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Conceptual Framework guidance on when the definition of a liability is met
Issues Paper

Objective

1 This issues paper considers the issue on when a purchaser of a good or service should recognise a liability for variable consideration that depends on the purchaser's future actions. The scenario considered is a situation where the purchaser first agrees with the seller on the terms of the transfer. Then the seller transfers the agreed good or service to the seller and then the purchaser will have to pay the seller (in cash). The amount the purchaser will have to pay depends on the future actions of the purchaser.

2 Currently, it is considered to include in EFRAG's Discussion Paper on variable consideration four different approaches based on which it could be decided when variable consideration that would depend on the purchaser's future actions should be **recognised as a liability by the purchaser**:

(a) A Conceptual Framework approach – based on the guidance in the *Conceptual Framework for Financial Reporting* (the 'Conceptual Framework');

(b) *An IFRS 9 all-included-in-fair-value approach* under which a liability for variable consideration would be recognised when the related acquired good or service has been received.

(c) *An IFRS 16 Leases approach* under which variable payments that are dependent on an index or a rate or are, in-substance fixed payments (but structured as variable payments), would be included in the initial measurement of the liability. Other 'real' variable payments (such as those dependent on future activity of the purchaser) would not be included in the initial measurement of the liability on the date the related acquired good or service has been received. A liability for these variable payments would only be recognised when the future actions have been taken.

(d) *An IAS 37 approach* under which variable consideration that depends on the purchaser's future actions is not recognised as a liability until the future actions have been taken.

3 At the July 2021 EFRAG TEG meeting, differing views were presented on when variable consideration that depends on the purchaser's future actions would meet the definition of a liability in the Conceptual Framework. It was therefore suggested to further consider this issue. Such a discussion would also be needed to develop the approach based on the Conceptual Framework (see paragraph 2(a)). As the Conceptual Framework does not explicitly state whether/when a liability for variable consideration should be recognised, an approach based on this guidance would

necessarily have to represent a possible interpretation of the Conceptual Framework.

4 The development of the Conceptual Framework approach does not consider other aspects of the Conceptual Framework than the guidance on liabilities. Most notably, the qualitative characteristics of useful financial information should not be considered when developing the approach. Like with other approaches to be presented in the Discussion Paper, the advantages and disadvantages of an approach based on the guidance on liabilities for recognising variable consideration will, however, be performed. This will involve an assessment against the qualitative characteristics of useful financial information.

5 Although this paper refers to when a liability should be recognised, it does only consider when the definition of a liability is met. It does thus not consider whether an item meeting the definition of a liability should be recognised. (The definition of a liability could be met, but a liability not recognised if, for example, the liability cannot be measured sufficiently reliable or the liability would only be recognised if it is more likely than not that hat an outflow of resources embodying economic benefits will be required to settle the obligation.)

6 The objective of this paper is accordingly to discuss:

(a) Whether EFRAG TEG can agree on one (or perhaps two) possible interpretation(s) of the Conceptual Framework, based on which one (or perhaps two) approaches to determine when a liability should be recognised for variable consideration could be developed; or (if this is not possible)

(b) Whether EFRAG TEG can agree on which suggested alternative approaches (see paragraphs 2(b) to 2(d)) would not be compatible with the guidance in the Conceptual Framework; or (if this is not possible)

(c) Whether EFRAG TEG would conclude that the Conceptual Framework does not provide sufficient guidance for any approaches to be developed or being considered not to comply with the Conceptual Framework.

Suggestions of the EFRAG Secretariat

7 Based on the guidance in the Conceptual Framework, previous material considered by IFRIC and discussion of EFRAG TEG, the EFRAG Secretariat considers that EFRAG's Discussion Paper could present one, or both, of the following approaches under the Conceptual Framework approach mentioned in paragraph 2(a) above:

(a) An approach under which a liability for variable consideration that depends on the entity's future actions is generally not recognised until the entity performs those future actions. A liability is only recognised when the purchaser has no practical ability to avoid performing the future actions that will result in the entity having to pay variable consideration. An entity would have no practical ability to avoid the future actions when, for example, it would mean that it:

(i) Would not comply with legal requirements;

(ii) Would have to change its business model; or

(iii) Would have (at one point) to cease profitable sales.

(b) An approach under which a liability for variable consideration that depends on the entity's future actions would be recognised before the future actions are performed, if it would be significantly economically disadvantageous for the entity not to perform the future activity. The difference between this approach and the approach mentioned in (a) is that 'no practical ability to avoid' is interpreted broader. An entity is thus considered to have 'no practical ability to avoid' an action if it, in the context of the future transaction, would be

significantly economically disadvantageous for the entity not to perform the future activity. Under approach (a) 'no practical ability to avoid' is considered in the context of the entire entity. That is, if it would have severe consequences for the entire business not to perform the future action. When the economically effects are only considered in the context of the future action, it would, for example, mean that an entity would generally have 'no practical ability to avoid' making use of a good or service acquired.

8 The background for the two approaches is further explained below.

Definition and guidance on a liability in the Conceptual Framework

9 According to the Conceptual Framework (paragraph 4.26):

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

10 The Conceptual Framework further states (paragraph 4.27) that for a liability to exist three criteria must all be satisfied:

(a) The entity has an obligation;

(b) The obligation is to transfer an economic resource;

(c) The obligation is a present obligation that exists as a result of past events.

11 For the purpose of discussing whether variable consideration that depends on an entity's future actions, the criteria mentioned in (a) and (c) above are particularly relevant. Criterion (b) is thus not discussed in the following paragraphs.

The entity has an obligation.

12 According to the Conceptual Framework (paragraphs 4.29, 4.32 – 4.34):

> An obligation is a duty or responsibility that an entity has no practical ability to avoid.
>
> […]
>
> In some situations, an entity's duty or responsibility to transfer an economic resource is conditional on a particular future action that the entity itself may take. Such actions could include operating a particular business or operating in a particular market on a specified future date, or exercising particular options within a contract. In such situations, the entity has an obligation if it has no practical ability to avoid taking that action.
>
> A conclusion that it is appropriate to prepare an entity's financial statements on a going concern basis also implies a conclusion that the entity has no practical ability to avoid a transfer that could be avoided only by liquidating the entity or by ceasing to trade.
>
> The factors used to assess whether an entity has the practical ability to avoid transferring an economic resource may depend on the nature of the entity's duty or responsibility. For example, in some cases, an entity may have no practical ability to avoid a transfer if any action that it could take to avoid the transfer would have economic consequences significantly more adverse than the transfer itself. However, neither an intention to make a transfer, nor a high likelihood of a transfer, is sufficient reason for concluding that the entity has no practical ability to avoid a transfer.

13 In the Basis for Conclusions (paragraph BC4.55) accompanying the Conceptual Framework, it is stated that:

> Paragraph 4.34 of the 2018 Conceptual Framework refers to actions that would have economic consequences significantly more adverse than a transfer of economic resources as an example of when an entity may have no practical ability to avoid a transfer. This is intended to mean not just that it would be economically advantageous to make the transfer. Rather, the adverse economic consequences of not making the transfer are so severe that the entity has no practical ability to avoid the transfer. Although the entity has the theoretical right to avoid the transfer, it has no practical ability to exercise that right.

14 It also appears, implicitly, from the Basis for Conclusions (paragraph BC4.51) that if the variable consideration depends on the entity achieving a specified level of annual sales, a liability exists if the annual sales level is expected to be achieved. In this regard, it should, however, be noted that IAS 32 *Financial Instruments - Presentation* (paragraph 25) considers that variability that depends on the entity's 'future revenues, net income or debt to equity ratio' is beyond the control of the entity. The variability would thus not depend on the entity's future actions.

The obligation is a present obligation that exists as a result of past events

15 According to the Conceptual Framework (paragraph 4.43)

A present obligation exists as a result of past events only if:

(a) the entity has already obtained economic benefits or taken an action; and

(b) as a consequence, the entity will or may have to transfer an economic resource that it would not otherwise have had to transfer.

16 It follows (from paragraph 4.44) that if economic benefits are obtained, or an action is taken, over time, the resulting present obligation may accumulate over that time.

17 The Basis for Conclusions explains that the criteria mentioned in paragraph 15 above were introduced because (paragraph BC4.66 and BC4.67):

In some cases, a chain of events creates and obligation. For example, an obligation may arise if a minimum threshold is reached in a period (such as a minimum amount of revenue, a minimum number of employees or a minimum amount of assets) and if the reporting entity is still operating on a specified later date. In such cases, identifying which of those events (reaching the threshold or operating on the specified date) is the obligating event can be particularly difficult […]

[a]n entity may have an obligation if only some of the events in the chain have occurred: an entity could have an obligation if it has no practical ability to avoid the events that have not yet occurred. Therefore, it is important to explain which of the events in the chain must have occurred for an entity to have a present obligation 'as a result of past events'.

IFRS Interpretations Committee conclusions and discussions

18 When the IFRS Interpretations Committee ('IFRIC') discussed variable payments for asset purchases, the Conceptual Framework had not been issued. However, analyses were made based on the Conceptual Framework Exposure Draft issued in May 2015. In these analyses, the IFRIC staff noted:

(a) [I]t would be possible to reach two different views on whether a purchaser has received the benefits or conducted the activities that established the extent of its obligation to make variable payments. On one hand, it could be argued that the entity has received the asset and, therefore, has received the economic benefits. On the other hand, it could be argued that the entity has not performed the activity or received the benefit that establishes the extent of the variable payments, and hence the extent of its obligation on the date of purchase of the asset. (Paragraph 40 of Agenda Paper 02A for the November 2015 IFRIC meeting). In support of the latter view, it has been noted that, among other things, arrangements in which the variable payments are linked to future activity are means through which the purchaser and seller can share risks and profits to be derived from the use of the assets after the asset has been delivered. The variable payment arrangement can thus be seen as a form of arrangement that is distinct from the initial purchase of the asset. (Paragraph 15 of Agenda Paper 02A for the November 2015 IFRIC meeting).

(b) It is generally in the purchaser's best interest to undertake the future activity on which the variable payment is based (for example, generate sales through the use of the asset). Avoiding this action would generally lead to more serious

adverse consequences than making the actual variable payment itself. We therefore think that in most cases, on the date of purchase of an asset, a purchaser could be assumed to have no practical ability to avoid making the variable payments. (Paragraph 37 of Agenda Paper 02A for the November 2015 IFRIC meeting).

(c) We think that while the proposals in the Conceptual Framework Exposure Draft provide some additional clarity, they do not provide a definitive answer that would direct the Interpretations Committee to a conclusion on whether variable payments that depend on the purchaser's activity meet the definition of a liability. (Paragraph 43 of Agenda Paper 02A for the November 2015 IFRIC meeting).

19 IFRIC members have been split on the issue. Some had the view that the purchaser's agreement to make the variable payment is the obligating event in a purchase transaction if the asset has been received by the purchaser, even if the variable payments are dependent on the purchaser's future activity. Also, the contract is not executory, if the corresponding asset has been delivered/granted to the purchaser. Other had the view that variable payments are a form of joint arrangement that is distinct from the initial purchase of the asset. It should be accounted for separately from the initial purchase of the asset and is initially executory until the activity requiring the payment is performed. (Appendix A of Agenda Paper 02A for the November 2015 IFRIC meeting).

Differences between the 2015 Conceptual Framework Exposure Draft and the Conceptual Framework published in 2018

20 The Conceptual Framework does include additional/different guidance compared with the 2015 Exposure Draft on which the discussions of the IFRIC were based.

No practical ability to avoid

21 In relation to the 'no practical ability to avoid' criterion, the Basis for Conclusions accompanying the 2015 Exposure Draft noted:

[…]

The IASB thinks that these criteria make it clear that:

(a) economic compulsion may be a factor that reduces the entity's practical ability to avoid a future transfer—so it would need to be considered in assessing whether that criterion is met; but.

(b) economic compulsion on its own cannot create a present obligation—there is also the requirement for the obligation to have arisen from a past event (receiving economic benefits, or conducting activities, that establish the extent of the entity's obligation).

22 The 2015 Exposure Draft did not include much of the guidance referred in paragraph 12 above and the Basis for Conclusions accompanying the 2015 Exposure Draft did not include the statement in paragraph BC4.55 replicated in paragraph 13 above. The 2015 Exposure Draft, perhaps particularly the part referred to above in paragraph 21 could thus have given the impression that economic compulsion, to the extent there is also a past event, should be taken more into account than under the final Conceptual Framework, in which it is explained in the Basis for Conclusions (see paragraph 13 above) that 'the adverse economic consequences of not making the transfer are so severe that the entity has no practical ability to avoid the transfer [of variable consideration]'.

The obligation is a present obligation that exists as a result of past events

23 The 2015 Exposure Draft did not include the guidance that a relevant past event to consider is one that results in 'the entity will or may have to transfer an economic resource that it would not otherwise have had to transfer.' (see paragraph 15 above).

24 Also, unlike the Basis for Conclusions accompanying the Conceptual Framework (paragraph BC4.67 – see paragraph 17 above), the Basis for Conclusions accompanying the 2015 Exposure Draft did not clarify that if an entity has an obligation if only some of the events in a chain of events occurs, and entity could have an obligation if it has not practical ability to avoid the events that have not yet occurred.

Previous EFRAG TEG discussions

25 At the July 2021 EFRAG TEG meeting, some EFRAG TEG members were of the view that if an entity had acquired an asset, it had no practical ability not to use that asset. It was also noted that if there would be several 'past events' that could be relevant, the first of these events seemed to be the relevant to consider following the Basis for Conclusions accompanying the IASB Exposure Draft *Regulatory Assets and Regulatory Liabilities*.

26 The Basis for Conclusions (paragraph BC45) accompanying the IASB's Exposure Draft *Regulatory Assets and Regulatory Liabilities*, states that:

> The Board concluded that a regulatory liability meets the definition of a liability because:
>
> […]
>
> (c) the obligation is a present obligation that exists as a result of past events because:
>
> (i) the entity has already obtained economic benefits by charging customers amounts that are reflected in revenue already recognised; and
>
> (ii) as a consequence, the entity will have to transfer an economic resource that it would not otherwise have had to transfer, because it will have to reduce future regulated rates.
>
> (d) although the mechanism for fulfilling a regulatory liability is by decreasing regulated rates in future periods, the regulatory liability is a present obligation and exists because of a past event: the entity has recognised revenue and part of that revenue will provide part of the total allowed compensation for goods or services to be supplied in the future.

Suggestions of the EFRAG Secretariat

27 The situations involving variable consideration, that is currently considered by EFRAG TEG have the following fact patterns:

(a) Entity A (the purchaser) agrees to purchase a good or service from Entity B (the seller) in exchange for variable consideration;

(b) Entity B transfers the good or service to Entity A;

(c) Entity A pays a variable consideration depending on its future actions (that is, the future actions of the purchaser).

28 Under this scenario, the EFRAG Secretariat considers that there could be identified three *potential* 'past events' in accordance with the guidance in paragraph 4.43 of the Conceptual Framework (see paragraph 15 above):

(a) When Entity A agrees to purchase a good or service in exchange for variable consideration;

(b) When Entity A receives the agreed good or service;

(c) When Entity A would take future actions that would result in it having to pay variable consideration.

29 Based on the guidance in paragraph 4.43 of the Conceptual Framework (see paragraph 15 above), which was not available when the IFRIC discussed variable

consideration, the EFRAG Secretariat considers that when a purchaser enters into an agreement to purchase a good or service from a seller in exchange for variable consideration (see paragraph 15 above):

(a) It has taken an action (entering the contract); and

(b) As a consequence, it will or may have to transfer an economic resource that it would not otherwise have had to transfer (after entering the contract, the entity would have to transfer an amount to the seller if it performs the actions on which the variable consideration is based – which it would not have had to do if it had not entered the contract).

30 The EFRAG Secretariat accordingly considers that the entity has a present obligation as a result of a past event when Entity A agrees to purchase a good or service in exchange for variable consideration (that is (a) in paragraph 28 above). However, the EFRAG Secretariat could also see arguments for only considering that Entity A has a present obligation as a result of a past event when it has received the agreed good or service. An argument for this could be that until Entity A has received the agreed good or service, the contract is executory, and Entity A would thus not have an independent obligation, but a combined right and obligation to exchange economic resources (see paragraph 4.57 of the Conceptual Framework).

31 The EFRAG Secretariat considers that both of these interpretations are in accordance with the guidance received from EFRAG TEG in July 2021 (see paragraph 25 above).

32 When the relevant past event to consider is when the seller and the purchaser enters into a contract (or when the agreed good or service has been received), whether or not the seller has a liability in relation to variable consideration at that point in time or later, depends on whether the purchaser has no practical ability to avoid performing a future action that will result in it having to pay variable consideration.

33 As it appears from the Basis for Conclusion accompanying the Conceptual Framework 'no practical ability' means that economic compulsion should only be considered to the extent that the adverse economic consequences are so severe that the entity has no practical ability to avoid performing these future actions.

34 The EFRAG Secretariat considers that 'no practical ability to avoid' would only exist, for example, when not performing the future actions that would trigger variable payments would mean that the entity:

(a) Would not comply with legal requirements;

(b) Would have to change its business model; or

(c) Would have (at one point) to cease profitable sales.

35 Unlike some EFRAG TEG members (see paragraph 25 above), the EFRAG Secretariat does not consider that if an entity acquires an asset, it would generally have no practical ability to avoid using the asset. The EFRAG Secretariate considers that the adverse economic consequences of not using an acquired asset would generally not be so severe that the entity has no practical ability not to use the acquired asset. In this regard, the EFRAG Secretariat also notes that sometimes entities acquire e.g., brand names, not to use them, but to prevent competitors from using them. Also, after an entity has acquired, for example, a machine, it may decide that it will not use the machine anyway as it is not (sufficiently) profitable.

36 The EFRAG Secretariat accordingly considers that EFRAG's Discussion Paper could present two approaches based on the Conceptual Framework:

(a) One approach where 'no practical ability to avoid' is interpreted strictly in accordance with paragraph 34 above. This approach would mean that a liability for variable consideration that depends on the entity's future actions is generally not recognised until the entity performs those future actions.

(b) One approach where economic compulsion has a more prominent role when interpreting 'no practical ability to avoid'. Under this approach, a liability for variable consideration that depends on the entity's future actions would be recognised when not performing the future actions would be significantly economically disadvantageous. For example, it would generally be significantly economically disadvantageous for an entity to acquire a good or a service without subsequently making use of that good or service.

Compatibility of approach with the guidance in the Conceptual Framework

37 It is the assessment of the EFRAG Secretariat that none of the other approaches currently considered for the recognition of a liability for variable consideration that depends on an entity's future activities (see paragraph 2 above) would be compatible with either of the two approaches mentioned in paragraph 36 above.

38 The 'IFRS 9 all-included-in-fair-value approach' would result in a liability being recognised for variable consideration even when it is relatively uncomplicated for an entity to avoid becoming in a situation where it would have to pay an amount following the variable consideration.

39 Under the 'IFRS 16 Leases approach' and the 'IAS 37' approach no liability would generally be recognised for variable consideration that depends on the purchaser's future action until the future action is taken by the purchaser – not even if the entity has no practical ability to avoid this future action.

Questions for EFRAG TEG

40 Does EFRAG TEG agree that the relevant 'past event' to consider is the time when the contract between the seller and purchaser is agreed (see paragraph 29 below)? If not, does EFRAG TEG thinks that considering the relevant 'past event' to be the time when the contract between the seller and the purchaser is agreed could be one, of several, acceptable interpretations of the Conceptual Framework, on which the 'Conceptual Framework' approach to be presented in EFRAG's Discussion Paper could be based?

41 Does EFRAG TEG have an interpretation of the guidance related to liabilities included in the Conceptual Framework that has not been presented in this paper?

42 Does EFRAG TEG agree that the guidance in the Conceptual Framework could result in the two approaches mentioned in paragraph 36?

43 Does EFRAG TEG considers that EFRAG's Discussion Paper could present one or both of the approaches mentioned in paragraph 36? If EFRAG TEG considers that EFRAG's Discussion Paper should present only one of the approaches, which approach should be presented? Or is there a third approach that should instead be presented?

44 If EFRAG TEG does not think that the Discussion Paper can present a 'Conceptual Framework approach', for example, because there would be too many manners in which the guidance in the Conceptual Framework could be interpreted, would EFRAG agree that none of the alternative approaches presented in paragraph 2 would be compatible with the Conceptual Framework?

45 Does EFRAG TEG have any other comments in relation to the guidance in the Conceptual Framework and how to account for variable consideration?