits’; that is, an amount in excess of the price the insurer would demand for bearing the risk of loss. These include markets for extended warranties and financial guarantees. If the liability to customers (the insurance contracts liability) is measured at current value, for example, at fair value, the amount of premium received from the customers to compensate the insurer for bearing the risk of loss will often exceed the fair value of the insurance contracts liability at contract origination.

87 As an indication of the disagreements that can occur, the IASB and the FASB have failed to reach agreement on which acquisition costs should be included in the initial measurement of an insurance contracts liability. The IASB believes the costs should include those relating to both successful and unsuccessful efforts in assembling a portfolio of insurance contracts, whereas the FASB believes they should be limited to the costs arising from successful contract acquisition activity. Both boards agreed to provide a list of the type of costs that could and could not be deferred in an attempt to provide some degree of comparability. See IASB Staff Paper *Effect of board redeliberations on ED Insurance Contracts*, February 2013, page 18. Accessible at <http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Documents/Status/Effect-Board-decisions-on-ED-February-2013.pdf> (June 2013)



represent a present economic burden that could require the transfer of resources to an external party in the future, there is no economic basis for subsequent recognition of revenues and expenses. In other words, whatever basis the standard setter (or preparer) chooses would be arbitrary.

- 4.21 Various bases have been specified or have evolved, from the relatively uncomplicated, such as straight line and time proportionate bases, to the highly complicated, such as ‘earnings’ bases. The insurance industry has provided examples of the latter, in respect of both deferred insurance policy acquisition costs and deferred insurance policy profit margins. Indeed, the complicated ‘amortisation’ methodologies that have evolved in that industry are a major cause of criticism from the users of the financial statements of insurance companies, particularly life insurance companies, with many comparing their financial statements with a ‘black box’.
- 4.22 I noted previously that standard setters will often justify these complexities on the grounds that initial measurement of the liability is difficult and subject to potentially significant measurement error. Initial measurements will typically be subjective since there will rarely be a price for the liability in an active market that can be used as the measure or a reference point for the measure. Standard setters’ aversion to the recognition of day one gain (or revenue) is magnified when the amount of day one gain (or revenue) is directly affected by the existence of any measurement error.
- 4.23 I am not convinced by this argument. I believe it is a smokescreen for an underlying concern about opportunistic behaviour by preparers around a highly market sensitive item. In support of this contention, I note the absence of concern about measurement when there is day one recognition of a loss<sup>88</sup>. I also note that the initial measurement of many other liabilities that result from transactions and other events that are not revenue-generating, can be complex and would be subject to potentially significant measurement error, for example derivatives, provisions and employee benefit liabilities, and yet will not include an item of deferred income or expense. Furthermore, if a liability is subject to measurement uncertainty, the potential for measurement error to affect the measured amount of revenue (or other income) for a particular period is unavoidable – it will affect ‘day one’ measurement and/or measurement over the reporting periods during which the liability is settled. The fact that the IASB and FASB were concerned about the potential for such measurement error to overstate ‘day one’ revenue but not about potentially overstating subsequent revenue implies a conservative bias in their thinking.
- 4.24 In my view, transactions that are revenue (or income) generating should be accounted for on initial recognition consistently with the definition of liabilities. This does not mean that all of the profit expected to be generated from these transactions would be recognised upfront. This is a common misunderstanding by many of those who oppose the recognition of day one gain (or revenue). As will be discussed later in this

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88 Day one loss recognition has been proposed by the IASB in both ED/2013/7 on insurance contracts and ED/2011/6 on revenue recognition. See IASB Exposure Draft ED/2013/7 *Insurance Contracts*, op. cit. paragraph 18 and IASB Exposure Draft ED/2011/6 *Revenue from Contracts with Customers*, op. cit. paragraph 54.



Chapter<sup>89</sup>, day one measurement of the liability arising from revenue-generating transactions, as with liabilities arising from other types of transactions and events, should reflect the uncertainties related to expected future resource outflows and should include a margin for risk. This margin for risk, also known as a profit margin, reflects the amount the entity expects to be compensated by the customer for bearing the risk inherent in providing the goods and services<sup>90</sup>. As the entity performs under the contract; that is, delivers the goods or services, it is released from risk and would recognise the embedded profit<sup>91</sup>. Any ‘day one’ profit that happens to be recognised under this measurement approach is distinct from the profit ‘earned’ from providing the goods or services.

- 4.25 In my view, the financial statements resulting from an approach that recognises and measures liabilities arising from revenue-generating transactions in a manner consistent with the definition of liabilities would better reflect the economic effects of these transactions and, accordingly, would be more transparent, more comparable and less complex than is currently the case. I believe concerns about opportunistic behaviour by preparers is better dealt with by requiring disclosure of relevant information relating to measurement uncertainties, as will discussed in Chapter 5.

### **A current estimate of the economic burden**

- 4.26 In Chapter 3 it was noted that failure to recognise a liability in the statement of financial position on the grounds it could not be reliably measured would deprive financial statement users of useful information. It was contended that concerns about reliable measurement stem from the uncertainty of future resource flows inherent in certain liabilities. It was reasoned that these concerns could be overcome by selection of an appropriate measurement basis and disclosure of appropriate information related to the measurement process. In my view, an appropriate measurement basis would reflect the economic burden represented by the liability and thereby capture any inherent uncertainties that under existing standards and practices have precluded or delayed recognition of some liabilities.
- 4.27 In order for a measurement to reflect the economic burden represented by a liability, I believe it must:
- (a) reflect the characteristics of the liability; and
  - (b) be a current estimate of the relevant inputs that reflect those characteristics.
- 4.28 The characteristics of a liability refer to the amount and timing of future resource flows and the uncertainty related to the amount and timing of those flows, including the possibility that the obligation will not be fulfilled by the entity (non-performance risk). Take for example, a litigation liability compared with a fixed rate, fixed term loan. If these liabilities are held by the same reporting entity they would have the

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89 See paragraphs 4.92-4.96.

90 If the entity were to transfer its obligation to a third party or endeavour to settle it with the counterparty (the customer) the price it would have to pay would include a margin for risk.

91 If the actual future resource flows that arise in providing the goods or services are more or less than those that were expected, the profit actually recognised will be more or less than the estimated risk margin.



same non-performance risk. However, they have significantly different characteristics relating to the amount and timing of future resource flows; inherent in the litigation liability is uncertainty in relation to both the amount and timing of future resource flows, whereas the amount and timing of future resource flows for the loan are certain, ignoring non-performance risk. A measurement basis that ignores the uncertainties inherent in the litigation liability and presents the liability as if the future resource flow were certain would not reflect the economic burden represented by the litigation liability and would not be a faithful representation of the liability<sup>92</sup>.

- 4.29 If a measurement basis is to adequately reflect the economic burden represented by a liability it must be a current value measurement basis. Current values are assessments of economic utility or worth. They may be prices determined in markets from the perspective of market participants; that is, entry or exit prices, or values derived by entities from their own perspective. Current values are basic components of economic decisions and, accordingly, provide useful information to the users of financial statements in making economic decisions and assessing accountability<sup>93</sup>.
- 4.30 In the remainder of this Chapter a number of possible current value measurement bases for liabilities at initial recognition and subsequently are evaluated, some of which are contained in current standards and others that are actively being developed by standard-setting bodies. In addition, other measurement bases and methods contained in existing accounting standards or discussed in the accounting literature are evaluated.

### Exit price

- 4.31 The exit price (or ‘fair value’ as it is characterised in IASB, IPSASB and FASB literature) of a liability is a measure of the price an entity would currently be required to pay to a market participant to be relieved of the liability. In setting the price a transferor would be required to pay to be relieved of a liability, market participants would take into account the following elements (or ‘building blocks’), which encompass a liability’s economic characteristics:
- (a) market participants’ expectations about the amount and timing of future resource outflows;
  - (b) the time value of money;

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92 Of course, a measurement of the fixed rate, fixed term loan that did not capture the effect of changing interest rates would also fail to reflect the economic burden represented by the liability.

93 In a forthcoming paper, Mary Barth (a former member of the IASB) calls for the development of concepts relating to measurement in financial reporting. To that end, she applies the higher levels of the existing IASB and FASB conceptual frameworks, namely those relating to the qualitative characteristics of financial information and the definitions of assets and liabilities, to assess whether cost-based measurements (unmodified historical cost and modified historical cost) or a current value-based measurement (fair value) are more consistent with those higher level concepts and therefore better achieve the objective of financial reporting. She found that “...in the context of measuring individual assets and liabilities, fair value measurement is more consistent with existing Framework concepts than either modified or unmodified historical cost”. See Barth M, *Measurement in Financial Reporting: The Need for Concepts*, forthcoming in *Accounting Horizons*.



- (c) the risk that the actual resource outflows may ultimately differ from those expected (i.e. a market risk premium); and
- (d) non-performance risk<sup>94</sup>.

4.32 Accordingly, at initial recognition (and subsequently) exit price would provide a current estimate of the economic burden a liability represents.

### Historical proceeds

- 4.33 Measuring a liability at initial recognition at ‘historical cost’; that is, historical proceeds, may also provide a current estimate of the economic burden the liability represents, because it too is a price; an ‘entry price’. However, any part of the gross proceeds that is unrelated to the liability would need to be excluded from the measurement, as discussed in paragraphs 4.4 to 4.25, and the amount received by the entity would need to reflect the liability’s economic characteristics. The proceeds may not reflect the liability’s economic characteristics if the transaction is between related parties or has been ‘mispriced’ by the entity, for example, the entity may be treating the good or service that is the subject of the transaction as a loss leader<sup>95</sup>.
- 4.34 Historical proceeds is an indirect, or bottom-up measurement approach for liabilities, that may require deconstructing the transaction amount to identify the portion of the proceeds representing the liability, and would need to be subject to some type of liability adequacy test to ensure that the liability is not ‘understated’<sup>96</sup>. In addition, as noted in paragraph 1.2, for many liabilities there will be no historical proceeds.
- 4.35 For purposes of measurement at initial recognition, I believe historical proceeds could be used because it is a price determined in an exchange transaction. However, it should only be used where the amount of proceeds attributable to the liability is clearly evident and the amount reflects the characteristics of the liability. In these circumstances historical proceeds would be a reasonable surrogate for exit price<sup>97</sup> or entity-specific value.

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94 Each of these measurement building blocks is discussed in greater detail below.

95 For not-for-profit entities, the amount received may include an implicit donation.

96 A liability adequacy test would assess whether the proceeds attributable to the liability are an adequate representation of the economic burden represented by the liability, taking into account the liability’s economic characteristics. The IASB has proposed a liability adequacy test in the insurance contracts exposure draft when an entity uses a simplified approach to measure the liability for remaining coverage under the contract. The simplified approach uses the premium received from customers (‘historical proceeds’) as the measure of the liability for remaining coverage and if this measure is considered to be an inadequate measure of the liability it must be remeasured using a ‘building blocks’ approach. See IASB Exposure Draft ED/2013/7 *Insurance Contracts*, op. cit. paragraphs 36 and 39 (c).

97 For the amount of historical proceeds attributable to the liability to be a surrogate for fair value, consideration would have to be given to whether the market in which the transaction takes place is different from the principal or most advantageous market that the entity would access to exit the transaction. For example, a retailer that sells extended warranties to its customers in a retail market may transfer the obligation to insurers in a wholesale market. The exit price of the liability is the amount market participant insurers operating in the wholesale market would charge the retailer for assuming the warranty obligation – and this amount would typically be significantly below the amount the retailer charged the customer. The difference is income (or gain) on initial recognition. See IASB, IFRS 13 *Fair Value Measurement*, paragraphs 57-60 and B4 (d).



## Entity-specific value

- 4.36 In contrast to exit price and entry price (historical proceeds), entity-specific value is a measure of the economic burden represented by a liability from the entity's perspective. It is a current measure of a liability's economic characteristics, using the entity's own estimates<sup>98</sup>. The measurement takes into account the following elements (or 'building blocks'):
- (a) the entity's expectations about the amount and timing of future resource flows;
  - (b) the time value of money;
  - (c) the risk that the actual resource outflows may ultimately differ from those expected (i.e. a risk premium); and
  - (d) non-performance risk.
- 4.37 Similarly to exit price (and entry price in certain circumstances), at initial recognition (and subsequently) entity specific value would provide a current estimate of the economic burden a liability represents.

## IASB and IPSASB requirements

- 4.38 Earlier in the Paper it was noted that IFRSs and IPSASs currently require financial instruments to be measured at fair value at initial recognition and certain other liabilities to also be measured at fair value at initial recognition in the context of business combinations. As such, these measurements will provide a current estimate of the economic burden the liability represents. In addition, the requirements in a number of other standards may produce measurements that approximate fair value. For example:
- (a) *IAS 17 Leases* and *IPSAS 13 Leases* require finance lease liabilities to be measured initially at the fair value of the leased property or, if lower, the present value of the minimum lease payments using the interest rate implicit in the lease;
  - (b) *IAS 37* and *IPSAS 19* require provisions to be measured at the best estimate of the expenditure required to settle the obligation (with the counterparty or by transferring the obligation to a third party – something akin to a fair value measure); and
  - (c) *IFRS 2 Share-based Payment* requires liabilities related to share-based payment transactions to be measured at 'fair value', which, although not necessarily fully consistent with fair value as defined in *IFRS 13*, is a 'market-based' measure.

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98 The IASB recently coined the term 'present value of fulfilment cash flows' (known colloquially as 'fulfilment value') to describe an entity-specific value of a liability. See IASB Exposure Draft ED/2013/7 *Insurance Contracts*, op. cit. paragraph 17 (a).



- 4.39 However, the initial measurement requirements in a number of other standards would typically not produce initial measurements that provide a current estimate of the economic burden the liability represents. For example:
- (a) IAS 12 *Income Taxes* requires deferred tax liabilities to be measured at a nominal amount, namely taxable temporary differences multiplied by the relevant tax rate, a measure that does not capture fully any of the measurement building blocks identified previously. For example, it does not explicitly take account of the time value of money<sup>99</sup>, nor does it take into account uncertainties related to the timing and amount of future tax payments arising from, for example, possible changes in tax rates and uncertain tax positions. In short, this measure is neither a current exit or entry price nor an entity-specific value, it is merely a calculation;
  - (b) IAS 19 and IPSAS 25 require employee benefit liabilities to be measured at the present value of their ultimate cost to the entity. Although this measurement bears some similarities to a building block approach in that it is based on current expectations about the timing and amount of future resource flows and is a discounted amount, there are significant differences. In particular, it is a deterministic measure that does not reflect fully the uncertainties related to the amount and timing of future resource flows. In addition, the discount rate may include asset specific risks (for example, default risks) and as such might be a poor surrogate for a rate that would reflect the time value of money; that is, a risk free rate<sup>100</sup>;
  - (c) IPSAS 23 *Revenue from Non-Exchange Transactions (Taxes and Transfers)* requires liabilities resulting from non-exchange transactions to be measured "...at the best estimate of the amount required to settle the present obligation at the reporting date"<sup>101</sup>. Although this measurement is required to take into account "... the risks and uncertainties that surround the events causing the liability to be recognised"<sup>102</sup>, and to take into account the time value of money, it too is a deterministic measure that does not reflect fully the uncertainties related to the amount and timing of future resource flows.

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99 The measurement may indirectly incorporate a time value if the taxable temporary difference is a discounted amount. However, the efficacy of this component of the measure will depend on the extent to which the time value of money has been appropriately incorporated in the measurement of the relevant asset or liability and whether the timing of the asset or liability cash flows are the same as the tax cash flows.

100 IAS 19 and IPSAS 25 require entities to discount estimated future cash flows using market yields on high quality corporate bonds if there is a deep market in such bonds. In the absence of a deep market in high quality corporate bonds, entities must use the market yields on government bonds. This has been a very controversial issue in recent years as government bond rates have been at historically low levels. The appropriate discount rate for taking into account the time value of money is discussed in paragraphs 4.77-4.91.

101 IPSASB, IPSAS 23 *Revenue from Non-Exchange Transactions (Taxes and Transfers)*, paragraph 57.

102 Ibid, paragraph 58.



## Current developments

- 4.40 The IASB has acknowledged that the measurement approach in IAS 19 needs to be reconsidered in the light of constituent concerns about the poor quality of information being provided under the existing standard and recent developments in the measurement of liabilities<sup>103</sup>. Of particular relevance are the IASB's projects on Insurance Contracts and the Review of IAS 37. In these projects the IASB is endeavouring to develop an entity-specific measure that captures the uncertainties associated with the timing and amount of future resource flows that are characteristic of these types of liabilities. The measurement basis has been described as 'fulfilment value' and it uses the building block approach described earlier in this Paper as entity-specific value, but excludes the building block 'non-performance risk'<sup>104</sup>.
- 4.41 The IASB considered whether to specify fair value as the measurement basis for insurance liabilities and liabilities within the scope of a revised IAS 37, but rejected that basis for two main reasons. In the first place, the IASB observed that entities incur these liabilities, particularly insurance liabilities, with the intention of meeting or fulfilling their obligations and not transferring them to a third party. Accordingly, using the estimates of hypothetical market participants rather than the entity's own estimates in measuring the liability seemed incongruous. In addition, it would potentially be more difficult and more costly to derive these estimates than using the entity's own estimates. Secondly, the IASB thought that it is incongruous to include in the measure of a liability the possibility that it may not meet its obligations (non-performance risk) when it has incurred the liability with the intention of fulfilling its obligations. Moreover, it was concerned about the seemingly counter-intuitive reporting that results when non-performance risk changes during a reporting period; for example, a deterioration in an entity's credit standing during a period would result in the recognition of a gain in profit or loss when the entity is suffering financial distress. The issue of non-performance risk, including its relevance to an entity-specific measure of a liability, is discussed in paragraphs 4.103 to 4.112.

## Measurement at initial recognition – recommendations

- 4.42 The preceding discussion demonstrates that the current and proposed requirements for the measurement of liabilities at initial recognition are a curious mixture of direct value-based measures and indirect 'cost-based' measures that have been developed on an ad hoc basis with no clearly defined and commonly applied measurement objective in mind. Although not explicitly stated, it is clear that the standard setters have had in mind two distinct categories of liabilities when specifying measurement requirements – those that they might characterise as 'income deferrals' and those that are not.

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103 The basic measurement approach was first developed by the IASB's predecessor body the International Accounting Standards Committee 30 years ago. See IASC IAS 19 *Accounting for Retirement Benefits in the Financial Statements of Employers*, January 1983. The IASB added a project to its agenda in 2006 to undertake a review of IAS 19 but limited the scope of the project because of the time it would take to undertake a comprehensive review. However, it acknowledged the need for such a comprehensive review. See IAS 19 *Employee Benefits*, paragraphs BC3-BC4 and BC9.

104 Fulfilment value is discussed in paragraphs 4.54, 4.55 and 4.113.



Measurements of the former have typically been hostage to a desired pattern of income recognition, particularly the avoidance of day one gains, and so have tended to be indirect ‘cost-based’ measures that mix income deferral with liability measurement. Although other liability measurements are typically direct measures of the liability based on a price or value, there are some that are not: such as deferred tax liabilities, which are measured using a formulaic calculation; and employee benefit liabilities, which are measured directly but do not represent a price and are an incomplete measure of entity-specific value.

- 4.43 This means the measurement of liabilities at initial recognition under existing requirements is inconsistent and often will fail to provide a faithful representation of the economic burden undertaken by a reporting entity. While recent development work being undertaken by the IASB on insurance contracts and provisions is encouraging, more needs to be done and on a broader basis.
- 4.44 I believe that if financial statements are to present complete, comparable, and relevant information about liabilities, then liabilities should be measured at initial recognition using a common measurement basis that captures the characteristics of the liabilities and is a current estimate of the inputs that reflect those characteristics. A measurement basis that is a current price or a current entity-specific value will capture these elements.
- 4.45 In my view, exit price (fair value) should be the basis used to measure liabilities at initial recognition because I believe it provides the most comprehensive and objective measure of a liability. The price market participants would charge a reporting entity to relieve it of a liability would be a current estimate of the inputs that reflect the characteristics of the liability. In addition, the price would be determined on the basis of assumptions that would reflect the perspective of market participants (including the reporting entity). As such, this price would not reflect the expected efficiencies or inefficiencies of a specific reporting entity. For example, a reporting entity may expect to be able to meet its obligations under future warranty claims more efficiently (that is, at less cost) than its competitors because it uses its own repair facilities. Because exit price reflects assumptions based on the average market participant, a reporting entity’s expected efficiencies would not be included in the current exit price of the liability but would be recognised in profit or loss if and when those expectations are realised. As such, it is, arguably, a more objective current measure of a liability than one that incorporates the potentially idiosyncratic current estimates of an individual reporting entity.
- 4.46 Although I would prefer all liabilities to be measured at exit price at initial recognition, I acknowledge that standard setters might decide that in some circumstances the benefit of obtaining the current estimates of market participants does not outweigh the additional cost that may need to be incurred<sup>105</sup>. They might decide that the measurement difference between using market participants’ estimates and a reporting entity’s own estimates is marginal but the additional cost of obtaining

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105 These comments assume that standard setters would wish to measure liabilities directly using a measurement basis that reflects the economic characteristics of the liabilities.



market participants' estimates is potentially significant. For example, when developing ED/2013/8 on insurance contracts, the IASB found that the assumptions market participants would make in estimating fair value and those a reporting entity would make in estimating a current entity specific value would probably be similar except possibly in respect of claim servicing costs<sup>106</sup>. In respect of claim servicing costs the IASB noted that it would not expect the difference in the estimates to normally be significant, but acknowledged that the cost to entities of assessing whether a material difference did exist could be potentially significant.

- 4.47 If standard setters believe exit price is not appropriate for measuring liabilities at initial recognition in all circumstances, for example, on cost benefit grounds, then in my view, a hybrid approach would produce an acceptable outcome. This approach would be as follows:
- (a) use exit price if it is readily determinable; or
  - (b) if exit price is not readily determinable, measure the liability at a current value using current market-based estimates where they are available, for example, in determining the discount rate to take into account the time value of money, and current entity-specific estimates otherwise.
- 4.48 This approach would produce a current measure of all of the building blocks and so provide relevant information about the economic burden represented by the liability, and would minimise the loss of comparability resulting from not applying a common measurement basis.

## Measurement subsequent to initial recognition

- 4.49 For most liabilities dealt with in IASB and IPSASB standards, the measurement requirements are the same for subsequent measurement as for measurement at initial recognition. A notable exception is financial liabilities; for which a range of different subsequent measurement approaches is specified, including fair value and 'amortised cost'<sup>107</sup>.

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106 IASB, Exposure Draft ED/2010/7 *Insurance Contracts*, July 2010, paragraph BC49

107 The other measurements apply to financial liabilities that arise when a transferred financial asset does not result in derecognition (subsequent measurement of the liability is driven by the accounting for the related (recognised) financial asset), and financial guarantee contracts and below-market loan commitments (in both cases subsequent measurement is at the higher of the amount determined under IAS 37 and the amount initially recognised less cumulative amortisation recognised in accordance with IAS 18). These are hybrid measurements that are potentially complex and difficult to understand. The former measurement results from failure to account properly for the transferred financial asset. Continuing to account for financial assets for which control has passed to the transferee results in having to account for consideration received as a liability when it does not meet the definition of a liability (the consideration received is revenue (or other income)), and not accounting directly for liabilities that arise as part of the sale transaction. The latter measurement applies when the liabilities are not subsequently measured at fair value and results from combining revenue recognition with liability measurement. The accounting endeavours to measure the revenue earned from the transactions but with an overriding liability adequacy test courtesy of IAS 37. If these liabilities were subsequently measured at exit price the revenue earned or expense incurred would be measured directly.



- 4.50 As a general statement, amortised cost applies to those financial liabilities with limited variability in the amount and timing of future cash outflows. Like other financial liabilities, they are measured at fair value at initial recognition, but then only remeasured (other than for repayments of principal) to reflect the accretion of interest as the liability draws closer to maturity and, for those denominated in a foreign currency, for the effect of changes in the foreign currency exchange rate<sup>108</sup>. The rate at which the accretion occurs is the effective interest rate or the internal rate of return, and it is the rate that exactly discounts the cash flows associated with the financial liability through to maturity or the next repricing date to the net carrying amount at initial recognition<sup>109</sup>. Standard setters have tended to rationalise the use of amortised cost on the basis that for most non-derivative financial liabilities the future cash flows are typically subject to limited variability and entities will typically assume them with the intention of paying interest and principal to creditors rather than settling them or transferring them to third parties. Accordingly, they have reasoned that users are primarily interested in the unamortised historical proceeds (the nominal outstanding debt) and the nominal cost of borrowing (accrued interest) rather than in the current value of such liabilities and changes in their current value.
- 4.51 Although I would prefer a current measurement basis for all liabilities both at initial recognition and subsequently, I believe a cost-based measurement for certain liabilities would provide useful information to users and can be justified on cost-benefit grounds. However, I would limit the use of such a measurement basis to those liabilities for which there is expected to be little or no variability in the timing or amount of future resource flows. For these liabilities amortised cost may be a reasonable surrogate for current value<sup>110</sup>.
- 4.52 In respect of liabilities for which there is expected to be variability in the timing or amount of future resource flows, I believe they should be measured using a common, current value measurement basis. As for the measurement of liabilities at initial recognition, I would prefer that measurement basis to be exit price, for the reasons stated in paragraph 4.45. However, I acknowledge that there is a great deal of resistance to the use of exit price in measuring liabilities subsequent to initial recognition. This is particularly so where entities generally expect to fulfil their liabilities over time by providing promised goods or services rather than transferring the liabilities to a third party or settling them with a counterparty. In these cases, standard setters have shown sympathy for constituents' arguments that the objective of the measurement approach should be to reflect the fact that the entities generally expect to fulfil their liabilities over time, rather than reflecting an estimate of the price entities would have to pay to transfer the liabilities to a third party or settle them with a counterparty. They argue that a transfer objective is the wrong principle for items that

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108 Remeasuring a financial liability for changes in the foreign currency exchange rate recognises part of the change in the fair value of the liability.

109 As noted previously, for financial liabilities subsequently measured at amortised cost, fair value at initial recognition is adjusted for directly attributable transaction costs.

110 Of course, amortised cost would be a poor surrogate for current value if there has been a material change in non-performance risk or a material change in the time value of money.



will not be, and often cannot be transferred, even if current exit price might often be very close to a current entity-specific value in practice<sup>111</sup>.

- 4.53 As noted above and will be discussed further below, constituents have raised another strong objection to the use of exit price as the measurement basis for liabilities subsequent to initial recognition: namely, the inclusion of non-performance risk in the measurement of exit price. This objection has been magnified in the wake of the global financial crisis and, again, has engendered a sympathetic response from standard setters.
- 4.54 In light of these developments and the IASB's projects on Insurance Contracts and the Review of IAS 37, I expect the IASB and possibly the IPSASB to develop an alternative current value measurement basis for liabilities that a reporting entity expects to fulfil rather than transfer to a third party. As noted above, that valuation basis has been loosely termed 'fulfilment value' by the IASB. Fulfilment value is an entity-specific value that measures a liability using the building blocks identified earlier in this Paper except for non-performance risk.
- 4.55 For the reasons outlined in paragraphs 4.101 and 4.102 and paragraphs 4.110 to 4.112, I do not support fulfilment value as it is currently being developed by the IASB. If exit price is deemed by standard setters to be unsuitable or unacceptable for the subsequent measurement of some liabilities where there is expected to be variability in the timing or amount of future resource flows, then I would urge the use of entity-specific value as defined in this Paper for those liabilities not measured at exit price. As noted in paragraphs 4.36 and 4.37, this measurement basis would provide a current measure of all of the building blocks and so provide relevant information about the economic burden represented by the liability.
- 4.56 The following section discusses each of the building blocks in the context of an exit price model and the entity-specific value model articulated in this Paper.

## **The building blocks**

### **The amount and timing of future resource flows**

- 4.57 The amount and timing of future resource flows required to satisfy an obligation will affect the current value of a liability. A liability that would require an outflow of CU1million in 10 years to satisfy an obligation would have a lower current value than a liability that would require an outflow of CU1 million in one year to satisfy an obligation. This is simply the effect of the time value of money, which is discussed in paragraphs 4.81 to 4.91. Similarly, a liability that would require an amount to satisfy an obligation that could vary between CU1 million and CU10 million in 5 years will have a different current value to a liability that would require a certain outflow of CU5 million in 5 years to satisfy an obligation. These liabilities have different characteristics because even though they would be satisfied at the same time, for one of them the amount that would be required to satisfy the obligation is uncertain. Failure to reflect such uncertainties in the measures of a liability would result in the

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111 IASB, Exposure Draft ED/2013/7 *Insurance Contracts*, *ibid*.



measures not being faithful representations of the economic burden represented by the liabilities.

### Expected value

- 4.58 The most appropriate technique for capturing the effect on the current value of a liability of the amount and timing of future resource flows is ‘expected value’. It is the probability-weighted sum of the distribution of possible outcomes and is commonly known as the arithmetic mean. It is a powerful measurement technique because it enables entities to determine a current value for uncertain future resource flows at any point in time.
- 4.59 Estimating expected value involves:
- (a) identifying each possible outcome;
  - (b) making an unbiased estimate of the amount and timing of the future resource flows for that outcome; and
  - (c) making an unbiased estimate of the probability of each outcome.
- 4.60 Expected *present* value is the probability-weighted average of the present values of the resource flows for the possible outcomes, and takes into account the effect of the time value of money<sup>112</sup>.
- 4.61 Some commentators acknowledge the need to take into account the timing and amount of future resource flows when measuring liabilities at reporting date, but express concerns about the complexity of the expected value technique. They claim that the costs involved in the additional precision the expected value technique affords exceed the benefits of having a more representationally faithful measure. In their view, alternative techniques such as ‘best estimate’, ‘most likely outcome’, and ‘maximum amount that is more likely than not to occur’ are easier to apply and either produce a reasonable surrogate of expected value or a superior measure of a liability.

### Best estimate

- 4.62 ‘Best estimate’ of the future cash flows is a ‘technique’ that has been identified in the accounting literature and referred to by practitioners over many years. However, the term has never been clearly defined and as a result there is no common understanding of its meaning. It is one of those terms that emerge in the accounting literature from time to time that are well intentioned and have intuitive appeal but, because they remain either poorly defined or undefined, provide broad scope for interpretation<sup>113</sup>. Staff of the IASB and FASB identified the following possible range of interpretations of ‘best estimate’:

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112 For further discussion of the expected value technique, refer to IASB Working Draft of a proposed International Financial Reporting Standard *Liabilities*, Appendix B “Measuring the present value of the resources required to fulfil an obligation”, 19 February 2010, accessible at <http://www.ifrs.org/Current-Projects/IASB-Projects/Liabilities-and-Equity/Pages/Board-Discussions-3.aspx>, and to IASB Agenda Paper 2 “Cross-cutting issues – measuring uncertain cash flows. Overview of exercise.” IASB/FASB meeting, week commencing 14 February 2011.

113 The terms ‘true and fair view’ and ‘economic substance’ suffer a similar fate.



“...some accountants think that it means ‘most likely outcome’. Others regard it as a term that allows them to choose whichever measure they judge to be ‘best’ for their particular asset or liability. Actuaries sometimes use the term to mean the probability-weighted average of the future cash-flows, taking account of the time value of money (i.e. expected present value). Statisticians apply the term to any unbiased estimate with minimum variance”.<sup>114</sup>

- 4.63 Whatever the understanding or intended meaning of this ‘technique’, it is clearly unsuitable as a means of taking into account in the measurement of a liability the effect of the amount and timing of future resource flows.

*Most likely outcome*

- 4.64 ‘Most likely outcome’ is the single amount with the highest individual probability of occurring. It is known in statistical terms as the mode. IFRSs and IPSASs do not specifically require any liability to be measured at its most likely outcome. However, as noted above, the ‘best estimate’ of a liability might be interpreted as the most likely outcome.
- 4.65 Some find this technique appealing because it is simple to understand and easy to measure. Although, like expected value, all possible outcomes must be identified, there is no need to quantify the less likely outcomes or calculate probability-weighted averages.
- 4.66 ‘Most likely outcome’ might be a reasonable surrogate for expected value if it can be assumed that the range of possible outcomes is approximately symmetrically distributed around a single most likely outcome. However, if the distribution of outcomes is skewed and outlier outcomes are significant, it will be a poor surrogate for expected value. For example, if the most likely loss from an insurance policy covering a catastrophic risk such as storm damage is CU1million, but the loss could be as much as CU100 million and the likelihood of a significantly greater loss occurring is not insignificant, then measuring the insurance liability at CU1 million would be likely to significantly understate the current value of the liability. Measuring the liability at CU1 million would not be a faithful representation of the economic burden the liability represents. Moreover, if the distribution of possible outcomes has more than one ‘most likely’ outcome, i.e. the distribution has more than one peak, the technique would be inoperative.
- 4.67 Furthermore, ‘most likely outcome’ can contain an implicit recognition threshold. For example, assume there are four possible outcomes for a transaction. The most likely outcome, with a 40% probability of occurring, is that there will be zero outflows. Each of the remaining outcomes of CU1 million, CU10 million and CU100 million has a 20% probability of occurring. A liability would not be recognised even though there is a 60% probability that the outcome of the transaction will be CU1 million or higher<sup>115</sup>.

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114 IASB Agenda Paper 2 op. cit. paragraph 5.

115 For a more detailed discussion of ‘most likely outcome’ refer to IASB Agenda Paper 2, op. cit.

*Maximum amount that is more likely than not to occur*

- 4.68 ‘The maximum amount that is more likely than not to occur’ is another technique that could be used to measure uncertain future resource flows. It is similar to the statistical term ‘median’. The median outcome of a probability distribution is the outcome that separates the two halves of a distribution – it is the point at which there is no more than a 50% chance of a higher outcome occurring and no more than a 50% chance of a lower outcome occurring.
- 4.69 IFRSs and IPSASs do not prescribe this technique for any assets or liabilities. However, the FASB does prescribe it for measuring the benefit of uncertain tax positions<sup>116</sup>.
- 4.70 The following example illustrates the determination of the maximum amount more likely than not to occur:

Probability	Resource flow estimate
35%	200
25%	400
40%	700

- 4.71 The median outcome is 400. The chance of an outcome lower than 400 is not more than 50% (i.e. it is 35%) and the chance of an outcome higher than 400 is not more than 50% (i.e. it is 40%).
- 4.72 ‘The maximum amount more likely than not to occur’ is easy to understand and may be easier to measure than expected value because there may be no need to identify all of the possible outcomes. For example, if there is one outcome that has a greater than 50% probability of occurring, that is the median outcome. However, if there is significant uncertainty about the amount and timing of future resource flows, the median outcome may be no easier to determine than expected value.
- 4.73 ‘The maximum amount more likely than not to occur’ has significant limitations when compared to expected value. It can have an implicit ‘probable’ recognition threshold. If a transaction has an outcome of zero cash flows that is more than 50% likely to occur, no liability would be recognised. In addition, it can result in what is known as ‘cliff-edge’ accounting. For example, if a transaction has two possible outcomes: CU1million, with a 49% probability of occurring; and, CU10 million, with a 51% probability of occurring, then the liability will be measured at CU10 million. If in the next period the probabilities are reversed, the liability will be measured at CU1 million. A slight change in the respective probabilities results in a significant change in the measured amount of the liability; in this example a reduction of 90% in the liability’s carrying amount resulting in a gain of CU9 million in period 2. By contrast, the expected value of the liability changes by 3%, from CU5.59 million<sup>117</sup> in period 1 to CU5.41 million<sup>118</sup> in period 2, resulting in a gain of CU180,000 in period 2.

116 Refer FASB Interpretation No. 48, *Accounting for Uncertainty in Income Tax Positions*, July 2006

117 CU1million multiplied by 49% plus CU10 million multiplied by 51%.

118 CU1 million multiplied by 51% plus CU10 million multiplied by 49%.



## Issues with the use of expected value

4.74 The use of expected value as a technique for taking into account uncertainty in the amount and timing of future resource flows in measuring the current value of liabilities has been proposed by the IASB in its projects on Insurance Contracts and Revision to IAS 37. Feedback the IASB has received from constituents has identified a number of concerns with the use of expected value.

### *Complexity*

4.75 One of the most commonly voiced concerns about the use of expected value has been complexity, principally because of the perceived need to identify all possible outcomes resulting from a transaction of other event. The IASB's response to this concern has been captured succinctly in the following proposed guidance to accompany the revised IAS 37:

In some cases, an entity might have access to extensive data and be able to identify many outcomes. In other cases, the information available to the entity might be more limited. Even if there is evidence to support many outcomes, it is not always necessary to consider distributions of literally all possible outcomes using complex models and techniques. Rather, a limited number of discrete outcomes and probabilities can often provide a reasonable estimate of the distribution of possible outcomes.<sup>119</sup>

4.76 The concerns of practitioners about the complexity of an expected value approach when compared with some of the other measurement techniques that have been used in practice, such as 'best estimate', are acknowledged. It will often be more difficult and more costly to apply the technique. However, when appropriate, suitable approximations would suffice and would enable the added difficulty and cost to be minimised. What is sometimes overlooked in these discussions is the added benefit of the expected value approach in being able to capture outcomes (or scenarios) that have a potentially significant effect on the current value of a liability and thereby provide a more faithful representation of the economic burden represented by the liability. The following proposed guidance included in the IASB's insurance exposure draft captures these perspectives in the context of applying the expected value technique in the measurement of insurance contracts liabilities:

When considering the full range of possible outcomes, the objective is not necessarily to identify every possible scenario but instead to incorporate all relevant information and not ignore any that is difficult to obtain. In practice, it is not always necessary to develop explicit scenarios if the resulting estimate is consistent with the measurement objective of considering all of the relevant information when determining the mean. For example, if an entity estimates that the probability distribution of outcomes is broadly consistent with a probability distribution that can be described completely with a small

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119 IASB Working Draft of a proposed International Financial Reporting Standard *Liabilities*, op. cit., paragraph B4.



number of parameters, it will suffice to estimate that smaller number of parameters. Similarly, in some cases, relatively simple modelling may give an answer within an acceptable range of precision, without the need for a large number of detailed simulations. However, in some cases, the cash flows may be driven by complex underlying factors and respond in a highly non-linear fashion to changes in economic conditions. This may happen if, for example, the cash flows reflect a series of interrelated options that are implicit or explicit. In such cases, more sophisticated stochastic modelling is likely to be needed to satisfy the measurement objective.<sup>120</sup>

### *Binary outcomes*

- 4.77 Another common criticism of the use of expected value is its perceived failure to deal rationally with transactions or other events that have binary outcomes. Assume for example that an entity has a litigation liability that will ultimately be satisfied by the payment of one of two amounts, zero or CU1 million. The probability attached to each outcome is 50%. The expected value of the liability is CU500,000<sup>121</sup>. Critics would claim that expected value is an inappropriate measure of the liability in this example because it is certain that the entity will not satisfy the obligation by paying CU500,000 to the litigant; the entity will either pay CU1 million or nothing at all.
- 4.78 What the critics of the use of expected value in these circumstances often fail to acknowledge is that the objective of the use of expected value is to measure the liability at a current value – or in the conceptual language used in this Paper, at a current value that provides a faithful representation of the economic burden represented by the liability. In my view, measuring the liability at zero or at CU1 million would not provide a faithful representation of the liability. The former amount would understate the value of the liability and the latter amount would overstate its value. What then would be a faithful representation of the liability?
- 4.79 I find that a good test of the veracity of a liability (or an asset) measurement is to evaluate the measurement in the context of a business combination. In the case of the example above, assume the entity is to be acquired by another entity. What value would the acquirer place on the liability when determining the price it would be prepared to pay for the entity and what value would the vendor place on the liability when assessing the price it would be prepared to accept? Assuming that the transaction is at arm's length, the facts of the case are agreed by both parties and the parties agree not to compensate one another post-acquisition for any 'loss' suffered; it would be irrational for an acquirer to offer a price that included no discount at all for the unsettled litigation liability. Similarly, it would be irrational for the vendor to accept an offer price that included a discount of CU1 million. The parties would

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120 IASB ED/2013/7 *Insurance Contracts*, op. cit. paragraph B41.

121 Zero multiplied by 0.5 plus CU1 million multiplied by 0.5.



negotiate a value for the liability that would be rationally expected to gravitate towards its expected value; that is, they would share the risk of an ‘adverse’ outcome<sup>122</sup>.

- 4.80 In circumstances where there are binary outcomes I believe expected value provides a more representationally faithful measure of the value of the liability than measuring it at either of the two possible outcomes, because it better embodies the characteristics of the liability. In the litigation example, expected value reflects the fact that there is uncertainty in the amount of future resource flows; that is, there are two possible payouts. Measuring the litigation liability at one or other of these amounts fails to reflect this uncertainty and implies that the outcome is certain.

### The time value of money

- 4.81 In paragraphs 4.31 and 4.36, time value of money was identified as a building block in the estimation of a liability’s exit price or entity-specific value. Entities are not indifferent to the timing of cash flows. An amount payable by an entity in one year has a different utility to the same amount payable in 5 years. Accordingly, the timing of future resource flows is a characteristic of a liability and needs to be encompassed in any measurement of a liability’s current value. Failure to reflect the time value of money would mean that the resulting measurement would not be a faithful representation of the economic burden the liability represents.
- 4.82 Although the notion that money has a time value is generally accepted, how that time value should be reflected in the measurement of liabilities is a controversial issue. To be more specific, there is widespread disagreement about what is the appropriate rate for discounting the future cash flows to reflect the time value of money.
- 4.83 IFRSs and IPSASs have contributed to this state of disagreement or perhaps confusion by containing different discounting requirements, as the following summary illustrates.
- (a) IAS 19 requires the use of current market high quality corporate bond yields to discount future cash flows relating to future employee benefit payments when there is a deep market in high quality corporate bonds in the relevant jurisdiction. In the absence of a deep high quality corporate bond market the entity must use the current market government bond yield<sup>123</sup>.
  - (b) IPSAS 25 states that the discount rate shall reflect the time value of money and notes that the entity will need to exercise judgement in deciding “... whether the time value of money is best approximated by reference to market yields at

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122 If an acquisition took place, the litigation liability would be measured at fair value in the acquirer’s financial statements in accordance IFRS 3 *Business Combinations*.

123 IASB, IAS 19, op. cit., paragraph 83. Interestingly, in the Basis for Conclusions to IAS 19 it notes that the IASC “... decided that the discount rate should reflect the time value of money...”, but ultimately decided that the rate that should be used is the yield on high quality corporate bonds (IAS 19, paragraph BC134). I suspect the IASC made this decision for pragmatic reasons, in the sense that the yield on high quality bonds would normally be a reasonable surrogate for the risk free rate and would generally be more readily determinable than the risk free rate.



the reporting date on government bonds, high quality corporate bonds, or by another financial instrument”<sup>124</sup>.

- (c) IAS 37/IPSAS 19 require the use of a “... rate (or rates) that reflect(s) current market assessments of the time value of money ...”<sup>125</sup>.
- (d) IFRS 13 states that when determining fair value using present value techniques, the time value of money is “... represented by the rate on risk-free monetary assets that have maturity dates or durations that coincide with the period covered by the cash flows and pose neither uncertainty in timing nor risk of default to the holder (i.e. a risk free rate)”<sup>126</sup>.
- (e) IAS 17/IPSAS 13 require the use of the interest rate implicit in the lease to calculate the present value of the minimum lease payments, or, if that rate is not practicable to determine, the lessee’s incremental borrowing rate<sup>127</sup>.
- (f) IAS 36 *Impairment of Assets* and IPSAS 26 *Impairment of Cash-generating Assets* state that in determining an asset’s (or cash-generating asset’s) value in use, the estimated future cash flows shall be discounted to reflect the time value of money at a rate “... represented by the current market risk-free rate of interest”<sup>128</sup>.

4.84 Recent work by the IASB on Insurance Contracts and the Revision of IAS 37 perhaps identifies the Board’s latest thinking. The working draft of the proposed replacement for IAS 37 proposes that, in determining the present value of resources required to fulfil an obligation, an entity must discount expected cash flows to their present value “... using rates that reflect current market assessments of the time value of money ...”<sup>129</sup>. The IASB Exposure Draft ED/2013/7 *Insurance Contracts* proposes that:

An entity shall determine the fulfilment cash flows by adjusting the estimates of future cash flows for the time value of money, using discount rates that reflect the characteristics of those cash flows. Such rates shall:

- (a) be consistent with observable current market prices for instruments with cash flows whose characteristics are consistent with those of the insurance contract, in terms of, for example, timing, currency and liquidity.
- (b) exclude the effect of any factors that influence the observable market prices but that are not relevant to the cash flows of the insurance contract<sup>130</sup>.

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124 IPSASB, IPSAS 25, paragraph 94.

125 IASB, IAS 37, op. cit., paragraph 47 and IPSASB, IPSAS 19 op. cit., paragraph 56.

126 IASB, IFRS 13, op. cit., paragraph B13(c).

127 IASB, IAS 17 op. cit., paragraph 20 and IPSASB IPSAS 13 op. cit., paragraph 28.

128 IASB, IAS 36 *Impairment of Assets*, paragraph 30(c) and IPSASB, IPSAS 26 *Impairment of Cash-generating Assets*, paragraph 43(d).

129 IASB proposed IFRS *Liabilities* op. cit., paragraph B14.

130 IASB ED/2013/7 *Insurance contracts*, op. cit., paragraph 25.



- 4.85 Although IASB and IPSASB literature contain differing requirements, a common approach seems to be emerging in more recent standards and in projects in the development phase. Two principles would appear to be embedded in those requirements and proposed requirements:
- (a) future cash flows should be adjusted for the time value of money by discounting the cash flows at a current market risk-free rate of interest; and
  - (b) the current market risk-free rate is represented by the current market rate for assets with cash flows whose characteristics reflect those of the liability with respect to timing, currency and liquidity and that pose no risk of default to the holder.

### **Why a risk-free rate?**

- 4.86 Some commentators believe that the appropriate rate to discount future cash flows relating to liabilities is an asset earning rate. This view is most commonly expressed in relation to measuring insurance contract liabilities and defined benefit pension liabilities and most likely has its genesis in actuarial science, where the focus has been on funding these types of long-term liabilities. By discounting the expected liability cash flows at the earning rate on the actual portfolio of assets funding the liabilities or the earning rate on a hypothetical portfolio of assets, a measure of the extent to which the liabilities are adequately funded can be obtained.
- 4.87 However, financial reporting is concerned with providing users of the financial statements with information about the assets controlled and liabilities incurred by an entity (and changes in those assets and liabilities) so that users are able to understand and evaluate the entity's financial position and performance. In order to do this, financial reporting endeavours to provide a faithful representation of the economic impact of transactions and events affecting the entity. If the representation of liabilities resulting from transactions and events affecting the entity is dependent upon the measurement of assets that are funding or could fund those liabilities, then, except in rare circumstances, they would not be faithful representations of the economic phenomena they are purporting to represent<sup>131</sup>. In essence, the measurements would not reflect the characteristics of the liabilities.
- 4.88 Take the example of two entities that have a similar portfolio of liabilities (for example, two life insurance companies of a similar size offering a similar range of products), and assume one of them funds the future settlement of the liabilities with high quality government bonds and the other with junk bonds. If the asset earning rate is used to discount the liabilities' future cash flows, the measurements of the two similar portfolios of liabilities will differ significantly. Would this enhance comparability between the entities? Should the measured amount of an entity's

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131 A rare circumstance is where the payoff on the portfolio of liabilities is directly determined by the earnings on the portfolio of assets (e.g. 'defined contribution' or 'accumulation' plan entities that do not provide guaranteed minimum returns to plan beneficiaries). In this case, the characteristics of the liabilities mirror the characteristics of the assets, except for non-performance risk, so discounting the liability at the asset earning rate will reflect both the time value of money and the risks specific to the liability.



liabilities change simply because management decides to change the entity's asset mix?

- 4.89 It is axiomatic in financial reporting that measures of assets and liabilities reflect the characteristics of those assets and liabilities. Asset earning rates reflect the characteristics of the underlying assets. If the assets have default risk, the rate will include an expected return to compensate the holder for the time value of money and an additional expected return to compensate the holder for the risk of default. Discounting liability cash flows for the time value of money with a discount rate that includes asset default risk will overstate the adjustment to the cash flows for time value and will understate the current value of the liability. As a result, the measure of the liability will not reflect the characteristics of the liability and will not be a faithful representation of the economic burden represented by the liability<sup>132</sup>.

*Which reference rate?*

- 4.90 The logical sources of reference rates for determining risk-free discount rates are high quality bonds, for example, bonds issued by a financially sound government. These instruments should include no or insignificant default risk. They will also typically have a range of maturity dates or durations to match the liability durations. In the event that long-dated bonds are unavailable for liabilities with long durations such as some life insurance liabilities and defined benefit pension liabilities it would be necessary to use extrapolation techniques to estimate the rates.
- 4.91 Although rates on high quality government bonds will not need to be adjusted for default risk in determining the risk free discount rate, they may need to be adjusted for liquidity risk. Some government bonds are traded in deep and liquid markets enabling bond holders to readily sell them at minimal cost. The rate payable on such bonds is lower than the rate payable on an equivalent illiquid bond. Most liabilities are illiquid; that is, the holder (creditor) typically cannot transfer the obligation without incurring significant costs or may be prevented from doing so by contract or the law. Accordingly, it might be necessary to include a 'premium for illiquidity' in the observed rate by adjusting the rate upwards. This effectively removes from the observed rate a characteristic of the underlying reference instrument that is not present in the liability<sup>133</sup>. However, techniques for removing such effects are not yet well

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132 The impact of default risk is discussed in this paragraph to illustrate the point that it is important to exclude the effect of factors influencing the asset rate that are not relevant to liabilities. Other factors might be present that should also be excluded, for example the effect of liquidity risk, which is discussed in paragraph 4.91.

133 A more technical explanation of this phenomenon is found in the IASB's original insurance contracts exposure draft:

Said differently, the holder of a typical government bond acquires two things, a holding in an underlying non-tradable investment (paying a return higher than the observed return on the traded bond) and an embedded option to sell the investment (for which the holder pays an implicit premium through a reduction in the overall return). Thus, for a liability that the holder cannot sell or put (or can do so only at significant cost), the discount rate should equal the return on the underlying non-tradable investment, with no deduction for the premium on the embedded put option, because no such put option is present in the liability." IASB ED/2010/8 *Insurance Contracts*, July 2010, paragraph BC99.



developed. In acknowledgement of this, the IASB proposes in ED/2013/7 on insurance contracts that entities can use a ‘top-down’ approach to determining a risk-free discount rate by removing from observable asset rates “...any factors that influence the observed rates but are not relevant to the insurance contract liability (e.g. risks not present in the liability but present in the instrument for which the market prices are observed, such as any investment risk taken by the insurer that cannot be passed on to the policyholder)”<sup>134</sup>.

## Premium for risk

- 4.92 Another building block in measuring the current value of a liability is the risk that the actual resource flows may ultimately differ from those expected. This is known as a premium for risk. In measuring the exit price of a liability, the risk premium refers to the compensation market participants would demand for bearing the uncertainty inherent in the future resource flows. In setting the price they would demand from an entity for assuming the entity’s obligation, market participants would rationally not only factor in their expectations about the timing and amount of resource flows but would also allow for the possibility that those expectations ultimately might not be realised<sup>135</sup>.
- 4.93 Similarly, the entity-specific value of a liability includes a premium for risk. In this case, the risk adjustment is viewed from the entity’s perspective and represents the amount an entity would rationally pay to be relieved of the risk that the actual resource flows required to satisfy the obligation may ultimately differ from those expected by the entity<sup>136</sup>.
- 4.94 This entity perspective of the risk premium can perhaps be better understood by considering the way entities would rationally price the goods and services they provide to customers. Entities would rationally make provision in their pricing for the possibility that the actual cost to the entity of providing the goods and services to customers will exceed their expectations. Expressed differently, they would demand a price from customers for the risk they assume in providing the goods and services. That price represents the return they expect to generate from providing the goods and services, and as the goods and services are provided and the entity is released from risk, profit is recognised (unless the actual costs of providing the goods and services exceed the entity’s expectations and meet or exceed the risk premium). If the entity were to be relieved of the obligation to provide the goods and services it would have to

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134 IASB Staff Paper, Effect of board redeliberations on ED *Insurance Contracts*, February 2013, page 16, accessible at <http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Documents/Status/Effect-Board-decisions-on-ED-February-2013.pdf> (as at June 2014)

135 The risk adjustment is a premium, rather than a discount (or of nil amount), because market participants are risk averse; that is, they place greater weight on the potential for loss due to mis-estimating the actual (future) outcome than on the potential for gain from the same source.

136 The IASB, in its original insurance contracts exposure, similarly described the risk premium included in the measurement of the fulfillment value of an insurance contracts liability as “...the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfillment cash flows exceed those expected”. See IASB, Exposure Draft ED/2010/8, op cit., paragraph 35. The IASB changed the objective of the risk premium in the revised exposure draft, as discussed in paragraph 4.101.



compensate the counterparty or a third party for assuming the risk that the resource flows required to satisfy the obligation might exceed their expectations<sup>137</sup>.

- 4.95 The measurement model being developed by the IASB for insurance contract liabilities reflects an entity perspective. Under the proposals, the insurance contract liability would be measured at a current value that would include a premium for risk. As the insurer is released from risk, profit would emerge<sup>138</sup>.
- 4.96 Whether viewed from the perspective of a market participant or a reporting entity, a current value of a liability should include a premium for the risk that the actual resource flows will differ from those expected. As explained in paragraphs 4.28 and 4.29, this risk is a characteristic of a liability and failure to include it in the measurement of a liability would result in the measurement not being a faithful representation of the economic burden the liability represents.

### Risk adjustment techniques

- 4.97 Various techniques exist for including a risk adjustment in measuring the exit price or entity-specific value of a liability<sup>139</sup>. One of the techniques involves adjusting the rate used to discount future resource flows for the time value of money (that is, the risk free rate)<sup>140</sup>. The technique may seem counter-intuitive because it involves reducing the risk free rate. This is the converse of the adjustment that would be required in measuring the exit price or entity-specific value of an asset. For an asset, the adjusted rate would be higher than the risk-free rate (ignoring other adjustments to the rate) and the measured amount of the asset would be lower than the unadjusted amount. For liabilities, the adjusted rate would be lower than the risk-free rate (ignoring other adjustments to the rate) and the measured amount of the liability would be higher than the unadjusted amount.

### Determining the risk premium for entity-specific value

- 4.98 In paragraph 4.92, it was noted that the risk premium included in an exit price measure of a liability is a market risk premium reflecting the amount market participants would demand for bearing the risk that the actual resource flows may differ from their expectations. In paragraph 4.93, the risk premium included in an entity-specific measure of a liability was described as the amount an entity would rationally pay to be relieved of the risk that the actual resource flows required to satisfy the obligation may

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137 Of course, this discussion assumes the entity is operating in a competitive market environment and the pricing reflects the risk associated with the delivery of the particular goods or services. In reality, the entity may be operating in a regulated market where it is required to charge a price that may or may not compensate it fully for the risk assumed, or a niche market where it is able to earn 'excess' or 'super' profits (see footnote 87). In addition, an entity may choose to deliberately 'underprice' a good or service in order to generate returns from other, related, goods and services (a practice known as 'loss leading').

138 Refer to IASB ED/2013/7 *Insurance Contracts*, paragraph 27.

139 Refer to IASB/IPSASB IFRS 13 *Fair Value Measurement*, op. cit., paragraphs B12-B33 and IASB Working Draft of a proposed International Financial Reporting Standard, *Liabilities*, op. cit., paragraph B16.

140 This technique has its limitations, particularly where the expected future resource flows vary in both amount and timing. It also has to be used carefully to avoid double counting, that is, to avoid adjusting both the discount rate and the estimated future resource flows for risk.



ultimately differ from those expected by the entity. In contrast to exit price, where the risk premium is based on market participants' estimates of future resource flows, the risk premium included in the entity specific value of a liability is based on the entity's estimates of future resource flows. However, should the estimate of the risk premium included in the measurement of the entity specific value of a liability be an entity specific estimate or a market-based estimate?

- 4.99 Consistently with the view expressed in paragraph 4.47 about maximising the use of market-based estimates when measuring entity specific value, I believe the estimate of the risk premium, as with the estimate of the time value of money, should be market-based. In my view, basing the estimate on how the market would price risk would provide a more transparent and objective measure of the risk premium than if it were determined by individual entities from their particular perspectives. Accordingly, I believe the risk premium in an entity specific measure of a liability should be the amount market participants would demand if their estimates of the amount and timing of future cash flows were the same as the entity's estimates<sup>141</sup>.
- 4.100 This is the same approach as that required by the IASB and the IPSASB in determining the risk adjustment in measuring the value in use of impaired non-financial assets<sup>142</sup>. Value in use is an entity-specific current value of an asset that uses the entity's estimates of the amount and timing of cash flows expected to be derived from the asset. IAS 36 *Impairment of Assets* and IPSAS 26 *Impairment of Cash-Generating Assets* require the future cash flow estimates to be discounted by a rate or rates "... that reflect(s) current market assessments of: (a) the time value of money ...; and (b) the risks specific to the asset for which the future cash flow estimates have not been adjusted"<sup>143</sup>. They observe that "A rate that reflects current market assessments of the time value of money and the risks specific to the asset is the return that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the entity expects to derive from the asset"<sup>144</sup>.
- 4.101 The above approach to determining the risk premium in measuring the entity-specific value of a liability differs from the approach being developed by the IASB in the Insurance Contracts project for measuring the fulfilment value of an insurance contracts liability. The IASB has tentatively decided that the objective of the risk adjustment is to reflect the compensation the insurer requires for bearing the uncertainty inherent in the cash flows of a portfolio that arise as the insurer fulfils the

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141 In contrast, the IASB proposed in the original insurance contracts exposure draft that, consistent with fulfilment value being an entity specific measure, the risk premium should also be an entity specific estimate. See IASB, Exposure Draft ED/2018/8, op. cit., paragraphs 36 to 37.

142 IASB, IAS 36 *Impairment of Assets*, op. cit. and IPSASB IPSAS 26 *Impairment of Cash-Generating Assets*, op. cit.

143 IASB *ibid*, paragraph 55 and IPSASB *ibid*, paragraph 68

144 IASB *ibid*, paragraph 56 and IPSASB *ibid*, paragraph 69.



contract<sup>145</sup>, and is proposing that the risk adjustment would be determined using the risk aversion of the insurer rather than the risk aversion of a market participant<sup>146</sup>.

- 4.102 I disagree with both the tentatively agreed objective of the risk adjustment for insurance contract liabilities and the manner in which it would be determined. I believe that the approach set out in paragraph 4.99 and 4.100 would provide a more objective measure of the risk adjustment and would result in a more faithful representation of the entity-specific value of a liability. I am concerned that the IASB's proposed approach could result in a significant loss of comparability between reporting entities because it introduces into the estimate an element seemingly unrelated to a liability's cash flow characteristics, that is, an entity's risk preferences. For example, two insurers of similar size with similar portfolios of insurance liabilities could report significantly different fulfilment values for their insurance contract liabilities merely because managements of the two entities claim to have different risk aversions. The different fulfilment values for essentially the same liabilities would seem to imply that the liabilities have different economic characteristics, which in my view, they do not. Moreover, inter-period comparability for an individual insurer could be significantly impaired as a result of management changing its purported risk aversion without any change in the underlying economic characteristics of the liabilities.

### **Non-performance risk**

- 4.103 Non-performance risk; that is, the risk that an entity will not fulfil its obligations, is a characteristic of a liability. When a liability results from an arm's length exchange transaction, the amount received from the counterparty, whether the counterparty is a customer or a financier, will reflect the reporting entity's non-performance risk. A simple example will illustrate.
- 4.104 Assume that two entities, Entity A and Entity B, promise to pay an investor CU1 million in 5 years' time. Entity A has a 'AAA' credit rating while Entity B has a below-investment-grade credit rating of 'BB'. The investor prices the investment to reflect the current cost of money and the credit risk of the borrower. Entity A has a lower credit risk than Entity B, and this is reflected in the rate of return the investor charges on the loan of 6%. The investor charges Entity B a rate of return of 12% to reflect the entity's higher credit risk. Entity A would receive CU747,000 from the investor today in exchange for its promise to pay CU1 million in 5 years' time and Entity B would receive CU567,000 today in exchange for its promise to pay CU1 million in 5 years' time. These differing amounts reflect the entities' different credit risks.
- 4.105 Although the effect of an entity's non-performance risk on the initial measurement of a liability is generally transparent in transactions with investors it is implicit in other types of exchange transactions, such as transactions for the provision of goods or

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145 Refer to IASB ED/2013/7 *Insurance Contracts*, op. cit., paragraph B77.

146 Refer to IASB Staff Agenda Paper 3B *Risk adjustment: objective and confidence level disclosure*, week commencing September 2011, accessible at <http://www.ifrs.org/Meetings/Pages/IASB-Meeting-September-2011.aspx> (as at June 2013) and IASB ED/2013/7 *Insurance Contracts*, op. cit., paragraph B76.



services. For example, insurance premiums paid by policyholders would reflect the insurer's non-performance risk. The effect on the proceeds received by the insurer is likely to be minimal if the insurer is regulated, as is the case with direct insurers, since the activities of the regulator should serve to minimise the risk of non-performance by the insurer. However, the impact would be potentially more significant for unregulated insurers such as some reinsurance entities. Similarly, the liabilities measured at initial recognition under the lease accounting standards and the share-based payment standards would implicitly reflect the reporting entity's non-performance risk because the standards require market-based measures of the 'proceeds received'. In contrast, the initial measurement of liabilities resulting from other employee benefit exchange transactions accounted for in accordance with IAS 19/IPSAS 25 will not include the reporting entity's non-performance risk because, as discussed previously, the measurement is not market-based.

- 4.106 What then of liabilities that arise from non-exchange transactions? Do the standards require non-performance risk to be included in their initial measurement? The answer is 'maybe' in the case of liabilities recognised in accordance with IAS 37/IPSAS 19 and liabilities recognised in accordance with IPSAS 23 and 'no' in the case of liabilities recognised in accordance with IAS 12 and 'liabilities' recognised in accordance with IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*. In the case of liabilities recognised under IAS 37/IPSAS 19, some argue that because they are required to be measured at the best estimate of the expenditure required to settle the obligation (with the counterparty or by transferring the obligation to a third party), this is akin to a fair value measure that would incorporate non-performance risk. Others argue that the standard simply requires an entity to estimate the cash flows it expects to incur in the future in meeting its obligations and to discount those cash flows for the time value of money; that is, there is no explicit requirement to take into account the entity's non-performance risk. As for IAS 12, the measurement of deferred tax liabilities does not explicitly take into account uncertainty in the amount or timing of future tax payments. Similarly, the 'liability' recognised under IAS 20 is simply a deferral of the grant received, not a measurement of an uncertain future cash flow.
- 4.107 In the past, standard setters have typically either purposely avoided the issue of non-performance risk or have been blissfully ignorant of it. However, the recent development of standards on fair value measurement has brought to the surface the issue of whether the effect of an entity's non-performance risk is, or should be, included in the measurement of a liability<sup>147</sup>. These standards make it clear that the fair value of a liability, whether it is a financial or a non-financial liability or whether it results from an exchange transaction or a non-exchange transaction, includes the effect of an entity's non-performance risk<sup>148</sup>. The impact of this development has

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147 See IASB, IFRS 13 *Fair Value Measurement*, and FASB, SFAS 157 *Fair Value Measurements*.

148 In a fair value measurement, the non-performance risk is the same before and after the transfer of the liability to a market participant, on the basis that "A market participant taking on the obligation would not enter into a transaction that changes the non-performance risk associated with the liability without reflecting that change in the price (e.g. a creditor would not generally permit a debtor to transfer its



been magnified by the relatively recent changes to the standards dealing with business combinations<sup>149</sup>. These standards now make it clear that unless specifically exempted, all acquired liabilities must be measured at their fair value at the date of acquisition<sup>150</sup>.

- 4.108 Standard setters face something of a dilemma. Current literature makes it clear that liabilities measured at exit price (fair value), whether at initial recognition or subsequently, include the effect of non-performance risk. As explained in paragraphs 4.105 and 4.106, liabilities measured other than at fair value under current literature, whether at initial recognition or subsequently, may or may not include the effect of non-performance risk. These diverse requirements and the uncertainty surrounding the intention of standard setters in relation to some of those requirements have caused confusion and resulted in inconsistent and incomparable practices. The situation demands action by the standard setters and yet I suspect that for the time being at least, it will be a case of ‘letting sleeping dogs lie’.
- 4.109 In paragraph 1.5, it was noted that there has been unease amongst standard setters’ constituents, including financial statement users, preparers and regulators, about including non-performance risk in the measurement of liabilities. This is principally because of the seemingly counter-intuitive reporting that results when non-performance risk changes during a reporting period; for example, a deterioration in an entity’s credit standing during a period, would result in the recognition of a gain in profit or loss at the time the entity is suffering financial distress. The global financial crisis heightened constituents’ concerns when companies on the brink of bankruptcy were reporting huge gains in profit or loss<sup>151</sup>. Although such gains reflect the economics of entities in these circumstances, since the exit price of an entity’s financial liabilities would indeed decrease significantly as its creditworthiness

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obligation to another party of lower credit standing, nor would a transferee of higher credit standing be willing to assume the obligation using the same terms negotiated by the transferor if those terms reflect the transferor’s credit standing”): IFRS 13, paragraph BC 94(a).

149 IASB, IFRS 3 *Business Combinations* and FASB, SFAS 141 *Business Combinations*.

150 IFRS 3 & SFAS 141 exempt deferred tax liabilities, employee benefit liabilities and liabilities relating to share-based payment transactions from the requirement to be measured at their acquisition date fair values.

151 See, for example, Whittall C. “*Banks’ own credit risk hampers financial results*”, Risk.net, Financial Risk Management News and Analysis, Risk Magazine. Accessible at <http://www.risk.net/risk-magazine/news/1530662/banks-credit-risk-hampers-financial-results> (as at 6 June 2013). In the article, Whittall provides the following examples of gains and losses resulting from changes in own credit risk reported by some of the world’s largest banks during the global financial crisis:

HSBC – which reported \$6.6 billion of fair-value gains due to own credit risk over 2008 – registered a fair-value loss of \$2.5 billion for the first half of 2009, as CDSs referencing the bank tightened from 94 basis points to 75bp. CDSs on Barclays narrowed from 159bp to 136bp over the first half of the year, resulting in the UK bank sustaining fair-value losses on its own debt of £893 million, compared with fair-value gains of £1.7 billion in 2008.

Deutsche Bank recorded €176 million of fair-value losses on its own liabilities in the second quarter, as CDSs referencing the bank tightened from 135bp to 110bp. The bank previously registered fair-value gains attributable to own credit risk of €4.7 billion in 2008, as spreads referencing the bank widened from 46bp to 134bp.

JP Morgan’s credit spreads tightening from 199bp to 105bp over the second quarter resulted in losses on the bank’s own debt of \$1.1 billion. In contrast, it recorded fair-value gains due to own credit risk of \$2 billion in 2008, as CDSs referencing the bank pushed out from 50bp to 119bp.



collapsed, many commentators viewed the gains as fictitious because, they contended, the entities were in no position to realise them<sup>152</sup>. To them, the resulting profit or loss was misleading. The IASB moved to quell people's concerns by amending IFRS 9, to require the change in the fair value of financial liabilities resulting from changes in an entity's credit standing to be recognised outside of profit or loss (i.e. in other comprehensive income), unless to do so would create an accounting mismatch in profit or loss<sup>153</sup>.

- 4.110 As noted in paragraph 4.103, non-performance risk is an economic characteristic of a liability and should be included in the measurement of the liability whether it is measured at exit price or entity-specific current value. Accordingly, I disagree with fulfilment value as an alternative to exit price to the extent that it excludes the non-performance risk building block. The IASB has proposed that fulfilment value exclude non-performance risk because it is a measure of the value of a liability assuming the entity will fulfil its obligations; non-performance risk takes into account the effect on the value of a liability of the entity potentially not meeting its obligations. However, I believe these two perspectives are not mutually exclusive. The entity-specific value of a liability should include relevant inputs that measure the effect of the entity fulfilling its obligations, but it should also include the effect on the value of the liability resulting from changes in the likelihood that it will not meet its obligations. Entity-specific value should include the entity's non-performance risk in the same way that it includes a risk margin.
- 4.111 I am concerned that by excluding non-performance risk, fulfilment value may produce potentially misleading values for liabilities. An entity's liability will be another party's asset, albeit in some situations the identity of the party may be unknown at the present time, for example, where an entity has an obligation to carry out asset restoration. The value of the counterparty's asset will reflect the reporting entity's non-performance risk, irrespective of the entity's willingness and ability to meet its obligations. It is incongruous for an entity that holds another entity's promise to include in the measure of the value of that entity's promise the likelihood of the entity not meeting its promise, when the entity that has made the promise excludes that likelihood from its measure of the value of the promise. Moreover, it may well be the entity's intention to fulfil its obligations but it may not ultimately be able to do so. As the entity's creditworthiness deteriorates, in economic terms the value of its liabilities decreases (conversely, as the entity's creditworthiness improves, in economic terms the value of its liabilities increases). There is effectively a transfer of wealth from debt holders to the entity and, indirectly, to its equity holders. Not recognising this wealth transfer results in liabilities being overstated and net assets being understated.
- 4.112 Excluding non-performance risk from the entity-specific value of a liability would also result in an entity's current financing costs not being faithfully represented in the statement of financial performance. As an entity's creditworthiness changes, so too

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152 Of course, history has shown that entities have indeed been able to realise gains by settling their liabilities for less than their face values.

153 IASB, IFRS 9 *Financial Instruments*, paragraphs 5.7.7- 5.7.8.



does the entity's creditors' required rates of return. Again, it is incongruous for a creditor to reflect the effect of this change in its statement of financial performance when the debtor continues to reflect the cost of financing based on the entity's credit risk at initial recognition of the liability.

### **Fulfilment value**

4.113 Although I believe fulfilment value, as it has been developed to date by the IASB, is an incomplete measure of the current entity-specific value of a liability, I acknowledge that there is a very high level of resistance amongst the IASB's (and possibly the IPSASB's) constituents to including non-performance risk in the measurement of a liability in almost all circumstances<sup>154</sup>. Accordingly, I expect that standard setters would support the use of fulfilment value in circumstances where they believe a current value measurement is desirable but do not believe it would be feasible to require exit price or entity specific value as identified in this Paper. Although I believe this would be a sub-optimal outcome, I acknowledge that fulfilment value is a superior measure to many other liability measurements that have been specified in IFRSs and IPSASs or have been considered by the standard setters from time to time. My support for fulfilment value as opposed to other measurements, such as best estimate, expected ultimate cost to the entity, most likely amount, and maximum amount that is more likely than not to occur is based on the fact that it endeavours to incorporate all the remaining building blocks of a liability measurement<sup>155</sup> and thereby endeavours to reflect the economic characteristics of a liability other than the effect of non-performance risk.

### **Linking the proposals**

- 4.114 In this Chapter the measurement of liabilities is discussed and I express the view that all liabilities should be measured at initial recognition on a current value basis, and most liabilities should be measured subsequently on a current value basis. This, I believe, would provide relevant and representationally faithful information about the liabilities a reporting entity has incurred because the measurement of the liabilities would reflect their economic characteristics.
- 4.115 In Chapter 3 I observed that by requiring liabilities to be measured on a current value basis there would be no need for separate recognition criteria; that is, the uncertainties addressed in the traditional recognition criteria would be captured by the current value measurements. As a result, the financial statements would include more complete information about a reporting entity's liabilities than at present. Liabilities that meet the definition of liabilities under current reporting requirements but are not recognised in the financial statements because they fail the recognition criteria would be recognised and measured at their current values.

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154 Constituents would probably generally accept that non-performance risk should be included in the measurement of a liability that is used to hedge the credit risk component of an asset, and in the measurement of liabilities that are held for trading purposes.

155 Albeit unsatisfactorily in the case of the risk premium, as explained in paragraph 4.101.



4.116 Requiring all liabilities to be recognised in the financial statements and all or most of them to be measured at current value would potentially raise concerns about the subjectivity of some of the recognition decisions and the subjectivity surrounding many of the measurements reported in the financial statements. Chapter 5 discusses some key disclosure issues that that would need to be addressed in order to make the recognition decisions and measurement processes understandable to users of the financial statements and to engender confidence in the representational faithfulness of the liability measurements ultimately included in the financial statements.



## 5. What information about liabilities should be disclosed?

- 5.1 This Chapter addresses particular disclosure issues relating to liabilities that flow from discussions in the previous Chapters of this Paper. It does not address broader liability disclosure issues; although the point can be made that standard setters need to devote more attention in their conceptual frameworks to presentation and disclosure issues<sup>156</sup>.

### Existence uncertainty

- 5.2 Chapter 2 of this Paper focused on the existence question; that is, does a liability exist as a result of a transaction or other event? Sometimes this question will be difficult to answer because of uncertainty surrounding the assessment of whether an entity is obligated in respect of a present economic burden. For example, if legal proceedings are in progress, pending or threatened against an entity there may be significant uncertainty about whether the transactions or other events that would give rise to the present economic burden have occurred or how the law applies to those events.
- 5.3 If the entity answers the existence question in the affirmative, under the approach advocated in this Paper a liability would be recognised and measured on initial recognition at its current value (fair value or entity-specific value). If the entity answers the existence question in the negative, a liability would not be recognised. In any particular set of facts and circumstances, the decision one way or the other may be marginal.
- 5.4 Are users of financial statements well served if they only receive information about liabilities that, in conditions of uncertainty, are judged by the entity to exist? Conceivably, users of the financial statements would also wish to be provided with

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<sup>156</sup> Decisions by standard setters around financial statement presentation and disclosure are often *ad hoc* with little or no reference made to underpinning concepts. With respect to disclosures, the process has typically involved adding more and more specific disclosures to the body of existing disclosures as projects dealing with specific financial reporting issues are considered in isolation from one another. These actions of standard setters have led to criticisms from constituents that financial statements have become unduly complex and are suffering from ‘disclosure overload’. Whether or not such criticisms are justified, there is clearly a need for standard setters to apply a more analytical approach to presentation and disclosure issues. Developing the conceptual framework in these areas by articulating presentation and disclosure concepts should both facilitate standards-level decision making by the standard setters and enhance the usefulness of the information presented in the financial statements. In this context, it is encouraging to see both the IASB and the IPSASB planning to address presentation and disclosure issues in their respective conceptual framework projects. Indeed, the IPSASB recently issued an exposure draft addressing some of these issues. See IPSASB Exposure Draft, *Conceptual Framework for General Purpose Financial Reporting by Public Sector Entities: Presentation in General Purpose Financial Reports*, April 2013. It is also encouraging to see more and more financial reporting commentators advocating a conceptual approach to addressing disclosure issues. See for example, AASB Essay 2013-1, *Rethinking the Path from an Objective of Economic Decision Making to a Disclosure and Presentation Framework*, Kevin M Stevenson, AASB Research Centre, August 2013.



information about transactions and other events that have occurred in conditions of uncertainty that the entity has explicitly considered and decided do not give rise to liabilities. In particular, they would probably wish to know about the particular circumstances the entity has addressed and be provided with information about the potential financial effects of a liability that might ultimately arise. This information would assist them in assessing the performance and financial position of an entity by better enabling them to estimate the amount, timing and uncertainty of future outflows of resources<sup>157</sup>.

- 5.5 This disclosure issue was specifically addressed by the IASB in its Review of IAS 37. The Board proposed the following disclosures where an entity has judged, in situations of uncertainty, that it does not have a liability:
- (a) a description of the circumstances;
  - (b) an indication of the possible financial effects;
  - (c) an indication of the uncertainties about the amounts or timing of any outflows of resources; and
  - (d) the existence of any right to reimbursement.
- 5.6 The IASB also proposed that the disclosures need not be provided if the possibility of any outflows of resources is remote<sup>158</sup>.
- 5.7 Limiting the circumstances in which these types of disclosures should be made would appear to me to be warranted on cost/benefit grounds. This is a judgement by the standard setter (the IASB in this case) that, although the information provided by the disclosures could be potentially relevant to users of the financial statements in all circumstances (that is, there is a potential benefit), in situations in which there is only a remote possibility that an economic burden does in fact exist, the cost imposed on the reporting entity in providing the information and on users in analysing and interpreting the information provided might not be justifiable (that is, there may be no net benefit to users).

## Conditional obligations

- 5.8 Chapter 2 of this Paper also discussed the recognition of liabilities in circumstances in which a conditional obligation exists. It was reasoned that where a conditional obligation is accompanied by an unconditional obligation, for example, in the case of a warranty, a liability should be recognised in respect of the unconditional obligation and should be measured by reference to the conditional obligation. However, on occasions a conditional obligation will exist unaccompanied by an unconditional obligation. One such circumstance discussed in Chapter 2 was the existence of a law

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157 Arguably this type of disclosure is currently required by IAS 1 *Presentation of Financial Statements*, paragraphs 122-123 and IPSAS 1 *Presentation of Financial Statements*, paragraphs 136-137. However, practice experience would suggest that the requirement is often ignored. The incidence of situations where preparers would be called on to address such disclosures would be significantly increased under the approach advocated in this Paper. Accordingly, a case could be made for assessing the effectiveness of the current requirements and consideration given to providing greater specificity.

158 IASB, Working Draft of International Financial Reporting Standard, *Liabilities*, op. cit., paragraph 51.



that imposes a levy on reporting entities if they meet a specified threshold, for example, a reported revenue threshold. It was reasoned that in such circumstances a liability should not be recognised until the threshold is met because an entity is not obligated in respect of an economic burden until that point in time. However, it was acknowledged that some will find that outcome discomfoting, particularly when reporting in interim periods before the threshold is met.

- 5.9 Disclosing information about the existence of conditional obligations would go some way to alleviating this discomfort. Specifically, disclosing information about the nature of the conditional obligation, the likelihood of the entity reaching the threshold and the amount of the levy that would be payable if the threshold is met, would inform users of the existence of a possible liability and better enable them to estimate the amount, timing and uncertainty of future resource outflows.

## Estimation uncertainty

- 5.10 Chapter 3 of this Paper advocated that a liability should be recognised in the financial statements if the definition of a liability has been satisfied. Chapter 4 advocated that all liabilities should be measured at current value on initial recognition and most liabilities should be measured subsequently at current value. If these approaches were implemented they would result in major changes to current practice. While the changes would, I believe, enhance the utility of the financial statements for users of the financial statements by providing more decision-useful information, they would need to be supported by appropriate disclosures. Some of those disclosures have been identified in this Chapter. Others are already embedded in existing literature where the topic requirements largely mirror the approaches advocated in this Paper, for example, the financial instruments literature. Of particular relevance in this context are disclosures about estimation uncertainty.
- 5.11 A generic package of disclosures about liabilities with estimation uncertainty is an essential element of the approaches advocated in this Paper. Although users of the financial statements would be expected to find the reporting of current value measures of liabilities a rich source of information, they would also be mindful of, and at times concerned about, the subjectivity often involved in making such measurements. Accordingly, in order to obtain insights into the uncertainties surrounding current value measurements, users would be likely to seek disclosure of information about the methods and significant assumptions used in the measurements, and how the measurements changed over the reporting period.
- 5.12 The IASB recently considered this disclosure issue in its Review of IAS 37. The Board proposed a range of disclosures for liabilities subject to estimation uncertainty, including a detailed breakdown of the changes in the carrying amount of the liabilities from the beginning to the end of the reporting period, the expected timing of any resulting outflow of resources, and an indication of the uncertainties about the amount or timing of the future outflows of resources, including where necessary major assumptions regarding future events<sup>159</sup>.

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159 IASB Working Draft of a proposed International Financial Reporting Standard *Liabilities*, paragraph 49.



- 5.13 Financial statement users are increasingly demanding more disclosures about estimation uncertainty. The demand for this information was highlighted in a recent report by Standard & Poor's Ratings Services, in which the firm noted that "Disclosures by banks about valuation uncertainties and the underlying assumptions they make in their internal valuation models have improved markedly since the onset of the global financial crisis, in response to investor demand and revised requirements from accounting standard setters"<sup>160</sup>. But the report continued to express concerns, noting that "... there is one area, however, that is calling for greater transparency by banks: valuation uncertainty about the range of possible values of assets and liabilities on their trading books"<sup>161</sup>. The call for these 'sensitivity' types of disclosures is growing louder and will increasingly need to be taken seriously by the standard setters, notwithstanding the protestations of the preparers of financial statements.

## Prejudicial information

- 5.14 In unusual situations standard setters may decide to modify requirements relating to the disclosure of information about liabilities because of the possibility that the disclosed information may prejudice the reporting entity's relationship with external parties. For example, IAS 37 and IPSAS 19 modify the disclosure requirements relating to provisions, contingent liabilities and contingent assets by providing relief from the detailed disclosures "... in extremely rare cases ..." in which the disclosures, in whole or in part, "... can be expected to prejudice seriously the position of the entity in a dispute with other parties on the subject matter of the provision, contingent liability or contingent asset". If an entity avails itself of the disclosure relief it is required to disclose only "... the general nature of the dispute, together with the fact that, and the reason why, the information has not been disclosed"<sup>162</sup>.
- 5.15 I believe standard setters should exercise extreme caution in modifying required disclosures on the grounds that the disclosures might be prejudicial to a reporting entity, since failure to disclose the information would deprive users of relevant information. In the case of IAS 37 and IPSAS 19, the modification was considered to be appropriate because of the possibility that the disclosed information (and supporting undisclosed information that could be obtained through the legal process of discovery) could be used against the entity by litigants in settlement negotiations and by the courts in adjudicating a case and awarding damages.
- 5.16 An argument might be made that in these circumstances some users of the financial statements; that is, those with a financial stake in the entity, may benefit more from the entity not disclosing the information than they would if the entity disclosed the information. However, this argument needs to be evaluated against the fact that all users would be deprived of information that would assist them in assessing the

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160 Standard & Poor's Ratings Services, Ratings Direct, "What's Fair Value? Reducing Valuation Uncertainty Could Boost Confidence In UK Banks – And Global Peers", March 7, 2013, page3.

161 Ibid, page 2

162 IASB IAS 37, op. cit., paragraph 92 and IPSASB IPSAS 19, op. cit., paragraph 109. It is important to bear in mind that liabilities that meet the recognition criteria in IAS 37 and IPSAS 19 will have been recognised in the financial statements. The relief allows non-disclosure of granular information about the liabilities (and contingent liabilities and contingent assets in the case of IAS 37 and IPSAS 19).



amount, timing and uncertainty of future cash flows. It is likely that, given a choice, users would prefer more disclosure than less in these circumstances. This preference may be driven in part by a distrust of reporting entities' motivation for invoking the disclosure relief and a concern that standard setters may come under pressure to broaden the circumstances in which such relief might be considered to be appropriate.



## 6. Where to now?

- 6.1 This Paper has endeavoured to provide a conceptual analysis of the principal issues concerning the financial reporting of liabilities. The objective of the analysis has been to develop a series of inter-related proposals that, if implemented, have the potential to significantly improve the quality of reported information about liabilities.
- 6.2 This Paper presents a definition of liabilities and advocates a consistent approach to recognition and measurement across all liability types that, if applied in practice, would produce a more complete representation of a reporting entity's liabilities and better reflect the economic burdens imposed on an entity by those liabilities than is presently the case. This Paper acknowledges that standard setters will find it difficult to achieve that consistency in all respects and in all cases. However, even if standard setters are unable to achieve the 'perfect outcome', I believe they can achieve significant improvements in the financial reporting of liabilities by articulating a consistent approach at a conceptual level and striving to develop specific financial reporting requirements at a standards level based on that approach to the greatest extent possible. Of course, the same would be true of the financial reporting of assets. But that is a story for another day.
- 6.3 It is timely that the IASB and the IPSASB are currently enhancing and developing their respective conceptual frameworks, and may well extend this work to developing consequential changes to existing standards. It is hoped that the analysis and related proposals in this Paper can assist the boards in their task and contribute specifically to improving the quality of financial reporting about an entity's liabilities, and more generally to enhancing the financial reporting framework.