FINANCIAL REPORTING | BASIC

Video Transcription: Liabilities according to the Conceptual Framework

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Hi. I'm Taryn. Did you know that the 2018 Conceptual Framework brought about changes to the definition and recognition criteria for assets and liabilities? The purpose of this video is to help you understand the new definition of liabilities, in accordance with this Framework.

It's important to remember that the Conceptual Framework is not a standard, and so to the extent that an existing IFRS gives guidance on how to account for a particular transaction, the IFRS requirements prevail over the Conceptual Framework's. Ideally, the two should be aligned, but this is not always the case. For example, IAS 37 provides detailed guidance on how to account for provisions, contingent liabilities and contingent assets; and includes its own definition of a liability for this purpose. If you are dealing with a transaction that results in a provision or contingent liability, you must be sure to apply the requirements within IAS 37. Have a look at the video entitled "What are liabilities in terms of IAS 37?" for more information on this IFRS.

The new definition of a liability is: a present obligation of the entity to transfer an economic resource as a result of past events. For a liability to exist, there needs to be (i) an obligation, (ii) that requires a transfer of economic resources, and (iii) is a present obligation as a result of past events. Let's have a look at these three parts of the definition, one by one.

An obligation is a duty or responsibility that the entity has no practical ability to avoid. Many obligations are established by contract or legislation, and are what we would call 'legal obligations' because they are legally enforceable. Obligations can however also arise due to an entity's customary practices, published policies or specific statements, if the entity has no practical ability to act in a manner inconsistent with those practices, policies or statements. These obligations are sometimes called 'constructive' obligations. If an entity's policy is to fix land that it damages in business operations, the entity normally has no practical ability to avoid doing so. Why? The public expect it of them, and not fulfilling its promise could cause serious reputational and even financial damage for the entity. These could be severely worse economic consequences for the entity, than simply complying with its policy and fixing the land. And so the entity really has no practical ability to avoid the obligation.

An entity may have an obligation *now*, even though it is *yet to perform* some sort of action that will trigger the requirement to transfer an economic resource. So long as the entity has no practical ability to avoid the action, an obligation exists for the entity. Take for example, the fact that every company has a legal obligation to pay tax on taxable income earned. Even though the company may not yet have earned any taxable income, (say it is a brand new company), the company once it is formed, has no practical ability to avoid doing business which would most likely lead to taxable income being earned. That is why the company has been established! Therefore regardless of the fact that no taxable income has yet been earned, the obligation to pay tax still exists. Note carefully that we are still only on the first part of the definition of a liability, and haven't yet considered the last part, which is whether the obligation is *present as a result of past events*. At this point, all we are doing is establishing whether there is an obligation or not.

Deciding whether or not that entity "has no practical ability to avoid the transfer" is sometimes a matter of judgment. We probably feel pretty comfortable about the tax example we've just discussed; but what if the entity has ordered some goods? Does the

entity have a duty or responsibility that it has no practical ability to avoid? There is a contract in place (remember that even a verbal agreement is a contract), so there is a legal duty to follow though with the contract. Practically, can the entity avoid the transfer? Well, it probably depends… what are the terms of this contract? What penalties or consequences are in place if the entity phones up the supplier tomorrow and wants to cancel the contract? In other words, are the economic consequences of cancelling the contract more adverse than following through with the contract? If the facts were that the entity had 10 days to cancel the order without any repercussions, then the entity has a practical ability to avoid the obligation to pay for the goods. But if the terms were, that should the entity cancel the order at any point, the entity would have to pay *full price anyway*, then the entity has no practical ability to avoid the transfer. So you can see, the answer is not always clearcut, and may depend on the nature of the entity's operations and the terms of the agreement.

For the second part of the definition: the requirement to transfer an economic resource; this could be in the form of cash, or a good or service, or any other economic resource. Note that the transfer does not have to be certain or even likely. A *potential* transfer is sufficient to meet this criterion. Say an entity (a restaurant) realises that it inadvertently caused food poisoning, and is therefore obliged (either legally or constructively) to compensate its aggrieved customers for medical and other costs. So long as there is the possibility that at least one customer will require this of them, then there is the potential that the entity may be required to transfer an economic resource, and the second criterion of the liability definition is met.

The final part of the definition requires that the obligation be *present as a result of past events*. This is the case 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. Let's look again at some of the examples we've discussed.

i. For the Obligation to fix land damaged by entity, only once the land has actually been damaged by the entity, has the entity taken the action that will require a transfer of an economic resource. *Damaging the land* is the event that would make the obligation a *present obligation*; and it's only at this point in time that all aspects of the liability definition are met. In other words, the entity cannot recognise a liability for future costs of restoring the land, until it has actually caused the damage.
ii. For the Obligation to pay tax, only once the entity has started to earn taxable income, has the entity taken the action that will require a transfer of an economic resource. *Earning taxable income* is the event that would make the obligation a *present obligation*; and its only at this point in time that all aspects of the liability definition are met. In other words, the entity cannot raise a liability for future tax payable, before it starts operating and generating some taxable income.
iii. For the Obligation to compensate ill customers who experienced food poisoning, only once the entity has served their customers poisonous food, has the entity taken the action that will require a transfer of an economic resource. *Providing customers with poisoned food* is the event that would make the obligation a *present obligation*; and its only at this point in time that all aspects of the liability definition are met. In other words, the entity cannot raise a liability for possible future costs of compensating potentially poisoned customers in the future, before it has actually caused the illness.

iv. For the Obligation to pay for goods ordered (assuming there is an obligation that the entity has no practical ability to avoid), only once the entity has obtained control over the goods, has the entity *obtained the economic benefits that* will require a transfer of an economic resource. *Obtaining control over the ordered goods* is the event that would make the obligation a *present obligation*; and it's only at this point in time that all aspects of the liability definition are met. In other words, the entity cannot raise a liability for goods that it has ordered.

And so, we need to distinguish between whether there is an obligation firstly, and secondly what event has caused that obligation to become present, or 'current'. So long as the obligation is present and will require a transfer of economic resources, the liability definition has been met.

Although the definition of liabilities that we've discussed is different to that of the old Conceptual Framework and IAS 37, in almost all instances, we expect that the outcome of applying either definition will be the same. At this point, you may be wondering what the point of changing the definition was? A valid question! But we hope that in due course, you will come to appreciate that the changes *are* helpful in addressing some of the problems associated with identifying that mysterious and obscure point in time, where no liability now becomes a liability.