



**Board Meeting Handout  
Conceptual Framework – Elements Phase  
May 7, 2008**

**PURPOSE OF THIS MEETING**

1. The purpose of this meeting is for the Board to discuss two issues that relate to the definition of a liability that is being developed in Phase B of the joint conceptual framework project. Those two issues are (a) distinguishing between a liability and business risk and (b) identifying what constitutes a stand ready obligation.

**BACKGROUND**

2. Following the IASB's and FASB's discussions in December 2007, the working definition of a liability is as follows:

A *liability* of an entity is a present economic obligation that is enforceable against the entity.

- a. *Present* means that the economic obligation exists on the date of the financial statements.
- b. An *obligation* establishes the link between the entity and that which it has to do.
- c. An *economic* obligation is something that is capable of resulting in cash outflows or reduced cash inflows, directly or indirectly, alone or together with other economic obligations.
- d. Obligations are *enforceable* against the entity by legal or equivalent means.

**ISSUE 1—DISTINGUISHING BETWEEN A LIABILITY AND BUSINESS RISK**

**Liability**

3. The working definition emphasizes the need to identify a *present* economic obligation, instead of searching for the transaction or event that created it. Identifying the transaction or event can provide evidence to support a present economic obligation, but it is not essential. Thus, the working definition focuses on the existence of a present economic

obligation based on evidence available at a point in time—at the date of the statement of financial position—as to whether there is “something” that is capable of resulting in cash outflows or reduced cash inflows, directly or indirectly, alone or together with other economic obligations.<sup>1</sup>

4. The working definition goes on to explain that obligations are enforceable against the entity by legal or equivalent means. Thus, there is an external party that can make the entity fulfill the obligation and, if required, can seek enforcement of it through legal or equivalent means. In other words, the entity cannot, through its own actions, avoid the obligation or the required cash outflows.

## **Business Risk**

5. U.S. Standards and IFRS literature do not define business risk. The staff thinks that business risk is an ‘umbrella’ or ‘catchall’ term that captures all risks faced by an entity as a result of its business activities.
6. Building on this assertion, the staff thinks that business risks result from where, when, and how an entity conducts its business. Some business risks result from an entity’s transactions: for example, selling goods in overseas markets might expose an entity to the risk of future cash flow fluctuations because of changes in foreign exchange rates. Other business risks result from an entity’s operating environment: for example, operating in a highly specialized industry might expose an entity to the risk that it will be unable to attract sufficiently skilled staff to sustain its operating activities. The staff thinks that its description of business risk is reasonably consistent with the definitions of ‘risk’.

## **Staff Analysis**

7. Based on the descriptions above, the staff thinks that a liability and a present business risk both are capable of resulting in cash outflows. (A risk can also contribute to producing cash inflow (upside risk).) What distinguishes a liability from a business risk is that, in the case of a liability, the entity is presently obligated to making that cash outflow or to stand ready to do so, whereas in the case of a business risk, that cash outflow might

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<sup>1</sup> For simplicity, the remainder of the handout uses the phrase “cash outflows” to refer to both cash outflows and reduced cash inflows, directly or indirectly, alone or together with other economic obligations.

occur sometime in the future, or might not occur at all. That is, for a liability to exist there must be a present economic obligation<sup>2</sup>.

8. A liability exists when an entity is unable to avoid the consequences. The working definition of a liability requires that an obligation must be enforceable against the entity such that an external party can take actions to make the entity fulfill the obligation.
9. A business risk might exist on the statement of financial position date and the entity might be required in the future to make a cash outflow as a result of that risk, but an entity does not have a *present obligation* as a result of a business risk on the statement date. This is because an entity can choose to take action to avoid or mitigate the effect of a risk and reduce or obviate the cash outflow. No third party can force the entity to fulfill or make a cash outflow solely as the result of a business risk.
10. **Do Board members agree that the existence of a present economic obligation distinguishes a liability from a business risk?**

## **Constituents' Concerns**

11. Constituents' remarks in their comment letters to the IASB Exposure Draft, *Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits* (IASB ED), and at the IAS 37 round-tables suggest that the current description of a present obligation in IFRS is not sufficiently clear. Similarly, the constituent's remarks in their comment letters to the FASB Invitation to Comment, *Selected Issues Relation to Assets and Liabilities with Uncertainties*, which was based on the IASB ED, suggest that there is insufficient guidance on what constitutes an obligating event in the existing liability definition. As a result, there is some confusion about when and why an entity is truly obligated, and therefore a liability exists. Expressed in context of the working definition of a liability, constituents need more guidance on how to determine the existence of a *present obligation*.

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<sup>2</sup> For simplicity, the remainder of the handout uses the phrase "obligation" to refer to economic obligation as the financial implication or economic nature of the obligation is known.

12. Based on staff analysis, (see Appendix), the staff have identified the following key points regarding *present* obligations:
- a. Operating in a jurisdiction subject to a law (including contract law), statute or regulation, by itself, **does not** give rise to a present economic obligation and hence, does not satisfy the definition of a liability. A qualifying action or event must have occurred on or before the date of the statement of financial position
  - b. An action or event, by itself, does not give rise to a present economic obligation if there is no mechanism that establishes an external party's right or other ability to call upon the entity
  - c. A *future* action or event in a jurisdiction where there is a mechanism that establishes an external party's right or other ability to call upon the entity does not give rise to a present economic obligation. An economic obligation must exist **on** the date of the statement of financial position
  - d. Making or receiving an offer that can be withdrawn and is not binding does not give rise to a present economic obligation, does not satisfy the definition of a liability
  - e. A past action or event resulting in a present breach of an existing law (including contract law) or regulation **does give rise** to a present economic obligation and, hence, may satisfy the definition of a liability
  - f. An ability to control **when** an economic obligation will be settled does not change the fact that a liability exists
  - g. Uncertainty about future events or the actions of others does not change the fact that a liability exists
13. The staff has concluded that a present obligation is an essential characteristic of a liability but not a business risk. A present obligation exists when:
- a. An entity is **committed** to a particular action(s) that is **capable of resulting in cash outflows**, and

- b. There is a **mechanism to enforce** that economic obligation against the entity.

Laws (including contract law) and regulations by themselves are not present obligations. But they are examples of mechanisms that enable an external party to enforce an economic obligation against the entity because they establish an external party's right or other ability to call upon the entity to fulfil an obligation.

- 14. A business risk might exist on the date of the statement of financial position. In the future, the entity might have an economic obligation as a result of the risk, but on the statement date, an entity does not have a *present* economic obligation as a result of a business risk. This is because an entity can choose to take action to avoid or mitigate the effect of a risk.
- 15. **Do Board members agree with the staff's key points and tentative conclusions laid out in paragraphs 12 through 14 of the handout?**

## **ISSUE 2—IDENTIFYING WHAT CONSTITUTES A STAND READY OBLIGATION**

### **Amplifying Text to Definitions of Asset and Liability**

- 16. To be clear regarding the application of the definitions to contractual obligations, the proposed amplifying text to the definitions of an asset and a liability will outline how inbound and outbound obligations may be:
  - a. *Conditional*—Performance of the obligation is subject to an event that is not certain to occur.
  - b. *Unconditional*—Nothing other than the passage of time is necessary for performance of the obligation to occur.
  - c. *Mature*—Performance of the obligation is not subject to any event, including the passage of time<sup>3</sup>.
- 17. In the context of the liability definition, an outbound contractual promise that is conditional would not be an economic obligation because its performance is **not** presently required until the uncertain future event occurs. However, an outbound contractual

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<sup>3</sup> The descriptions of the different types of contractual obligations have been previously discussed in the conceptual framework and other joint projects, such as revenue recognition.

promise that is unconditional or mature (that is, non-conditional) may qualify as a present economic obligation because its performance is presently required.

18. Some Board members have questioned whether it is more confusing than beneficial to analyze contracts and other binding arrangements into unconditional and/or conditional obligations.
19. The staff believes such analyses could help to identify and communicate when unconditional obligations exist and the definition of a liability is met.
20. Entities commonly enter into contracts in which they agree to perform in the future if a specified event occurs. In such situations, an entity may have only a passive role until the specified event occurs. As a result, some think that no liability exists until the specified event occurs and the entity is required to perform, which is viewed as taking an active role. Such an approach focuses on the outcome of a contract and not on what the contract presently requires the entity to do.
21. For example, some think that an entity which has guaranteed another party's debt to a lender does not have a liability until the other party defaults and the entity is required to pay the lender. However, providing a financial guarantee does require the entity to provide a service before the party defaults, that is, the entity provides credit protection to the lender while the other party's debt is outstanding. This is a requirement that the entity cannot avoid because the lender has the ability to demand and enforce that requirement against the entity. The nature of this commitment is also demonstrated by how the entity would have to compensate the lender if the entity were to cease providing the credit protection. Regardless of whether or not the entity is ever called upon to pay the debt, the entity is obliged to provide credit protection service to the lender. Though providing this service may appear to be passive, providing credit protection could result in the entity having to reserve its cash resources or arrange financing in case it is called upon to pay the debt, each of which has a cost to the entity.
22. To help identify the different requirements for which an entity is obligated in contracts and other binding arrangements, the staff thinks that it is useful to analyze the types of

obligations an entity has undertaken. There are two types of obligations, those that require performance to occur if an uncertain future event occurs, and those that require performance to occur now or over a period of time. In the financial guarantee example, the requirement to pay the debt if the other party defaults is an obligation that requires performance if and when an uncertain future event (default) occurs. In contrast, providing credit protection is an obligation that requires performance to occur now and over a period of time; because it can result in cash outflows, directly or indirectly, it gives rise to a liability.

23. To communicate in a clear manner, the staff proposes to call these obligations conditional and unconditional, respectively. Based on staff analysis, contracts and other binding arrangements that involve a conditional obligation often also involve an accompanying unconditional obligation. Accordingly, unconditional and conditional obligations are useful tools to help identify and communicate the different types of obligations that exist in contracts and other binding arrangements. If a conditional obligation is identified that would direct one to seek whether there also is an accompanying unconditional obligation.
24. **Do the Board members agree that it is: (a) helpful to analyze contracts and other binding arrangements to identify whether they contain unconditional and conditional obligations; and that (b) unconditional obligations exist when an external party can enforce the obligation against the entity?**

### **Noncontractual Scenarios**

25. The staff thinks that the notion of a 'stand ready obligation' describes those present unconditional obligations whereby an external party can enforce the obligation against the entity, but may not do so, and is accompanied by a conditional obligation. The external party can enforce the obligation against the entity because it has a present enforceable right to call upon an entity to act in a certain way in the future, but either the circumstances entitling the external party to exercise its right may not arise or it may elect not to exercise the right. The impact of the party's election on the unconditional obligation could be considered in the measurement of the unconditional obligation.

26. The staff agrees that contracts are the clearest and most prevalent examples of stand ready obligations. However, the staff thinks that the notion of a stand ready obligation can be extended to noncontractual scenarios. The staff has identified two different scenarios when the notion of a stand ready obligation might apply: (a) offers enforceable at law, and (b) statutes and regulations.

### **Offers Enforceable at Law**

27. An entity might make an offer to provide a good or perform a service in the future, but that offer has not yet been accepted and no consideration has changed hands. As a result, the offer is not yet captured by contract law. However, in some jurisdictions another law may state that an offer is irrevocable. For example, the Uniform Commercial Code (UCC) in the United States states that “firm offers” are irrevocable if the offeror gives written assurance that an offer will be held open. In such circumstances, although there is no contract, the offeror *stands ready* to honour the offer.
28. At this stage, the staff thinks that it is important to emphasise that only binding offers like firm offers under the UCC are stand ready obligations. Non-binding offers do not give rise to a present obligation; and hence no liability exists.

### **Statutes and Regulations**

29. FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, provides an example of a statutory stand ready obligation. In this example, the entity’s past actions mean that the entity is legally required to perform asset retirement activities. The government may call upon the entity to perform asset retirement activities, or the government may choose to waive the entity’s legal requirement to perform asset retirement activities. But the entity must *stand ready* to perform, regardless of the government’s ultimate decision.
30. At this stage, the staff thinks that it is important to emphasize that an entity simply operating in a jurisdiction in which it is subject to a particular law, statute or regulation does not give rise to a stand ready obligation to comply. An action or event is also required.

## Staff Analysis

31. The staff thinks that it is appropriate to use the notion of a stand ready obligation in each of those two scenarios—when offers are enforceable at law or under statutes and regulations. This is because in both scenarios an unconditional obligation exists whereby an external party can enforce the present obligation against the entity, but may not do so, and is accompanied by a conditional obligation.
32. **Do Board members agree that the notion of a stand ready obligation can be applied to noncontractual scenarios? If not, why?**

### **Do We Need the Term *Stand Ready Obligation*?**

33. The staff agrees that explaining when and why a liability exists is more important than the term we attach to that explanation. The staff also agrees that the *notion* of a stand ready obligation identifies more precisely the nature of the liability in existence at the statement date.
34. In support of using the term *stand ready obligation*, the staff notes that:
  - a. Clarifying the distinction between a liability and a business risk (memorandum B) and explaining what a stand ready obligation (see section 1 of this paper) may alleviate some of the concerns and confusion expressed in the comment letters and at the round-tables.
  - b. The term ‘stand ready obligation’ is used regularly in U.S. Standards. Using different words to explain the same notion in IFRS literature could increase, rather than decrease confusion.
  - c. Time is required to establish a familiarity with any new term. As noted by one round-table participant, some members of the IASB insurance working group have become increasingly familiar with the term ‘stand ready obligation’ over time.
  - d. The term is useful short-hand for the detailed analysis in this paper and in memorandum B.
35. On the other hand, in support of dropping the term *stand ready obligation*, the staff:

- a. Agrees with those round-table participants who argued that explaining when and why a liability exists is more important than the term we attach to that explanation.
  - b. Notes that the recognition principle in GAAP is to recognize items that satisfy the definition of a liability. In memorandum B, we were able to analyze when and why a liability exists **without** using the term *stand ready obligation*.
  - c. Is concerned that distinguishing features of a stand ready obligation (compared to all other present obligations) may be too subtle to be useful and may not translate easily.
  - d. Notes that it could decrease the confusion that a stand ready obligation is a synonym for a contingent liability when it is not.
36. The staff acknowledges that whether or not we use the term *stand ready obligation*, it does not eliminate the need to clarify the important notion being conveyed.
37. On balance, the staff proposes to use the term *stand ready obligation* but will consider other phrases or terms when drafting and in conjunction with the IAS 37 project team.
38. **Do Board members agree to retain the term stand ready obligation?**

## Appendix

1. In this appendix, the staff analyzes two scenarios, and different examples of those scenarios, to explain how, when and why a business risk becomes a present obligation and therefore meets the definition of a liability. The staff thinks that these scenarios also illustrate the tension points and potential inconsistencies associated with this issue. Therefore, when appropriate, the analysis includes an alternative view.
2. It is important to note that this analysis focuses only on risks that could have a negative financial effect. This analysis excludes non-financial risks (for example, a restriction on one's freedom of speech) and future risks (for example, anticipated loss of future sales) because neither of these risks is capable of resulting in a liability for financial reporting purposes.

### Scenario 1: Digger

**1A** Digger has the right to mine in two jurisdictions.

In Jurisdiction A, environmental rehabilitation laws state that all mine shafts deeper than 10 metres must be entirely filled in by December 31, 2020 or the mining company that dug the shafts will be fined \$100,000 per unfilled shaft.

Jurisdiction B has no environmental rehabilitation laws.

The geologists' reports indicate that Digger will be able to extract significant quantities of ore for at least 20 years in both jurisdictions. The ore is located 15 meters below the surface in both jurisdictions.

On the date of the statement of financial position, Digger has not started mining in either jurisdiction.

3. On the date of the statement of financial position, Digger does not have an obligation because Digger is not required to mine in either jurisdiction, and no external party could enforce or has a right to call upon Digger to take an action as result of mining in either

jurisdiction. In other words, Digger can simply walk away from the status quo on the statement date.

4. Digger has a risk of potentially incurring more costs for mining in Jurisdiction A. But the ability of an entity to mine in a jurisdiction that is subject to environmental rehabilitation laws do not give rise to a present obligation.

**1B** Facts as in 1A, except that Digger has started mining in both jurisdictions.

At the date of the statement of financial position, Digger has mined five shafts in Jurisdiction A and five shafts in Jurisdiction B. Each shaft is 5 meters deep.

### **Jurisdiction A**

5. At the statement of financial position date, Digger does not have an obligation in Jurisdiction A because each shaft is less than 10 meters deep and Digger is not required by the environmental rehabilitation laws to fill the shafts that already exist. In other words, the environmental rehabilitation laws do not impose upon Digger any requirement that is capable of resulting in cash outflows. Instead, at the statement date, Digger has a risk of having to fill the shafts if they are dug another 5 meters deeper.
6. Based on the facts outlined in this example, it is highly likely that Digger will mine beyond 10 meters *in the future* and therefore will be required to fill each shaft. However, a present *intention* to mine beyond 10 meters in the future is not the same as a present *obligation* as a result of mining beyond 10 meters. Digger can choose not to mine beyond 10 meters and no external party can enforce or has a right to call upon Digger to mine beyond 10 meters. In other words, Digger can simply walk away from the status quo on the statement of financial position date.
7. Also, no external party has an enforceable right to call upon Digger to fill shafts that are less than 10 meters deep.

## **Jurisdiction B**

8. At the statement date, Digger does not have an obligation or a risk in Jurisdiction B because there are no environmental laws requiring Digger to fill any mine shafts, no matter how deep Digger has mined or how deep Digger intends to mine in the future. Also, no external party has an enforceable right to call upon Digger to fill the shafts because there are no environmental laws requiring Digger to fill any mine shafts.
9. **This example demonstrates that:**
  - a. **Operating in a jurisdiction subject to a law, statute or regulation, by itself, does not give rise to a present obligation because a qualifying action or event must have occurred on or before the statement date**
  - b. **An action or event, by itself, does not give rise to a present obligation if there is no law or equivalent mechanism to enforce the obligation against the entity**
  - c. **A future action or event in a jurisdiction where there is a mechanism to enforce the obligation does not give rise to a present obligation.**

<b>1C</b> Facts as in Example 1B, except that each shaft is 12 meters deep on the statement of financial position date.
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## **Jurisdiction A**

10. At the statement date, Digger has a present obligation in Jurisdiction A because each shaft is more than 10 meters deep and the environmental rehabilitation laws require Digger to fill the shafts on or before December 31, 2020 (or pay the fine). The governing body that established and enforces the environmental rehabilitation law can demand Digger obey the law and fill the five shafts (in the future). If Digger refuses to do so, the governing body could take legal action against Digger to force Digger to do so. Filling the shafts is capable of resulting in Digger making cash outflows – either having workers fill the shafts or paying the fine.

11. Based on the facts outlined in this example, it is highly likely that Digger will mine a further 3 meters *in the future* (to reach the ore) and, therefore, will be required to fill five 15 meter shafts. However, as noted in Example 1B, a present intention is not the same as a present obligation. Digger may choose not to mine a further 3 meters. As at the statement of financial position date, Digger's present obligation is limited to that related to 12 meter shafts.
12. As well, the governing body that established and enforces the environmental rehabilitation law has an enforceable right to call upon Digger to fill the five 12 metre deep shafts that already exist on 31 December 2020 (or pay the fine).

### **Jurisdiction B**

13. Digger does not have an obligation or a risk in Jurisdiction B, for the same reasons given in Example 1B.
14. **This example demonstrates that:**
  - a. **A past action or event resulting in a present breach of an existing law or regulation does give rise to a present obligation**
  - b. **An action or event, by itself, does not give rise to a present obligation if there is no law or equivalent mechanism to enforce the obligation against the entity.**

<b>1D</b> Facts as in Example 1C, except that the law in Jurisdiction A requires that all mine shafts deeper than 10 metres must be entirely filled "when mining operations cease."
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### **Jurisdiction A**

15. On the statement date, Digger has an obligation in Jurisdiction A, for the same reasons given in Example 1C.
16. The staff acknowledges that Digger can choose **when** to cease mining each shaft and that the governing body that established and enforces the environmental rehabilitation law could not enforce Digger to fill the five shafts **until** he ceases mining. However, Digger

can **either** continue mining **or** as required by the law fill the five shafts that already exist. In other words, Digger cannot walk away from its present obligation on the statement date, even though he can control **when** to incur the cash outflows to settle the obligation.

17. As well, the governing body that established and enforces the environmental rehabilitation law has an enforceable right to call upon Digger to either continue mining or fill the five shafts that already exist (or pay the fine).
18. Some may argue that, on the statement date, Digger does not have a present obligation because Digger is not required to fill the mine shafts until he ceases mining. Thus, Digger can avoid filling the five mine shafts by continuing to mine. The staff does not agree with this view because, presumably, there is a finite period to Digger's mining activities, even though Digger thinks that he will be able to extract ore for at least another 20 years. At the statement date, Digger may not be able to predict exactly when he will cease mining, but this does not affect the existence of an obligation for environmental rehabilitation.
19. Moreover, the staff thinks that its conclusion in Example 1D is consistent with its conclusion in Example 1B: that we cannot use a present intention to conclude that a liability exists. Logically, we therefore cannot use Digger's present intention to continue mining to conclude that an obligation does not exist on the statement date.
20. **This example demonstrates that an ability to control *when* an obligation will be settled does not change the fact that a liability exists.**

**1E** Facts as in Example 1C, except that Digger has **offered** to apply the same standards as in Jurisdiction A to both existing and future mine sites in Jurisdiction B if the local municipal council extends its right to mine in Jurisdiction B for another 15 years. Digger’s offer is not binding until accepted. On the statement date the municipal council has not accepted Digger’s offer.

Background facts: There is no possibility that a court would enforce Digger’s offer until the offer is accepted by the municipal council.<sup>4</sup>

21. On the statement date, Digger does not have an obligation in Jurisdiction B because the municipal council has not accepted its offer. As a result, Digger is not committed to fill the shafts that already exist and are deeper than 10 meters, Digger can avoid this commitment by withdrawing its offer, and no external party can enforce Digger to fill the shafts that already exist and are deeper than 10 meters. By extending the offer to the municipal council, Digger has created a risk that it might have to fill the shafts.
22. Some may argue that, at the statement date, Digger has an obligation because it has not yet withdrawn its offer to the municipal council. Digger is not committed to fill the shafts that already exist and are deeper than 10 meters, but it is committed to honoring the offer. In other words, Digger must honor its offer until either the municipal council accepts the offer, or it withdraws the offer.
23. The staff acknowledges that Digger cannot simply walk away from its offer on the statement date because Digger must inform the municipal council that it is withdrawing its offer. In some jurisdictions, if the municipal council accepts the offer before Digger withdraws it, Digger would have to honour the offer. However, according to the facts in Example 1E, no court in this jurisdiction would enforce Digger’s offer until the offer is accepted by the municipal council. Thus, the staff does not support this view because, on the statement date, no external party can enforce Digger to leave its offer on the table and honour its offer. The municipal council must accept Digger’s offer and extend Digger’s right to mine in Jurisdiction B for another 15 years before they have an enforceable right

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<sup>4</sup> In certain jurisdictions, such as the United States, this is not a firm offer as defined under the Uniform Commercial Code.

to call upon Digger to honour its offer, and if necessary, enforce Digger to honour its offer.

24. **This example demonstrates that:**

- a. **A future action or event in a jurisdiction where there is a mechanism to enforce the obligation does not give rise to a present obligation**
- b. **Making or receiving an offer that can be withdrawn and is not binding does not give rise to a present obligation.**

<b>1F</b> Facts as in Example 1E, except that the municipal council has accepted Digger's offer.
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25. At the statement date, Digger has a liability in Jurisdiction B to fill the five shafts that already exist and are deeper than 10 meters, for the same reasons given in Example 1C for Jurisdiction A. Digger does not have an obligation to fill *future* mine shafts, for the same reasons given in Example 1A.

26. In this example, the contract between Digger and the municipal council has the same effect as the law in Jurisdiction A because both the law in Jurisdiction A and the contract law in Jurisdiction B are mechanisms that establish the obligation to fill the qualifying shafts. From the external party's perspective, the mechanisms establish its right to call upon Digger to fill those shafts and provide an ability to enforce those rights, if necessary.

27. **This example demonstrates that a past action or event resulting in a present breach of an existing law or regulation does give rise to a present obligation.**

## SCENARIO 2: Auto

**2A** Auto sells car breakdown services. Auto's standard services agreement states that Auto will repair all cars contracted for that break down over 12 months from the date the agreement is signed. Auto reserves the right to inspect each car before entering into a services agreement. Once signed, the services agreement is non-cancellable.

Auto recently mailed standard services agreements to 50 drivers offering 12 months breakdown service at market rates, waiving the right to inspect each car if the driver returns a signed services agreement on or before January 31, 2011. Auto cannot withdraw the offer.

On December 31, 2010, no drivers have returned a signed services agreement.

Assumption: no signed services agreements are in the post.

28. On December 31, 2010, Auto has a liability because it has waived the right to refuse to enter into a services agreement. As a result,
- a. Auto must accept a signed standard services agreement if a driver returns a signed services agreement on or before January 31, 2011
  - b. Auto cannot avoid this commitment because he cannot withdraw the offer or influence each driver's decision to return a signed agreement
  - c. Each of those 50 drivers can enforce or has an enforceable right to call upon Auto to sign a services agreement if they return a signed services agreement to Auto on or before January 31, 2011.
29. Based on the facts in this example, it is not certain if any of the 50 drivers will return a signed services agreement. However, in effect, Auto has written an option. As a result, Auto has no realistic alternative but to accept any returned, signed services agreements. If Auto did not accept a signed services agreement, the driver who signed the agreement

could force Auto to honour the offer to provide services and if necessary, take legal action to do so. In other words, Auto cannot simply walk away from its offer on the statement date and this offer is capable of resulting in a cash outflow.

30. Some may argue that, on December 31, 2010, Auto does not have a liability because no drivers have returned a signed services agreement. Until a driver returns a signed services agreement, that driver cannot demand or force Auto to provide breakdown services.
31. The staff agrees that, on December 31, 2010, Auto does not have a liability to provide breakdown services. But the staff thinks that Auto does have a liability to honour the offer to those 50 drivers for the reasons outlined above. *Those drivers have an enforceable right to force Auto to accept the signed services agreements.*
32. The staff thinks that its conclusion is consistent with Example 1E. In this example, Auto cannot withdraw the offer (the offer is irrevocable) therefore a liability exists. In Example 1E, Digger's offer to the municipal council was not binding until accepted and the council extends Digger's right to mine in Jurisdiction B for another 15 years, so no liability exists. However, in example 1F, Digger's offer has been accepted and is binding, so a liability exists.
33. **This example demonstrates that uncertainty about future events or the actions of others does not change the fact that a liability exists.**

**2B** Facts as Example 2A, except that on December 31, 2010 one driver has returned a signed services agreement for one car used as part of its regular business operations. The period of the agreement is December 1, 2010 – November 30, 2011. On December 31, 2010, Driver’s car does **not** require repair.

Assumption: it is certain that Driver’s car does not require repair – there are no incurred but not reported (IBNR) breakdowns requiring repair.

34. On December 1, 2010, Auto made two promises to Driver. The first promise was to repair Driver’s car if it breaks down on or before November 30, 2011. The second promise was to protect Driver against the risk that the car might break down on or before November 30, 2011. The services agreement does not resolve whether Driver’s car will break down and require repair, but the agreement confirms that Auto has assumed that risk on Driver’s behalf for a 12-month period.
35. On December 31, 2010, Auto’s first promise (to repair if car breaks down) does not meet the definition of a liability because Driver’s car does not require repair. However, Auto’s second promise (to protect Driver against risk of breakdown) satisfies the definition of a liability because:
- a. Auto is committed to protect Driver against the risk that the car might break down for the next 11 months
  - b. Auto cannot avoid this commitment because the agreement is non-cancellable
  - c. Driver can enforce or has an enforceable right to call upon Auto to protect Driver against the risk that the car might break down during the next 11 months.

In other words, on the statement date, Auto cannot simply walk away from its obligation to protect Driver from the risk of breakdown for the next 11 months. Protecting Driver against the risk that the car might break down during the next 11 months satisfies the definition of a liability because Auto is providing a service that is capable of resulting in a cash outflow.

36. Some may argue that, on December 31, 2010, Auto has made just one promise to Driver—to repair Driver’s car if it breaks down on or before November 30, 2011 (the first promise). Therefore, Auto does not have a liability because there is no cash outflow until Driver’s car breaks down.
37. The staff does not agree with this view because providing a service (such as risk protection) is capable of resulting in cash outflows, directly or indirectly, to be ready and able to provide the service when needed. Moreover, the services agreement is non-cancellable, so Auto cannot avoid protecting Driver against the risk that the car might break down during the next 11 months.
38. **This example demonstrates that:**
- a. **Operating subject to a contract, by itself, does not give rise to a liability because a qualifying action or event must have occurred on or before the statement of financial position date**
  - b. **Uncertainty about future events or the actions of others does not change the fact that a liability exists.**

**2C** Facts as Example 2B, except that Driver and Auto can both cancel the services agreement with one month’s notice.

39. The staff continues to think that on December 1, 2010, Auto made two promises to Driver (the same as Example 2B). On December 31, 2010, the first promise does not satisfy the definition of a liability, but the second promise does.
40. However, there is one important difference in this example. In Example 2B, Auto’s first promise was to repair Driver’s car if it breaks down *on or before November 30, 2011*. Auto’s second promise was to protect Driver against the risk that the car might break down *on or before November 30, 2011*. In this example, both promises are for *1 month only*. This is because:

- a. Auto is only committed to protect Driver against the risk that the car might break down for the non-cancellable period of the services agreement
- b. Auto can avoid the commitment to protect Driver against the risk that Driver's car might break down for the remaining 10 months of the services agreement
- c. Driver cannot enforce or has no enforceable right to call upon Auto to protect Driver against the risk that the car might break down beyond the non-cancellable period.

In other words, Auto cannot simply walk away from its contract with Driver on the statement date, but it can walk away after 1 month.

- 41. Some may argue that Example 2C is the same as Example 2B. In other words, Auto has a liability for the promise to protect Driver against the risk that Driver's car might break down *for the full 12 month period*. This is because, on the statement of date, neither Auto nor Driver has given notice to cancel the agreement. Therefore, *any uncertainty about whether Auto will provide that service for the full 12 month period should be reflected in measurement*.
- 42. The staff does not support this alternative view because, on 31 December 2010, Driver has no enforceable right to call upon Auto to provide a service for the full 12 months. Moreover, the staff thinks that the alternative view is inconsistent with our conclusion in Example 1E.
- 43. (However, the staff thinks that it is important to note that *if* Driver can cancel the services agreement with one month's notice but Auto cannot, Auto has a liability for the promise to protect Driver against the risk that Driver's car might break down for the full 12 month period. This is because, in effect, Auto has written an option: it is irrevocably committed to providing breakdown services *if* Driver wants them.)
- 44. **This example demonstrates that:**
  - a. **Making or receiving an offer that can be withdrawn and is not binding does not give rise to a liability**

- b. **Uncertainty about future events or the actions of others does not change the fact that a liability exists.**

**2D** Facts as Example 2B, except that on December 31, 2010, Driver notifies Auto that the car requires repair. Auto will repair Driver's car in 2011.

45. On December 31, 2010, Auto has a liability to repair Driver's car. A present obligation exists because:
- a. Auto is committed to repair Driver's car as a result of the services agreement
  - b. Auto cannot avoid repairing Driver's car
  - c. Driver can enforce or has an enforceable right to call upon Auto to repair the car.
46. In other words, Auto cannot walk away from its contract with Driver on the statement date. A liability exists because repairing Driver's car is expected to result in cash outflows.
47. On the statement date, Auto also has a liability to protect Driver against the risk that the car might break down during the next 11 months, for the reasons outlined in Example 2B.
48. **This example demonstrates that a past action or event resulting in a present breach of a contract does give rise to a liability.**

**2E** Facts as Example 2B, except that on December 1, 2011, Driver (a) notifies Auto that the car requires repair, and (b) asks Auto to renew the services agreement for another 12 months.

Assumption: it is certain that Driver's car did **not** require repair on November 30, 2011 – no IBNR.

49. On the renewal date of the contract, December 1, 2011, Auto does not have a liability to repair Driver's car because:
- a. Auto is not committed to repair Driver's car if it breaks down after November 30, 2011
  - b. Auto can choose not to renew Driver's services agreement (Auto's offer to waive that right expired on January 31, 2011)
  - c. Unless Auto agrees to renew the services agreement on December 1, 2011, Driver cannot enforce or has no enforceable right to call upon Auto to either repair the car or protect him against the risk that the car will break down again in the next 12 months.

In other words, Auto can walk away from the now-completed contract with Driver on the statement date.

50. **This example demonstrates that making or receiving an offer that can be withdrawn and is not binding does not give rise to a present obligation.**

## WHAT WE HAVE LEARNED

51. The table below summarizes the key points from the examples analyzed above.

Key point	Examples	Conclusion
Operating in a jurisdiction subject to a law (including contract law), statute or regulation, by itself, <b>does not</b> give rise to a present economic obligation and hence, does not satisfy the definition of a liability. A qualifying action or event must have occurred on or before the date of the statement of financial position.	1A, 1B and the first promise in 2B	A liability requires: (a) an economic obligation exists <i>on the statement date</i> – action or event occurred on or before that date, <i>and</i> (b) that there is a mechanism to enforce the obligation upon the entity.
An action or event, by itself, does not give rise to a present economic obligation if there is no mechanism that establishes an external party's right or other ability to call upon the entity.	Jurisdiction B in 1B, 1C	
A <i>future</i> action or event in a jurisdiction where there is a mechanism that establishes an external party's right or other ability to call upon the entity does not give rise to a present economic obligation. An economic obligation must exist <i>on</i> the date of the statement of financial position.	1B and 1E	
Making or receiving an offer that can be withdrawn and is not binding does not give rise to a present economic obligation, does not satisfy the definition of a liability.	1E, 2C and 2E	
A past action or event resulting in a present breach of an existing law (including contract law) or regulation <b>does give rise</b> to a present economic obligation and, hence, may satisfy the definition of a liability.	1C, 1F and 2D	
An ability to control <i>when</i> an economic obligation will be settled does not change the fact that a liability exists.	1D	
Uncertainty about future events or the actions of others does not change the fact that a liability exists.	2A, 2B and 2C	



**Board Meeting Handout  
Proposed FSP EITF 03-6-a**

**May 7, 2008**

At today’s meeting, the Board will discuss the following issues noted in the pre-ballot draft of the proposed FASB Staff Position (FSP) EITF 03-6-a, *Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities*:

1. Consideration of share-based payment awards not expected to vest
2. Effective date and transition.

The Board will also discuss whether to resume the ballot process.

**ISSUE 1—CONSIDERATION OF SHARE-BASED PAYMENT AWARDS NOT EXPECTED TO VEST**

The staff received comments from various constituents on the Board's conclusion at the March 5, 2008 meeting that share-based payment awards not expected to vest should not be considered participating securities and, as a result, should not be included in the calculation of earnings per share (EPS) under the two-class method. The comments are summarized below:

Issue	Comments
Inconsistent treatment of shares not expected to vest in basic and diluted EPS calculations	<ul style="list-style-type: none"> <li>• There is a conceptual inconsistency between the Board's March 5 conclusion and the treatment of share-based payment awards in diluted earnings per share.</li> <li>• Excluding share-based payment awards that are not expected to vest from the computation of EPS using the two-class method creates inconsistency with FASB Statement No. 128, <i>Earnings per Share</i>, and unnecessary complexity in the computation of EPS.</li> <li>• The EPS effect of share-based payment awards with rights to nonforfeitable dividends on EPS should be the same whether or not the awards are expected to vest.</li> </ul>

The staff prepares Board meeting handouts to facilitate the audience's understanding of the issues to be addressed at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect the views of the FASB or its staff. Official positions of the FASB are determined only after extensive due process and deliberations.

Issue	Comments
Differences in EPS based on distributions of earnings	<ul style="list-style-type: none"> <li>The two-class method should reflect the earnings per common share assuming all current period earnings are distributed. However, the Board's decision results in different basic EPS based on whether and how much income is actually distributed. If all participating securities were to be included in the denominator, basic EPS would not differ for changes in actual income distributed.</li> </ul>
International convergence	<ul style="list-style-type: none"> <li>The Board should ensure that the guidance in this FSP will be consistent with conclusions that would be reached under IAS 33, <i>Earnings Per Share</i>.</li> </ul>
Required use of hindsight	<ul style="list-style-type: none"> <li>Prior to FASB Statement No. 123(R), <i>Share-Based Payment</i>, entities were not required to estimate expected forfeitures of share-based payment awards. Therefore, hindsight will likely be required to apply the provisions of this FSP retrospectively to periods prior to the adoption of Statement 123(R) based on the Board's conclusion at the March 5 2008 meeting.</li> </ul>

### Issue 1—Staff Recommendation

To address the comments above, the staff recommends that **all** awards that contain rights to nonforfeitable dividends be considered participating securities. The staff recommends that the FSP exclude from the earnings allocation in computing basic EPS dividends or dividend equivalents that are actually paid, because to do so would include the dividends as both (a) a reduction of earnings available to common shareholders (compensation cost) and (b) a reduction of earnings available to common shareholders (distributed earnings). **Undistributed** earnings should be allocated to all outstanding share-based payment awards, including those that are not expected to vest.

### Issue 1—Question for the Board

*Does the Board agree with the staff's recommendation?*

### ISSUE 2—EFFECTIVE DATE AND TRANSITION

At the March 5, 2008 Board Meeting, the Board concluded that the effective date of this FSP should be the same as the effective date for the standard issued as a result of the EPS

Convergence Project. There are three Views under this issue, as follows:

**View A**

Retain the Board's decision to require an effective date consistent with the anticipated effective date of the pending exposure draft of a standard issued as a result of the EPS Convergence Project. Proponents of this view believe that the Board should minimize the number of times that an entity will have to retrospectively adopt a new standard, so it should coordinate the effective dates of all new guidance related to EPS. Opponents of this view believe that the expected effective date is too long after the issuance of this standard, and that standards should be issued with a specific effective date, rather than linked to standards that have not yet been issued.

**View B**

Issue this FSP with an effective date consistent with the expected effective date of the standard issued as a result of the EPS Convergence Project, that is, for fiscal years beginning after December 15, 2009. Proponents of this view believe that the effective dates should be coordinated, but that this FSP should have a specific effective date as a "backstop" should the EPS Convergence Project not be completed. Opponents of this view also believe that the expected effective date is too long after the issuance of this standard. This extended period raises unnecessary questions of whether SAB Topic 11.M, "Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period," would require EPS presentation in accordance with this FSP in the notes to the financial statements and whether or not voluntary changes in accounting principle are permitted in the meantime.

**View C**

Issue this FSP with a current effective date, for example, effective for the first fiscal year after the final FSP is posted to the FASB website. Proponents of this view believe that TA&I guidance should be effective as early as possible within the bounds of the FASB's preferences (that is, as of the beginning of a fiscal year). Opponents of this view would prefer to minimize the number retrospective applications of changes in the EPS calculation.

## **Issue 2—Staff Recommendation**

The staff recommends View C. While it recognizes the potential issues with multiple retrospective applications of new accounting standards, the staff believes that users of financial statements will be better served through earlier implementation of this guidance. Such an approach also minimizes the potential issues related to voluntary changes in accounting noted above.

## **Issue 2—Question for the Board**

*Does the Board agree with the staff's recommendation?*

## **ISSUE 3—RESUME THE BALLOT PROCESS**

*Does the Board agree to resume the ballot process?*