

# Financial Accounting Series

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EXPOSURE DRAFT

## Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities

### **an amendment of FASB Concepts Statement No. 6**

This Exposure Draft of a proposed amendment to a Statement of Financial Accounting Concepts is issued by the Board for public comment. Written comments should be addressed to:

Director of Research and Technical Activities  
File Reference No. 213-C

Comment Deadline: March 31, 2001



Financial Accounting Standards Board  
of the Financial Accounting Foundation

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To be timely, comments should be postmarked by March 31, 2001. Comments also can be submitted by electronic mail to [director@fasb.org](mailto:director@fasb.org). Respondents submitting comments by electronic mail should clearly identify themselves and the organization they represent.

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<p style="text-align: center;"><b>Notice of Recipients of This Exposure Draft</b></p>
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As part of its broad project on financial instruments, the Board is addressing issues related to distinguishing between liabilities and equity. Concurrent with the issuance of this Exposure Draft, the Board has issued an Exposure Draft, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both*. During the deliberations that led to that Exposure Draft, the Board decided that certain financial instrument components embodying obligations that require (or permit at the issuer's discretion) settlement by issuance of equity shares should be classified as liabilities. Those components would not have been classified as liabilities under the original definition of liabilities in FASB Concepts Statement No. 6, *Elements of Financial Statements*. This amendment addresses that inconsistency between the decisions reached in the liabilities and equity Exposure Draft and the distinction between liabilities and equity in Concepts Statement 6.

*Issue:* The Board has concluded that certain obligations that require (or permit at the issuer's discretion) settlement by issuance of the issuer's equity shares should be classified as liabilities. That conclusion necessitates an amendment to the definition of liabilities in Concepts Statement 6. Do you agree with the proposed changes to the definition of liabilities?

## Summary

FASB Concepts Statement No. 6, *Elements of Financial Statements*, defines liabilities as follows:

Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. [Paragraph 35; footnote references omitted.]

This proposed amendment to Concepts Statement 6 would revise that definition to also include as liabilities certain obligations that require or permit settlement by issuance of the issuer's equity shares and that do not establish an ownership relationship.

**Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities**

**an amendment of FASB Concepts Statement No. 6**

**October 27, 2000**

**CONTENTS**

	Paragraph Numbers
Introduction and Background Information .....	1–2
Amendments to Concepts Statement 6 .....	3–5
Appendix A: Basis for Conclusions.....	6–12
Appendix B: Amended Paragraphs of Concepts Statement 6, Marked to Show Changes That Result from This Amendment .....	13–14

## **Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities**

### **an amendment of FASB Concepts Statement No. 6**

**October 27, 2000**

#### **INTRODUCTION AND BACKGROUND INFORMATION**

1. FASB Concepts Statement No. 6, *Elements of Financial Statements*, was issued in December 1985 and replaced FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises*. Concepts Statement 6 defines 10 elements of financial statements: 7 elements of financial statements of both business enterprises and not-for-profit organizations and 3 elements of financial statements of business enterprises only.<sup>1</sup> Included in that set of 10 elements are liabilities and equity (or net assets, in the case of not-for-profit organizations).

2. As part of the liabilities and equity portion of its financial instruments project, the Board issued an Exposure Draft of a proposed Statement, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both*. During the deliberations that led to that Exposure Draft, the Board decided that certain financial instrument components embodying obligations that require (or permit at the issuer's discretion) settlement by issuance of equity shares should be classified as liabilities. This amendment changes the definition of liabilities so that the definition accommodates those financial instrument components.

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<sup>1</sup>The seven elements of financial statements of both business enterprises and not-for-profit organizations are assets, liabilities, equity (business enterprises) or net assets (not-for-profit organizations), revenues, expenses, gains, and losses. The three elements of financial statements of business enterprises only are investments by owners, distributions to owners, and comprehensive income.

## AMENDMENTS TO CONCEPTS STATEMENT 6

3. Concepts Statement 6 is amended as follows:

a. The following footnote is added to the word *assets* in paragraph 35:

\*Certain obligations, primarily financial instruments or components of compound financial instruments, require or permit settlement by issuance of equity shares. If those financial instrument components establish a relationship between the issuer and the holder that is not an ownership relationship, they are liabilities. References throughout this Concepts Statement to liabilities as requiring a transfer or sacrifice of assets also include those limited situations in which an obligation that can or must be settled by issuance of the reporting entity's equity shares does not establish an ownership relationship. A financial instrument component establishes an ownership relationship if it (1) is an outstanding equity share that is not subject to mandatory redemption provisions or (2) is an obligation that can or must be settled by issuance of the issuer's equity shares and, to the extent the value that must be conveyed to the holder of the financial instrument upon settlement of the obligation at its maturity changes, the change is attributable to, equal to, and in the same direction as the change in fair value of the issuer's equity shares.

b. The following is added to the end of paragraph 196:

Additionally, certain obligations require or permit settlement by issuance of equity shares but do not establish ownership relationships. In those circumstances, shares of an entity's stock are essentially being used in lieu of assets to settle an obligation that meets the definition of a liability.

4. FASB Statement No. 1XX, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both*, identifies the criteria for determining when the relationship between the issuer and the holder is not an ownership relationship.

5. Appendix B to this Statement contains the amended paragraphs of Concepts Statement 6, marked to show the changes that result from this amendment.

## Appendix A

### BASIS FOR CONCLUSIONS

6. Paragraph 35 of Concepts Statement 6 defines liabilities as follows:

Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. [Footnote references omitted.]

7. Paragraph 36 of Concepts Statement 6 elaborates on that definition by enumerating three essential characteristics of liabilities:

A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened.

8. Paragraph 49 of Concepts Statement 6 defines equity as “the residual interest in the assets of an entity that remains after deducting its liabilities.” Paragraph 60 discusses equity in more detail:

In a business enterprise, the equity is the ownership interest. It stems from ownership rights (or the equivalent) and involves a relation between an enterprise and its owners *as owners* rather than as employees, suppliers, customers, lenders, or in some other nonowner role. Since equity ranks after liabilities as a claim to or interest in the assets of the enterprise, it is a residual interest: (a) equity is the same as net assets, the difference between the enterprise’s assets and its liabilities, and (b) equity is enhanced or burdened by increases and decreases in net assets from nonowner sources as well as investments by owners and distributions to owners. [Footnote references omitted.]

9. Obligations that require or permit settlement by issuance of equity shares and that do not establish an ownership relationship have arisen out of recent innovations in

financial markets. Questions have arisen as to whether those financial instrument components are in fact equity. For example, if an entity issues a financial instrument that embodies an obligation that requires settlement by issuance of \$100,000 worth of equity shares, should that obligation be classified as equity? Because of the fixed amount of value that must be conveyed to the holder, the relationship appears to be more akin to a debtor-creditor relationship than an ownership relationship. Unlike an owner of the entity, the holder of the instrument cannot benefit from increases or suffer from decreases in the fair value of the entity's equity shares.

10. During its deliberations on the liabilities and equity portion of its project on financial instruments, the Board considered and rejected an alternative to resolve the accounting issues raised by those financial instruments by strict adherence to the conceptual definitions of liabilities and equity that existed in Concepts Statement 6 before this amendment. The Board concluded that application of those definitions to obligations embedded in financial instruments relied too heavily on whether the issuer was required to transfer assets to settle the obligation. If the issuer had little or no discretion to avoid a transfer of assets to settle the obligation, the obligation was classified as a liability. If, however, the issuer could avoid a transfer of assets and could settle the obligation by issuing equity shares, the obligation was classified as equity without regard to other characteristics of the obligation. The Board decided that it was preferable to revise the definitions and characteristics of liabilities and equity because of concern that relying exclusively on whether an obligation required settlement by a transfer of assets might result in equity classification for certain obligations at the margin that do not have the characteristics of equity described in Concepts Statement 6.

11. The Board concluded that a fundamental basis for determining whether a financial instrument component should be classified as a liability or as equity is the nature of the relationship that the component establishes between the issuer and the holder. For most common types of financial instruments, the original definitions in Concepts Statement 6 appropriately reflected those relationships. The Board believes, however, that the original definitions did not encompass certain financial instrument components in which the type of relationship established was akin to a debtor-creditor relationship.

12. Obligations that require settlement by a transfer of assets meet the original definition of liabilities in Concepts Statement 6. Those obligations are probable future sacrifices of economic benefits arising from present obligations to transfer assets in the future as a result of past transactions or events. Those obligations will continue to be classified as liabilities under the amended definition because they provide no basis for establishing an ownership relationship between the holder and the issuer. Statement 1XX provides guidance on determining whether an ownership relationship exists. If an ownership relationship exists, the instrument should be classified as equity.

## Appendix B

### AMENDED PARAGRAPHS OF CONCEPTS STATEMENT 6, MARKED TO SHOW CHANGES THAT RESULT FROM THIS AMENDMENT

13. Paragraph 35 of Concepts Statement 6 is amended to read as follows:

Liabilities are probable<sup>21</sup> future sacrifices of economic benefits arising from present obligations<sup>22</sup> of a particular entity to transfer assets\* or provide services to other entities in the future as a result of past transactions or events.

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<sup>21</sup>*Probable* is used with its usual general meaning, rather than in a specific accounting or technical sense (such as that in Statement 5, par. 3), and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved (*Webster's New World Dictionary*, p. 1132). Its inclusion in the definition is intended to acknowledge that business and other economic activities occur in an environment characterized by uncertainty in which few outcomes are certain (pars. 44–48).

<sup>22</sup>*Obligations* in the definition is broader than *legal obligations*. It is used with its usual general meaning to refer to duties imposed legally or socially; to that which one is bound to do by contract, promise, moral responsibility, and so forth (*Webster's New World Dictionary*, p. 981). It includes equitable and constructive obligations as well as legal obligations (pars. 37–40).

\*Certain obligations, primarily financial instruments or components of compound financial instruments, require or permit settlement by issuance of equity shares. If those financial instrument components establish a relationship between the issuer and the holder that is not an ownership relationship, they are liabilities. References throughout this Concepts Statement to liabilities as requiring a transfer or sacrifice of assets also include those limited situations in which an obligation that can or must be settled by issuance of the reporting entity's equity shares does not establish an ownership relationship. A financial instrument component establishes an ownership relationship if it (1) is an outstanding equity share that is not subject to mandatory redemption provisions or (2) is an obligation that can or must be settled by issuance of the issuer's equity shares and, to the extent the value that must be conveyed to the holder of the financial instrument upon settlement of the obligation at its maturity changes, the change is attributable to, equal to, and in the same direction as the change in fair value of the issuer's equity shares.

14. Paragraph 196 of Concepts Statement 6 is amended to read as follows:

Most liabilities presently included in financial statements qualify as liabilities under the definition in paragraph 35 because they require an entity to sacrifice assets in the future. Thus, accounts and notes payable, wages and salaries payable, long-term debt, interest and dividends payable, and similar requirements to pay cash so obviously qualify as liabilities that they need no further comment. Responsibilities such as those to pay pensions, deferred compensation, and taxes and to honor warranties and guarantees also create liabilities under the definition. That they may

be satisfied by providing goods or services instead of cash, that their amounts or times of settlement must be estimated, or that the identity of the specific entities to whom an entity is obligated is as yet unknown does not disqualify them under the definition, although some may not be recognized because of uncertainty or measurement problems (paragraphs 44–48). Additionally, certain obligations require or permit settlement by issuance of equity shares but do not establish ownership relationships. In those circumstances, shares of an entity’s stock are essentially being used in lieu of assets to settle an obligation that meets the definition of a liability.