



**Board Meeting Handout
Conceptual Framework**

June 25, 2008

1. At today's meeting, the Board will discuss the final outstanding issues (except those dealing with liabilities and equity) to finalize and approve the proposed working definition of a liability. Based on the discussion, the staff will draft the supporting text for the working definition of a liability.
 - a) **Issue 1**—When do statutes, laws and other regulations give rise to a liability, including unconditional obligations that have an associated conditional obligation,
 - b) **Issue 2**—Different approaches that, can be used to deal with uncertainties when ascertaining the existence of a liability,¹
 - c) **Issue 3**—The tentative decisions made about the definition of a liability that should be used as the basis for drafting the supporting text, and
 - d) **Issue 4**—Whether additional situations meet the proposed working definition of a liability in order to test the robustness of the definition.

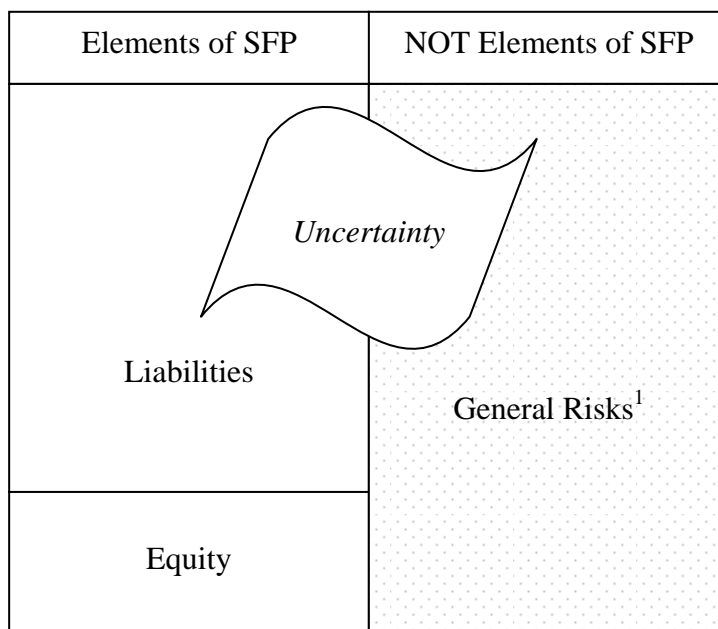
[For reference purposes, the existing liability definitions and the proposed working definition are included on the detachable last page of this handout.]

2. If required, in July 2008, the staff can address any critical follow-up issues that must be concluded in order to finalise the working definition of a liability. During July and August, the staff plans to write-up the conclusions of our work on assets and liabilities to date in the form of a first draft of that part of the expected Discussion Paper. In October 2008, or after the initial analysis of comments on the Discussion Paper, "Financial Instruments with Characteristics of Equity," is available, the staff plans to commence work on how to distinguish a liability from equity.

¹The first two issues are pertinent to both the joint Conceptual Framework Project and the IASB's IAS 37 Liabilities project. Project staff are collaborating.

OVERVIEW

3. One might view the remaining issues related to the definition of a liability in the form of a box representing possible credit items for the statement of financial position.



There are a number of candidates of things that might qualify as elements for what we typically portray in the statement of financial position. Some things will not qualify as elements of the statement of financial position. These include ‘general risks’² that result from where, when, and how an entity conducts its business, including those that can be imposed by statute—distinguishing when a statute can give rise to a risk or a liability is dealt with in these papers. Other things will meet the definitions of elements of the statement of financial position—liabilities or equity. We will return to the distinction between liabilities and equity at a later date. In some cases, there is uncertainty as to whether an item is a liability—which is dealt with in these papers.

²Other things that do not meet the definition of a liability include things that are not economic and things that do not relate to the entity.

ISSUE 1—WHEN DO STATUTES, LAWS, AND REGULATIONS GIVE RISE TO A LIABILITY?

4. Some Board members have questioned whether statutes, laws, and regulations can give rise to a stand-ready obligation—that is, an unconditional obligation that has an associated conditional obligation. To identify when statutes may give rise to such a liability as opposed to a general risk, this paper analyses some common examples of when an unconditional obligation is enforceable by statute³ and when a risk exists.
5. This paper applies decisions that the Boards have made regarding how to distinguish a liability from a general risk and what constitutes an unconditional obligation that has an associated conditional obligation. The FASB made these decisions in May 2008 as part of the conceptual framework project in the context of the proposed definition of a liability. The IASB made these decisions from March to July of 2007 as part of the work done on liabilities in the IAS 37 project in context of the existing definition of a liability by staff from the IAS 37 and the conceptual framework project.

ISSUE 1—OBJECTIVE

6. The objective is to demonstrate the situations when statutes can give rise to a liability, including unconditional obligations that have an associated conditional obligation.

ISSUE 1—PRIOR DECISIONS

7. In the context of the proposed definition of a liability, the Boards have made the following decisions regarding how to distinguish a liability from a general risk.
 - (a) A present economic obligation is an essential characteristic of a liability, but not a general risk.
 - (b) A present economic obligation exists when:

³For simplicity, the term “statute” will be used to refer to a statute, a law and a regulation.

- (i) An entity is committed to a particular action(s) that is capable of resulting in cash outflows, and
 - (ii) There is a mechanism to enable that economic obligation to be enforced against the entity.
 - (c) Laws and regulations are examples of mechanisms and are not, by themselves, present obligations.
8. The Boards have also decided the following in regards to stand-ready obligations:
- (a) It is helpful to analyse contracts and other binding agreements to identify whether they contain unconditional and conditional obligations.
 - (b) An *unconditional obligation* requires performance to occur now or over a period of time, whereas a *conditional obligation* requires performance to occur only if an uncertain future event occurs.
 - (c) In situations where a conditional obligation is identified, it can be helpful to assess if there is an accompanying present unconditional obligation that requires the entity to perform.
 - (d) Noncontractual scenarios can be analysed to identify unconditional and conditional obligations.

ISSUE 1—STAFF ANALYSIS

Introduction

9. Statutes can impose requirements upon an entity. Unlike contracts or other binding agreements, statutes are different because an entity does not explicitly agree to perform for another party. Statutes are created by governments and regulators on behalf of citizens and generally apply to broad populations.
10. By operating in a jurisdiction that has statutes, an entity is *subject* to the statutes. That means an entity can be affected if they violate the statute's requirements (or if another event occurs that triggers those requirements). Then, a government or other party could demand that the entity do what the statute requires. The entity might agree to comply with the statute and

honour the specified economic obligation,⁴ if the entity disagrees, it could challenge the obligation then imposed by the statute by seeking a judgement from the courts.

11. Some question why an entity does *not* have a stand-ready obligation to comply with a statute and when a statute can give rise to an enforceable obligation. As will be explained further in the next few paragraphs, an entity does not have a stand-ready obligation to comply with a statute by itself because being subject to a statute does not meet the definition of having an unconditional obligation that has an associated conditional obligation.
12. In prior Board discussions, a stand-ready obligation is a term that has been used to describe an unconditional obligation of an entity to perform now or over a period of time and has an associated conditional obligation for an entity to perform if an uncertain future event occurs. In these situations, the unconditional obligation results in the entity having a passive role, such as providing risk protection to a lender in the form of a loan guarantee until a specified event occurs, such as the default of the borrower. If the borrower subsequently defaults, the entity will then have an *active role*, namely that of taking action to repay the lender.
13. In the case of the statute, the entity might appear to have a similar passive role, but the entity is *not* providing a service to another party in the form of risk protection. Thus, no party can force the entity to abide by the statute until the entity *violates*, or another event occurs that triggers, the statute's requirements.
14. For example, a vendor could decide not to sell a potentially contaminated hamburger if a statute required the entity to pay compensation when it *sold* contaminated hamburgers. Thus, before the contaminated hamburger is sold, the statute cannot be enforced against the entity. Until an entity's actions trigger the requirements of the statute, the entity has the ability to decide what actions it takes—for example, to take actions to avoid violating the statute.
15. *When* an event occurs that triggers the requirements of a statute, another party can then demand that the entity perform as specified by the statute. The triggering events and the

⁴For simplicity, the remainder of the paper uses the phrase “obligation” to refer to economic obligation as the financial implications or economic nature of the obligation is known. The issue and focus of the paper is on whether an obligation exists.

performance required vary by statute and can depend on the facts and circumstances of the situation. Like contracts and other binding arrangements, statutes can result in:

- (a) Unconditional obligations (not associated with any conditional obligations), for example, a requirement to install an air filter on a smoke stack,
- (b) Unconditional obligations that have an associated conditional obligation (stand-ready obligations), for example, a statutory warranty (see scenario 2 below), or
- (c) Conditional obligations, for example, a requirement to repair or replace a good if it does not work.

16. Another way to test whether a situation results in a risk or an unconditional obligation, is to assess whether the entity would have to pay to be released from the obligation. For example, a customer that has relied on a guarantee provided by an entity would demand compensation if the entity tried to cancel it, whereas a potential customer could not. If the entity stopped providing guarantees with future sales, it could affect the purchasing decisions of potential customers and may result in missed business opportunities for the entity. However, it could not result in obligations to provide compensation to potential customers. This test is applied in the following statutory examples.

ISSUE 1—EXAMPLES

17. The following three scenarios demonstrate when a statute can give rise to the types of obligations described in paragraph 15, and which of those meet the definition of a liability.

Scenario 1: Environmental obligation

Effective January 1, 2001, a regulation requires businesses to take actions to offset the damage on the environment they cause by emitting carbon dioxide in excess of 100 tons per year. Alternatively, businesses can pay a fine of CU 25 per ton emitted in excess of the allowed limit.

In anticipation of the regulation going into effect, a courier company revises how it operates by consolidating delivery routes and making local deliveries by foot or bike (to reduce carbon emitted) and purchasing forested land (to offset carbon emissions). However, the company still expects to exceed the carbon dioxide limit in 2001.

18. In 2000, the courier company emitted 150 tons of carbon dioxide, but at year-end the company is not subject to the regulation because it is not yet effective.
19. Regardless of the steps taken to reduce its carbon emissions, the courier company projects that it will continue to generate carbon in excess of the limit. At December 31, 2000, the carbon emissions from the company's *future* operations, those post-January 1, 2001, do not presently obligate the company because the regulator could not fine or make the courier company take action now to offset any future damage. The regulator cannot enforce the regulation because that future carbon damage has not yet been occurred. Although, the company projects exceeding carbon limits in the future, it nonetheless has choices. For example, it could stop operating its carbon-emitting vehicles. The pending regulatory requirements and the likelihood that the company will generate carbon emissions in excess of the limit create a risk that the company may have to incur cash outflows to offset the damage or pay a fine *in the future*. However, that risk does *not* create a present obligation.
20. On June 30, 2001, after operating for six months under the new law, the courier company has emitted 100 tons of carbon. The company is subject to the statute but it does *not* yet have an unconditional obligation because its actions have *not* resulted in violating the regulation. The regulator cannot force the entity to do anything—that is to protect the environment or offset any damage done to date—until more than 100 tons of carbon is emitted. Thus, the regulation does *not* result in a stand-ready obligation.

21. By September 30, 2001, the company has generated carbon dioxide in excess of the limit, and therefore has an unconditional obligation because it is now required to take actions to offset the damage it has caused on the environment. For example, the company must either purchase carbon credits or pay the fine, each of which is capable of resulting in cash outflows. If the entity did not take those actions, the government could enforce the regulation against the company and fine it. Thus, this unconditional obligation is a liability of the courier company on the reporting date.

22. *The environmental obligation⁵ scenario demonstrates that an entity:*

- (a) *Does not have a present obligation to comply with a statute that is not yet effective,*
- (b) *Does not have a present obligation for expected future actions or intentions because the entity has the ability to avoid or change its future actions,*
- (c) *Does not have a present obligation to comply with the law by itself. An obligating event must also have occurred, that is, the company must emit carbon in excess of the limit,*
- (d) *Does not have an unconditional obligation that has an associated conditional obligation (a stand-ready obligation) because the statute does require an entity to provide risk protection, that is, the courier company is not required to protect the environment from carbon dioxide damage, and*
- (e) *Can have an unconditional obligation at the reporting date when an entity violates a statute, that is, company has emitted carbon dioxide in excess of the limit and is required to take action to offset the damage done. This can be a liability.*

⁵This analysis is consistent with the application of SFAS 143 *Accounting for Asset Retirement Obligations*, FSP FAS 143-1 *Accounting for Electronic Equipment Waste Obligations* and IFRIC Interpretation 6 *Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment*.

Scenario 2: Statutory warranty

A statute requires that any good sold must be fit for purpose.⁶ In the case of light fixtures, the statute requires that a “fit for purpose” lighting fixture must work for at least 1000 hours. If the good is not fit for purpose and does not operate as expected, the seller must repair or replace the good.⁷

An entity manufactures and sells light fixtures in a jurisdiction where the above statute applies. The entity does not explicitly provide or deny providing any warranty on the fixture. A customer purchases one of the entity’s light fixtures.

23. Consistent with the prior example, by itself, the fit for purpose statute does *not* give rise to any obligation until the manufacturer sells the light fixture, because the statute applies only to goods sold to a customer. Thus, while the entity manufactures and offers the light fixtures for sale, these actions of the entity are *not* subject to the statute.
24. A customer would expect that the manufacturer’s light fixture, once installed, will provide light for at least 1000 hours. Though the manufacturer did not provide any explicit warranty, upon sale of the good, the risk becomes specific to the manufacturer. The statutory warranty effectively becomes an implicit requirement in the sale agreement between the manufacturer and the customer. The statutory warranty then obligates the manufacturer to protect the customer from a light fixture that does *not* function for at least 1000 hours. If it does not function as expected, then the entity must repair or replace the good. Thus, upon sale, the manufacturer has an unconditional obligation associated with a conditional obligation. The unconditional obligation is to provide this protection service now and for a period of time (at least 1000 hours of service) and, therefore, is a present obligation. The conditional obligation to repair or replace the good is dependent on the occurrence of an uncertain future event (namely the failure of the light to perform as specified), thus, is *not* a present obligation.

⁶In common law jurisdictions, fitness for a particular purpose can be an implied warranty. A seller is required to know or have reason to know the *particular purpose* for which some item is being purchased by the buyer. The seller is guaranteeing that the item is fit for that particular purpose, i.e., the good functions as expected for a reasonable period of time. In international sales law, this requirement is found in Article 35(2)(b) of the [United Nations Convention on Contracts for the International Sale of Goods](#). In the United States, the warranty of fitness is in Article 2, Section 315 of the [Uniform Commercial Code](#).

⁷Final condition has been included in this example to provide a specific remedy if the requirement is breached.

25. Although the government imposed the statute, it would not directly seek to enforce the statutory warranty. Instead, similar to a contractual warranty, the customer is the party that would seek to enforce the statutory warranty against the manufacturer. If the manufacturer did not honor the warranty, the customer would have the support of the courts to enforce the warranty. Also, if the manufacturer wanted to cancel or transfer the warranty, the manufacturer would need to either compensate the customer or pay another party to assume the obligation.⁸
26. The customer installs the light fixture but after two hours of use, the light flickers and stops illuminating. Now, the uncertain future event has occurred and the conditional obligation has become unconditional and a liability. The statutory warranty implicit in the contract with the customer gives the customer the ability or right to demand that the manufacturer repair or replace the light fixture. Until the customer informs the manufacturer that the light fixture does not work, this situation is an example of an obligation that has been incurred but not reported (referred to as an 'IBNR' in insurance terminology) for the manufacturer.
27. Based on the above analysis, a statutory warranty included implicitly in a sale transaction results in the seller of the good having the same contractual obligations as if the warranty is explicitly agreed to in a binding arrangement between two parties.
28. *Compared to the environmental scenario, the statutory warranty example demonstrates that a statute can result in an entity having an implicit unconditional obligation that has an associated conditional obligation or stand-ready obligation.*

⁸It may be a question of law as to whether a manufacturer could legally cancel a statutory warranty by compensating the customer or by entering into an agreement with another party to transfer it.

Scenario 3: Speeding

The law requires drivers to drive vehicles at speeds that do not exceed the limits posted. If a driver drives at speeds higher than the posted limits, the police can ticket a driver. A ticket requires the driver to pay a fine, the financial consequences as stipulated in the law for speeding.⁹

To ensure the quick delivery of packages, an express courier company has indemnified¹⁰ its drivers by agreeing to pay the fines resulting from drivers' speeding tickets incurred while delivering packages.

29. For the drivers, this scenario results risks and obligations that are similar to those in the environmental obligation example. By itself, the law to drive vehicles at the posted rate does *not* impose a present obligation on the driver, because the courts cannot demand payment of fines unless the police have ticketed the drivers for driving at a speed in excess of the posted limit. The law creates a risk for drivers that they could have *future* cash outflows from speeding fines.
30. Even if drivers speed but have not yet been ticketed by the police, the law still does *not* give rise to any obligation, though the drivers' risk of future cash flows to pay speeding tickets likely has increased. Once ticketed, the driver has an unconditional obligation to pay the fine.
31. This scenario is different from the others because the courier company has indemnified its drivers and agreed to pay any speeding tickets incurred while they are on the job. The courier company has agreed to (a) bear the drivers' risk of fines from speeding tickets while they work and (b) pay the fines if the drivers are ticketed by the police. Thus, the staff thinks that the company has an unconditional obligation to its drivers that has an associated conditional obligation to them.
32. The unconditional obligation is present because the courier company has agreed to provide risk protection to the drivers from fines resulting from speeding tickets *when* the drivers drive

⁹In some jurisdictions, the ticket may also provide the driver the ability to challenge the charge and/or fine in court.

¹⁰For the purposes of this case, the indemnification is being assumed to be allowed. In practice, it may not be allowed because it encourages the violation of the law.

for the company. Thus, the company is obligated to provide this protection as long as they are employed as drivers.

33. The conditional obligation is to pay the fines if drivers are ticketed. The obligation is conditional because it is dependent on the occurrence of an uncertain future event—that is the drivers being ticketed while delivering their packages. Thus, the company does not have a present obligation or liability to pay fines resulting from speeding tickets until a driver is ticketed.
34. At each reporting date, the courier company must assess whether the conditional obligation has given rise to an unconditional obligation to pay any fines because drivers have been speeding and been ticketed by the police. This unconditional obligation is not associated with any other type of obligation. It is another example of an IBNR obligation. The courier company could implement procedures for drivers to report tickets and use past history to help them to identify and assess the existence of the unconditional obligations to pay fines resulting from speeding tickets. Information received after the reporting date can also subsequently confirm or prove the existence of these obligations.
35. To test whether this situation does result in a liability, consider what would happen if the courier company decided to stop paying the fines resulting from the speeding tickets incurred by its drivers. The drivers would demand compensation to cover the fines they might incur in order to deliver the packages as required, for example, a higher wage rate. Thus, the courier company cannot avoid the unconditional obligation to provide the drivers protection from fines resulting from speeding tickets without a cost.
36. *Compared to the prior scenarios, the speeding situation demonstrates that an entity can have an unconditional obligation that has an associated conditional obligation if the entity agrees to bear another's risk of being subject to a statute.*

ISSUE 1—SUMMARY

37. The following chart summarises the facts of each of the scenarios:

Scenario	Risk/Liability	Who enforces	Who to pay or satisfy
Environmental obligation	<ul style="list-style-type: none"> - All businesses emitting carbon are subject to regulation. - General risk until violate the regulation by emitting carbon dioxide in excess of limit. - Obligation is to offset damage done or pay the fine. 	Regulator	Regulator
Statutory warranty	<ul style="list-style-type: none"> - All vendors of goods are subject to the statute. - General risk until a light fixture is sold. - Law effectively inserts an implicit contractual obligation into sales agreement between the manufacturer and the customer. - Unconditional obligation to protect the customer from a light fixture that does <i>not</i> function as specified for 1000 hours and a conditional obligation to repair or replace the light fixture if it fails. 	Customer	Customer
Speeding ticket	<p>Drivers:</p> <ul style="list-style-type: none"> - All drivers are subject to the law. - General risk until violate the law and are ticketed. - Obligation to pay fine once ticketed. <p>Courier company:</p> <ul style="list-style-type: none"> - Agreement to bear the drivers' risk of incurring fines creates an unconditional obligation that has an associated conditional obligation to pay fines resulting from speeding tickets. 	Government Drivers	Government Government

38. In conclusion, the following list summarizes how an entity:

- (a) Does *not* have a present obligation to comply with a statute that is not yet effective,
- (b) Does *not* have a present obligation for expected future actions or intentions because the entity has the ability to avoid or change its future actions,
- (c) Does *not* have a present obligation to comply with the law by itself. An obligating event must also have occurred,

- (d) Can have an unconditional obligation at the reporting date when an entity violates a statute,
- (e) Can have an unconditional obligation that has an associated conditional obligation (a stand-ready obligation) when a statute requires an entity to provide risk protection, and
- (f) Can have an unconditional obligation that has an associated conditional obligation if the entity agrees to bear another's risk of being subject to a statute.

39. Does the Board agree with the above analysis in paragraph 37 and conclusions in paragraph 38? If not, why not?

ISSUE 2—DEALING WITH UNCERTAINTY ABOUT THE EXISTENCE OF A LIABILITY

40. This handout presents the staff's analysis on how to deal with uncertainty about the *existence* of a liability.

ISSUE 2—OBJECTIVE

41. It is important to keep in mind that, in the majority of cases, especially in contractual and other binding arrangements, it will be clear whether the definition of a liability has been met. Though uncertainties about the future cash outcome of the liability may make it challenging to measure, they do not negate the existence of a present obligation.

42. In rare cases, uncertainties can make it unclear whether the definition of a liability is met. In these uncertain situations, assessing whether there is a present economic obligation or whether it is enforceable is difficult.

43. *This handout analyses different approaches of how to deal with uncertainties when ascertaining the existence of a liability. The objective of the analysis is to select one approach that will most faithfully represent these uncertainties.*

44. As part of the IASB’s Liabilities project, planning to amend IAS 37, the IASB has been discussing uncertainty about a present obligation in the context of the existing definition of a liability.¹¹ This paper builds upon those discussions in the context of the working definition being developed in Phase B of the conceptual framework project.

ISSUE 2—DEFINITIONS & DESCRIPTIONS

Liability

45. Compared to the existing liability definitions in FASB Concepts Statement 6 and in the IASB Framework, the working definition emphasises 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.¹²

Uncertainty

46. Uncertainty is a real-world economic phenomenon. Uncertainties result from situations where evidence is lacking or facts are unclear. When ascertaining whether an item meets the definition of a liability, uncertainties can affect whether:

- (a) An item is an *economic obligation*;
- (b) It is *the entity’s* obligation; or
- (c) It is a *present* obligation of the entity.

¹¹It is possible that different conclusions might be reached between the IAS 37 and the conceptual framework project—in part because the IAS 37 project is dealing with the existing definition of a liability in the IASB Framework, and in part because the IAS 37 project is a standards-level project rather than a concepts-level project. However, we should be able to justify the reasons for any differences in conclusions reached in each project.

¹²For simplicity, the remainder of the paper 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.

Uncertainty can affect one, some, or all of the requirements of the definition. As a result, we might have insufficient information to know whether a liability exists.

47. In practice today, uncertainty about the existence of a liability is dealt with by the use of thresholds in the recognition criteria of the IASB Framework, as well as in U.S. standards and IFRSs.

Thresholds

48. In the IASB Framework, one recognition criterion requires that “an item that meets the definition of an element should be recognised if (a) it is probable that any future economic benefit associated with the item will flow to or from the entity...” Thus, an obligation that exists should be recognised when the resulting cash outflow to the entity is probable. The IASB Framework does not provide guidance on when it is uncertain that an obligation exists.

49. To deal with situations with uncertainties at the standards level, U.S. GAAP and IFRSs require that for a liability to be *recognised*, it must be probable that the liability has been incurred [Statement 5, paragraph 8a], or a liability is more likely than not to exist [IAS 37, paragraph 15].

ISSUE 2—HOW TO FAITHFULLY REPRESENT UNCERTAIN ITEMS

Role of the liability definition

50. The concepts in the framework are tools to determine the information that should be included in decision-useful financial reports to assist capital providers in assessing the entity’s ability to generate cash flows. As tools, the element definitions are one step in identifying what should be included in financial reports. The definitions identify the relevant items an entity presently has that are capable of affecting its future cash flows.

51. As a screen, the liability definition filters through negative economic phenomena and excludes items that are:

- (a) Not present at the statement date—they relate to the future;
- (b) Not of the entity—they belong to another entity,

- (c) Not economic—they are duties that are not capable of resulting in cash outflows, and
- (d) Not obligations—they are items that cannot be enforced against the entity. The entity can walk away, for example, budgeted items, or take actions to manage them, e.g. general risks.

After applying the liability definition filter, the remaining items are relevant and are candidates to be communicated to users in the financial reports. Using other concepts in the framework, the information is then assessed as to how to faithfully represent these items. Should they be recognised in the financial statements? Can they be measured? Should information about these relevant items be disclosed? In considering those questions, consideration is given also on how to capture and portray information in an understandable, verifiable, comparable, and timely manner in financial reports.

52. When considering liabilities, it will be clear for most items whether they are caught or are excluded. For the narrower range of items, where evidence is lacking or facts are unclear, it will not be clear. These items may or may not meet the definition of a liability. The difficulty is that at the statement date we *don't know*. To exclude these items could result in relevant information not being communicated to users and financial reports not faithfully representing the position of the entity. On the other hand, to include these items might not result in a faithful representation.
53. As uncertainty itself is a real world economic phenomenon, uncertainty does exist. Uncertainty could affect users' decisions, thus, information about uncertainty is relevant information to include in financial reports. The challenge is how to most faithfully represent those liabilities that may or may not exist.

Choices of where to deal with uncertainties

54. At the concepts level, uncertainties could be dealt with:
- (a) As part of the definition;
 - (b) In the accompanying guidance for applying the definition; or
 - (c) In the criteria for recognition.

55. *As part of the definition*—An additional criterion could be included in the definition to identify when an uncertain item meets the definition. We think that, to do so would detract from the key purpose of the definitions—to deal with generic situations. It would also make the definition cumbersome. The staff does *not* support this choice.
56. *In the accompanying guidance for applying the definition*—Assessing whether an element definition is met involves making a decision—either a liability exists or it does not. Following this approach, additional guidance could describe the steps that should be taken to gather and assess the facts and circumstances of a situation with uncertainties. Examples could be provided to demonstrate how such assessments can be made.
57. This approach would result in the application of a conceptual concept in a practical manner. It would also avoid the use of “likelihood” terms that were used in the existing definition to reflect that few things in life are certain. Not using “likelihood” terms would be an improvement because these terms in the existing definitions have been misunderstood by many. On the other hand, making an assessment based on facts and circumstances results in the implicit application of a threshold. To encourage consistent and comparable application, explicit guidance could be provided in standards.
58. Compared to including a requirement in the definition or the recognition criteria, guidance in the supporting text would be less prominent and therefore could be overlooked by some users.
59. *In the criteria for recognition*—Some think that assessing how to faithfully represent or portray information in financial reports is a recognition matter. It is not a definitional matter because the purpose of the liability definition is to identify the economic obligations of an entity that exist at a statement date. The existence of uncertainty makes the definition difficult to apply. But we cannot know the unknown—all we can do is to decide how to deal with such circumstances when representing items in financial statements—the first step of which is recognition.
60. One of the existing recognition criterion in the FASB and IASB’s framework is that an item must meet the definition of an element. Assuming this criterion is retained, following this

approach, uncertain items that may or may not meet the definition would need to be assumed to have met the definition of a liability in order to carry forward these items for consideration in recognition. Then, to strike a balance between developing concepts and providing practical guidance, an additional criterion for recognition at the concepts level could use a threshold to exclude more uncertain items from being recognised. This approach might result in a more consistent application across standards and in practice.

61. On the other hand, this approach might start to blur or confuse the role of a definition from that of recognition. The role of the liability definition is to identify liabilities that exist, whereas recognition is the process of formally incorporating a liability in the financial statements by depicting it in words and numbers. As uncertainty can affect the existence of an obligation as well as the amount and timing of future cash flows of an obligation, this approach may be less effective by considering the different types of uncertainty together in recognition.

62. Whether an uncertain item is a liability that exists or an uncertain liability should be recognised involves making a difficult decision. Leaving the decision to recognition may also be more inefficient as more items would need to be analysed in recognition though they may not be reported in financial statements.

ISSUE 2—STAFF RECOMMENDATION

63. Based on the above analysis, the staff thinks that uncertainty about existence of an asset or a liability should be addressed when ascertaining whether the definition of the element is met. Thus, we recommend that uncertainty be dealt with in how the definitions are to be applied—in the accompanying guidance for applying the definition.

64. Does the Board agree that uncertainty should be dealt with in the accompanying guidance for applying the definition, rather than in the criteria for recognition or as part of the definition? If not, why not?

How to apply the definition when uncertainties exist

65. In situations when there is uncertainty about the *existence* of liabilities, the definition of a liability could be applied in various ways. To demonstrate the range of options, the definition could be applied:

- (a) Strictly—Assume that a liability does *not* exist in the absence of clear evidence to the contrary.
- (b) Judgementally—Judge whether a liability exists based on facts and circumstances at the statement date.
- (c) Leniently—Assume that a liability does exist when there is any evidence that the item is capable of resulting in its existence.

66. The judgemental and lenient approaches will result in a greater number of uncertain items being assumed to be liabilities that exist than the strict approach. If the liabilities relating to those uncertain items meet the recognition criteria, if any, uncertainty of their existence could be reflected in how it is measured, and if needed, additional disclosures provided about the item.

67. The staff applied these three approaches to various scenarios to assess which approach would result in the most faithful representation of items when there are uncertainties about the existence of a liability. The analysis was discussed with conceptual framework's joint Board advisors, and the staff noted the following points:

Strict approach

- (a) Simplest of approaches because it accounts for all uncertain items as if a liability does not exist.
- (b) Will likely exclude information from financial reports that may be relevant to users.
- (c) Approach is conservative. It is *not* neutral.
- (d) Implicitly requires the application of a threshold as to which items are certain. But, how certain is certain? This concern is what led prior Boards to include the likelihood terms (*probable* and *expected*) in the existing definitions when the existing

frameworks were developed. Importantly, the likelihood terms in the existing frameworks are used to assess the *outcome* of the item, and not its *existence* as is being considered in this paper. In practice, the likelihood terms have been misinterpreted and misapplied. Thus, the working definition of a liability now excludes any likelihood reference.

- (e) Results in deferring the recognition of all cases of which some will be proven to be liabilities that existed. Thus, those cases will result in not recognising those liabilities until some future date—and also will result in recognising losses then.

Judgemental approach

- (a) As proposed, the judgemental approach uses an implicit threshold that is left to users to interpret and apply. To reduce the range of interpretations and result in more comparable application, guidance and consideration of using an explicit threshold, such as “more likely than not,” could be considered when developing additional guidance in standards. This approach can result in different entities judging similar items differently.
- (b) Only results in the reporting of incurred but not reported (IBNRs) liabilities when there is enough evidence to judge that a liability exists.
- (c) When there is uncertainty about whose obligation it is, the judgemental approach will more likely result in one entity reporting the existence of the liability if there are enough facts to make a judgement. If facts are unclear, multiple entities could independently judge that they each do or do not have a liability.
- (d) Considering past history can help to make a judgement.
- (e) Assessing a multiple number of similar uncertain items does not affect how one judges the existence of whether each item is a liability that exists.
- (f) Practically, it would exclude fewer items than the strict approach but more than the lenient approach.

Lenient approach

- (a) A conceptual approach that reports any uncertain items capable of resulting in a liability as a liability that exists.
- (b) A less practical, or a more cumbersome, approach because it includes all items that may be liabilities that exist.
- (c) Other concepts could be needed to reduce the number of items reported. For example, users could assess whether the benefits exceed the cost of reporting such items or exclude immaterial liabilities.
- (d) Results in the reporting of incurred but not reported (IBNRs) liabilities when there is a bit of evidence that an obligation is capable of existing, yet insufficient evidence to judge its existence.
- (e) When it is uncertain whose obligation it is, the lenient approach might result in multiple entities reporting a liability for the same obligation.
- (f) Results in recognition of “possible” liabilities and likelihood that some of them will turn out in the future *not* to have been liabilities—and also resulting in gains being recognised then.

ISSUE 2—STAFF RECOMMENDATIONS

68. In situations when there are uncertainties as to whether a liability exists, the liability definition should be applied in a practical manner that results in more relevant information being identified. In these situations, the staff recommends that a judgemental approach be used to weigh the facts and circumstances at the statement date and judge whether a liability exists.¹³

69. The staff recommends that this approach be applied neutrally when assessing the existence of any element when there are uncertainties.

70. As well, the staff thinks that, at a standards level, additional guidance should be developed on how those judgements can be made in a comparable manner.

¹³This approach is consistent with the methodology being followed in the IASB’s IAS 37 project on *Liabilities*.

71. Does the Board agree with the above recommendations? If not, why not?

ISSUE 2—EXAMPLES

72. In this section, the staff analysed two common scenarios with uncertainties to demonstrate how the liability definition can be judgementally applied.

73. The examples do not consider any uncertainty about the amount required to settle an obligation. Neither do they consider how the item should be measured, because that does not relate to determining the *existence* of an obligation. The staff acknowledges that, in real life, these other types of uncertainties must also be considered. However, at this stage, the staff wishes to focus on uncertainties that affect the *existence* of a present obligation.

74. For the purpose of this paper, the scenarios and evidence available are limited and deliberately simple. In real life, the staff acknowledges that assessing all of the available evidence relating to the circumstances at the statement date is likely to involve evaluating additional information, such as:

- (a) Past history of events occurring;
- (b) Preventive actions taken by an entity to manage the risk; and
- (c) Subsequent events.

Scenario 1: Hamburger vendor

A vendor sells hamburgers in a jurisdiction where the law stipulates that the vendor must pay compensation to each customer who buys a contaminated hamburger. On December 31, 200X, the last day of the reporting period, the vendor sold one hamburger.

Past experience indicates that one in every million hamburgers sold by the vendor is contaminated. No other information is available.

75. In this example, the uncertainty relates to whether the obligating event occurred or not (whether a contaminated hamburger was sold).

76. In this jurisdiction, the law imposes a general risk on the population of people who sell hamburgers or vendors. The vendors risk having to pay compensation if they sell contaminated hamburgers to customers. If a vendor violates the law by providing a contaminated hamburger, the customer who received the contaminated hamburger can then demand compensation from that vendor.
77. Some may suggest that vendors have an unconditional obligation to protect customers from the risk of buying a contaminated hamburger and have an associated conditional obligation to pay compensation if the hamburger is contaminated. The staff does not agree, because the law does not require vendors to guarantee or provide risk protection to potential customer(s) that hamburgers for sale are not contaminated. The law does not require vendors to do anything until a contaminated hamburger is sold. If a contaminated hamburger is sold, the vendor then has an unconditional obligation to pay compensation to the customer. This unconditional obligation does not have an associated conditional obligation as payment is due now and is not dependent on the occurrence of any uncertain future event.
78. *No facts or evidence* – At the statement date, the vendor assesses the available evidence. There is no information available about the hamburger sold or the customer’s experience after eating the hamburger. Past experience indicates that one in every million hamburgers sold by the vendor is contaminated. The evidence available suggests that the chance that a contaminated hamburger was sold is low. Therefore, the vendor judges that the one hamburger sold was *not* contaminated and that a liability does *not* exist.
79. *Some facts and evidence* – Compared to the “no facts or evidence” example, the vendor is aware that the refrigerator storing the uncooked hamburgers is broken. The vendor does not know if the refrigerator has been broken for a few hours or days. The evidence suggests that there is more of a chance that a contaminated hamburger was sold, but it is not clear. The vendor could judge that a contaminated hamburger was sold, thus, an obligation to pay compensation to the customer exists. On the other hand, the vendor could judge that there is insufficient evidence to say the hamburger was contaminated, thus, he is *not* obligated to pay compensation to the customer.

80. *Plenty of facts and evidence* – Compared to the “some facts and evidence” example, the vendor is also aware that the customer had her hamburger cooked rare and that bacteria are present on the other hamburgers in the broken refrigerator. As the vendor is aware that his stock of uncooked hamburgers is contaminated and that the customer’s hamburger may not have been cooked long enough to kill the bacteria present, the evidence suggests that there is a higher likelihood that a contaminated burger was sold. The vendor judges that a contaminated hamburger was sold, thus, an obligation to pay compensation to the customer, and hence a liability, exists.
81. *Customer’s perspective about possible corresponding asset* – Similar to the vendor, the customer does not have an enforceable ability or right to make the vendor pay, until she becomes aware that the hamburger was contaminated by eating or testing it. Once the customer becomes aware that the hamburger was contaminated, then she can use the mechanism to force the vendor to pay compensation and has an asset that exists.

Scenario 2: Lawsuit

On June 30, 200X, an entity has been served papers of a claim for damages by another party. The entity is otherwise unaware of any past wrongdoing.

82. Regardless of whether the claim has merit or not, upon being served, the entity knows it will have to take actions to either defend or settle the claim. It must do something even if the lawsuit is frivolous. For example, it may consume its employees’ time, hire lawyers and experts or pay a settlement. If an entity chose not to act or defend itself, a court could interpret the entity’s inaction as guilty and render a judgement in favour of the plaintiff. Each of these scenarios demonstrates that the claim is capable of resulting in cash outflows.
83. At June 30, 200X, the entity does *not* have unconditional obligations for any of the foregoing specific actions because none of employees, lawyers or experts have spent any time on the claim. Thus, the entity does not need to pay them. As well, the entity has not agreed to a settlement with the plaintiff nor has the court rendered a judgement requiring the entity to pay the plaintiff. Thus, at the reporting date, the entity is *not* obligated to pay compensation to the plaintiff.

84. Having been served with papers does raise the question of whether the entity did not perform as required or breached a requirement in the past. The entity would assess the particulars of the claim and determine whether the claim has merit. If the entity decided it was clearly at fault, then the entity would have an obligation to the plaintiff. On the other hand, the entity may challenge the particulars of the claim. For example, the entity may think that it did perform as required or that the event did not qualify as a breach of a requirement. In this scenario, the entity is *uncertain* whether it has an obligation that exists to the plaintiff.
85. Using the judgemental approach, the entity has to assess the available facts and circumstances of the claim at the reporting date. The entity will have to weigh the evidence and judge whether the evidence suggests that the entity is presently obligated. If the entity judges that there is sufficient likelihood that it is obligated, then it has a liability. If it judges that there is insufficient likelihood, then the entity has only a risk that it has a likelihood of cash outflows. The entity should also consider whether the risk should be disclosed.
86. At each reporting date, the entity will need to reassess the available evidence and judge whether it has an obligation.

ISSUE 2—CONCLUSION

87. The examples demonstrate that the definition of a liability and judging how to apply the definition in situations with uncertainties, are useful tools because they provide discipline of how to analyse difficult situations. They help to identify who an entity could be obliged to and why it is obliged.

ISSUE 3—SUMMARY OF TENTATIVE DECISIONS

88. By the end of the June 2008 meetings, the staff plans to have discussed, and sought agreement on, substantially all of the issues to be addressed in considering the definition of a liability, with the exception of those relating to the distinction between liabilities and equity. These latter issues will be discussed only once an initial analysis of comments on the Discussion Paper, “Financial Instruments with Characteristics of Equity,” is available. That analysis is expected to be available in October 2008.

89. The staff intends to draft Discussion Paper text on the definitions of an asset and a liability during July and August 2008.

ISSUE 3—OBJECTIVE

90. The objective is for Board members to confirm the tentative decisions relating to the definition of a liability that we should use as the basis for that drafting. We would also appreciate advice from Board members as to any additional matters related to the definition of a liability that they think it necessary be addressed before we commence drafting.

91. Previously, some Board members have suggested additional examples against which we should test our working definition of a liability. Those examples are analysed in Issue 4 of this handout.

92. *Board members are requested to review the following summary of tentative decisions and consider whether they:*

- (a) *Agree with the proposed working definition of a liability and the supporting tentative decisions as a basis for drafting. If not, why not; and*
- (b) *Think that any additional matters related to the definition of a liability need to be addressed before we commence drafting. If so, what are those matters?*

ISSUE 3—TENTATIVE DECISIONS REACHED

Proposed Working Definition of a Liability

93. Please see the proposed definition on the detachable last page of this handout.

94. In support of, this definition, the Boards made the following tentative decisions:

A liability:

- (a) Should continue to be defined directly, with reference to assets [February/March 2006];
- (b) Is the present obligation, not the future sacrifice [February/March 2006, reconfirmed December 2007];

- (c) Need not include probability or other notions of likelihood, which instead belong, if at all, in recognition criteria or measurement [February/March 2006, reconfirmed December 2007]; and
- (d) Consists of a *bad thing* and a *link* that binds the entity to that bad thing. Board members preferred to refer to an *economic obligation* to describe the bad thing *and* the link, rather than using two different terms to express the bad thing and the link [December 2007].

A present economic obligation:

- (a) Exists at the financial statement date [April 2006];
- (b) Can only have arisen from past events, thus, explicit reference to past events is unnecessary—redundant [February/March 2006, reconfirmed December 2007];
- (c) Is an obligation to provide economic resources to others, or to stand ready to do so—it is economic [April 2006]; and
- (d) Can include an obligation to forgo a cash inflow [February/March 2006].

An obligation is enforceable against the entity when:

- (a) The entity is obligated to act or perform (or to refrain from acting or performing) [April 2006];
- (b) (i) A party separate from the entity is involved [February/March 2006, reconfirmed December 2007]; and (ii) a mechanism is available to that party that enables it to force the entity to take a specified course of action [December 2007]. These are the essential attributes of an enforceable obligation; and
- (c) There is legal or other equivalent compulsion.¹⁴ This notion replaces the reference in the current definition to little or no discretion to avoid a future sacrifice [February/March 2006]. Thus, an equitable or constructive obligation can be a liability if it legally or equivalently compels potential outflows of cash or other

¹⁴Does not include economic compulsion.

potential sacrifices (or reduced cash inflows or other reduction of benefits) [February/March 2006].

Distinguishing a liability from a general risk

- (a) A present economic obligation is an essential characteristic of a liability, but not a general risk [March 2007 (IASB) & May 2008 (FASB)].
- (b) A present economic obligation exists when:
 - i. An entity is committed to a particular action(s) that is capable of resulting in cash outflows, and
 - ii. There is a mechanism to enable that economic obligation to be enforced against the entity [March 2007 (IASB) & May 2008 (FASB)].
- (c) Laws and regulations are examples of mechanisms and are not, by themselves, present obligations [March 2007 (IASB) & May 2008 (FASB)].

Types of obligations

- (a) It is helpful to analyse contracts and other binding agreements to identify whether they contain unconditional and conditional obligations. An *unconditional obligation* requires performance to occur now or over a period of time, whereas a *conditional obligation* requires performance to occur only if an uncertain future event occurs. In situations where a conditional obligation is identified, it can be helpful to assess if there is an accompanying unconditional obligation that presently requires the entity to perform. Non-contractual scenarios, as well as contractual scenarios, can be analysed to identify unconditional and conditional obligations [March 2007 (IASB) & May 2008 (FASB)];
- (b) It would be preferable to describe these situations in terms of their unconditional and conditional components [March 2007 (IASB) & May 2008 (FASB)].

<p>95. Does the Board agree with the proposed working definition of a liability and the summary of tentative decisions as a basis for drafting? If not, why not?</p>

96. Are there any additional matters related to the definition of a liability that the board thinks we need to address before we commence drafting? If so, what are those matters?

ISSUE 4—LIABILITY DEFINITION EXAMPLES

97. In December 2007, the Board discussed the application of the proposed working definition of a liability, as well as the existing IASB and FASB definitions, to various situations and identified issues arising from the application of those definitions. A list of those situations is provided below.

98. This handout analyses additional situations, based on examples that were suggested at the December 2007 meetings, or subsequently. As with the December 2007 analysis, Board members might wish to be selective in the examples they review. Therefore, even though the analysis is sometimes repetitive, we have tried to be as complete as possible in the analysis of each example.

ISSUE 4—OBJECTIVE

99. The objective is to illustrate how the working definition of a liability would apply in additional situations so as to help Board members evaluate whether the working definition is sufficiently robust.

100. Does the Board agree with the analysis of the following examples?

ISSUE 4—EXAMPLES

101. The following comprises a list of the examples analysed in this paper.

Examples that Meet the Working Definition of a Liability

Ex1. Stadium naming

Ex2. Cumulative preference share dividends

Examples that Do Not Meet the Working Definition of a Liability

- Ex3. Non-vested employee benefits (discretion to avoid)
- Ex4. Legal requirement to install air filters at a future date
- Ex5. Discretionary participation feature of an insurance contract

Liability	Proposed Working Definition	IASB Definition	FASB Definition
<p>Ex1. Stadium naming (Contractual promise to keep an advertiser’s name on a stadium for a period of five years)</p>	<p><i>Economic obligation:</i> Unconditional contractual promise to provide benefits—which is capable of resulting in cash outflows to maintain the name and reduced cash inflows from other possible naming of the stadium. In order to remove the obligation an outflow of cash would probably be necessary.</p> <p><i>Enforceable against the entity:</i> Contract identifies the entity as the obligor and is enforceable at law.</p> <p><i>Present:</i> Economic obligation—the contractual promise—is set out in contract. The other party can presently enforce the promise.</p>	<p>[Analysis omitted]</p>	<p>[Analysis omitted]</p>
<p>Comments: The entity is obligated to keep the advertiser’s name on the stadium for the five-year period. If it does not do that, then it might need to return to the advertiser some or all of the payment made to purchase the right. The entity’s liability is, therefore, for its contractual promise to keep the name on the stadium, thus forgoing alternative cash inflows, or to return payments previously received in exchange for the naming rights, if the name does not remain on the stadium. The refund aspect of this situation is very similar to that of “advances from customers” in December 2007.</p>			

Liability	Proposed Working Definition	IASB Definition	FASB Definition
Ex2. Cumulative preference share dividends (Promise to pay cumulative dividends on preference shares before paying any dividends on ordinary shares)	<p><i>Economic obligation:</i> Unconditional contractual promise to pay a specified rate when conditions are met.</p> <p><i>Enforceable against the entity:</i> Contract identifies the entity as the obligor and is enforceable at law.</p> <p><i>Present:</i> Economic obligation is set out in contract.</p>	[Analysis omitted]	[Analysis omitted]
<p>Comments: Note that the liability is based on the unconditional promise to stand ready to make payments when the conditions are met—it is an unconditional obligation associated with a conditional obligation. Eventually, over the life of the entity, it will have an obligation to distribute any residual interest, with the cumulative dividends on preference shares taking priority. The likelihood and timing of the conditions being met are factors that might be taken into account in measuring the liability, but not in determining its existence.</p>			
Not a liability	Proposed Working Definition	IASB Definition	FASB Definition
Ex3. Non-vested employee benefits (For example, promise to pay benefits only after an employee has been employed for a specified period of time. The specified period of time has not yet passed and the entity can terminate the employee with no consequence.)	<p><i>Economic obligation:</i> Unconditional contractual promise to provide benefits in the future if conditions are met—which is capable of resulting in cash outflows.</p> <p><i>Enforceable against the entity:</i> Contract identifies the entity as the obligor and is enforceable at law.</p> <p><i>Present:</i> Economic obligation—the contractual promise—is set out in the contract. However, the other party cannot presently enforce the promise.</p>	[Analysis omitted]	[Analysis omitted]
<p>Comments: The primary issue here is whether there is a present <i>enforceable</i> obligation. When the entity has the ability to terminate the contract with the employee, with no consequence, before the vesting date, then there is no enforceable economic obligation. However, if there would be consequences of terminating the contract—for example, other requirements in a jurisdiction might prevent an entity from terminating such a contract without cause very shortly before vesting—then the entity has an enforceable unconditional obligation to make payments, and the employee can hold the entity to that promise. Thus, a liability exists. The measurement of that liability is a separate issue, which might take into account the likelihood of the benefits being paid.</p>			

<u>Not a liability</u>	Proposed Working Definition	IASB Definition	FASB Definition
Ex4. Legal requirement to install air filters at a future date	<p><i>Economic obligation:</i> Law requires installation of air filters, which would require outflow of cash in the future to install.</p> <p><i>Enforceable against the entity:</i> The lack of air filters makes the entity the obligor, which can be enforced in accordance with the law.</p> <p><i>Present:</i> Other party cannot presently enforce anything. Law takes effect only in the future.</p>	[Analysis omitted]	[Analysis omitted]
<p>Comments: In each case, there is no present obligation, and hence, no liability. In contrast to the non-vested employee benefits when there are consequences of terminating the employee contract (Example 3), in this example there are no consequences to the entity before the effective date of the legal requirement. No other party can require the entity to do anything resulting in cash outflows before the date that the legal requirement becomes effective. Presumably, the air filters are to be attached to an asset. Although there is no liability, there might be a separate question as to whether the asset is impaired by virtue of not having air filters installed—the originally anticipated useful life of the asset without air filters and its residual value might be affected by the legal requirement.</p>			
<u>Not a liability</u>	Proposed Working Definition	IASB Definition	FASB Definition
Ex5. Discretionary participation feature of an insurance contract (For example, terms of an insurance contract providing the right for a policyholder to receive additional returns from a linked asset pool, at the sole discretion of the insurer.)	<p><i>Economic obligation:</i> Discretionary payments are capable of resulting in cash outflows. However, that is not required unless the entity’s past practices or actions create a valid expectation.</p> <p><i>Enforceable against the entity:</i> No enforceable obligation—another party cannot require entity to make payments (unless past practices or actions deem so).</p> <p><i>Present:</i> Not applicable. No enforceable obligation.</p>	[Analysis omitted]	[Analysis omitted]
<p>Comments: We think that this is no different from Example 20, in December 2007—Discretionary Employee Bonuses. In question in this example, is whether there is an economic obligation. In some cases, it might be held under legal doctrines such as promissory estoppel, that the entity’s actions are sufficient to create a valid expectation on the part of policyholders that discretionary payments will be paid. These might, for example, be based on past history of the insurer in making such payments, or on announcements by company officials that payments will be made. In those instances, a present economic burden or requirement to which the entity has a present enforceable obligation, and hence a liability, will exist. Note that, even if the entity feels “economically compelled” to make payments, because, say, it thinks that it will be unable to retain policyholders, or obtain new business, without making payments, that is not sufficient to create a liability.</p>			

Index to Examples Analysed in December 2007

Examples that Meet the Working Definition of a Liability

- Ex1. Bank overdraft by depositor
- Ex2. Account payable
- Ex3. Advances from customers
- Ex4. Property lease (lessor perspective)
- Ex5. Easement written
- Ex6. Warranty written on machinery
- Ex7. Loan guarantee written
- Ex8. Written contract to deliver future music revenues from the sale of copies of *existing* recordings
- Ex8A. Written contract to deliver future music revenues from the sale of copies of *future* recordings of music yet to be written
- Ex9. Written non-compete agreement
- Ex10. Lottery ticket (lottery perspective)
- Ex11. Insurance coverage written
- Ex12. Lease contract with rent based only on future sales (lessee perspective)
- Ex13. Forward contract to purchase corn
- Ex14. Oil spill remediation
- Ex15. Refunds to customers—stated policy
- Ex15A. Refunds to customers—no stated policy
- Ex16. Announced redundancy plan
- Ex17. Announced product recall

Examples that Do Not Meet the Working Definition of a Liability

Ex18. To obey the law

Ex19. Future purchases by an established business

Ex20. Discretionary employee bonuses

Ex21. Legal requirement to install air filters at a future date

EXISTING AND PROPOSED WORKING DEFINITIONS—FOR REFERENCE

Existing IASB and FASB Definitions of a Liability

A **liability** is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. [IASB Framework, paragraph 49]

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. [CON 6, paragraph 35; footnote references omitted.]

Proposed Working Definition of a Liability

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 *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.
- (c) Obligations link the entity with what it has to do because obligations are *enforceable* against the entity by legal or equivalent means.



Board Meeting Handout*
Ratification of EITF Consensuses and a Consensus-for-Exposure¹
June 25, 2008

At today's meeting, the staff will request that the Board consider ratifying three consensuses and a consensus-for-exposure that were reached at the June 12, 2008 EITF meeting.

Task Force Consensuses:

- 1. Issue No. 07-5, "Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock"**—The Task Force affirmed as a consensus the consensuses-for-exposure previously reached at the March 12, 2008 EITF meeting and exposed for public comment. The Task Force also approved clarifying language (including the addition of a definition for the term “exercise contingency”) and decided to add three additional illustrative examples.

The Task Force affirmed as a consensus the consensus-for-exposure that an entity should evaluate whether an equity-linked financial instrument (or embedded feature) is indexed to its own stock using the following two-step approach.

Step 1: Evaluate the instrument's contingent exercise provisions, if any.

Step 2: Evaluate the instrument's settlement provisions.

The Task Force affirmed as a consensus that outstanding instruments within the scope of this Issue are always considered issued for accounting purposes, except as discussed in the remainder of this paragraph. In some cases, parties to a business combination exchange contingently exercisable options to purchase equity securities of the other entity, at favorable prices, to encourage successful completion of that combination. If the merger is consummated as proposed, the options expire unexercised. If, however, a specified event occurs that interferes with the planned business combination, the options become exercisable. Such "lock-up options" are not considered issued for accounting purposes unless and until the options become exercisable. The guidance in this paragraph is carried forward from Issue 01-6.

Evaluation of Contingent Exercise Provisions (Step 1)

An exercise contingency would not preclude an instrument (or embedded feature) from being considered indexed to an entity's own stock provided that it is not based on (a) an observable market, other than the market for the issuer's stock (if applicable), or (b) an observable index, other than an index calculated or measured solely by reference to the issuer's own operations (for example, sales revenue of the issuer, EBITDA [earnings before

* **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.**

¹ Consensus-for-exposure refers to a conclusion reached by the Task Force on an Issue indicating that the Issue has been approved for release as an exposure draft subject to Board ratification.

interest, taxes, depreciation, and amortization] of the issuer, net income of the issuer, or total equity of the issuer). If the evaluation of Step 1 does not preclude an instrument from being considered indexed to the entity's own stock, the analysis would proceed to Step 2.

For purposes of applying the guidance in this Issue, an exercise contingency is a provision that entitles the entity (or the counterparty) to exercise an equity-linked financial instrument (or embedded feature) based on changes in an underlying, including the occurrence (or nonoccurrence) of a specified event. Provisions that accelerate the timing of the entity's (or the counterparty's) ability to exercise an instrument and provisions that extend the length of time that an instrument is exercisable are examples of exercise contingencies. If an instrument's strike price or the number of shares used to calculate the settlement amount would be adjusted upon the occurrence of an exercise contingency, then the exercise contingency would be evaluated under Step 1 and the potential adjustment to the instrument's settlement amount would be evaluated under Step 2.

Evaluation of Settlement Provisions (Step 2)

An instrument (or embedded feature) would be considered indexed to an entity's own stock if its settlement amount will equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed monetary amount or a fixed amount of a debt instrument issued by the entity. For example, an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond issued by the entity would be considered indexed to the entity's own stock. An instrument's strike price or the number of shares used to calculate the settlement amount are not fixed if its terms provide for any potential adjustment, regardless of the probability of such adjustment(s) or whether such adjustments are in the entity's control. If the instrument's strike price or the number of shares used to calculate the settlement amount are not fixed, the instrument (or embedded feature) would still be considered indexed to an entity's own stock if the only variables that could affect the settlement amount would be inputs to the fair value of a "fixed-for-fixed" forward or option on equity shares.

A "fixed-for-fixed" forward or option on equity shares has a settlement amount that is equal to the difference between the price of a fixed number of equity shares and a fixed strike price. The fair value inputs of a fixed-for-fixed forward or option on equity shares may include the entity's stock price and additional variables, including the strike price of the instrument, term of the instrument, expected dividends or other dilutive activities, stock borrow cost, interest rates, stock price volatility, the entity's credit spread, and the ability to maintain a standard hedge position in the underlying shares. Determinations and adjustments related to the settlement amount (including the determination of the ability to maintain a standard hedge position) must be commercially reasonable. An instrument (or embedded feature) would not be considered indexed to the entity's own stock if its settlement amount is affected by variables that are extraneous to the pricing of a fixed-for-fixed option or forward contract on equity shares. If an instrument's settlement calculation incorporates variables other than those used to determine the fair value of a fixed-for-fixed forward or option on equity shares, or if the instrument contains a feature (such as a leverage factor) that increases exposure to the additional variables listed above in a manner that is inconsistent with a fixed-for-fixed forward or option on equity shares, the instrument (or embedded feature) would not be considered indexed to the entity's own stock.

Evaluation of Settlement Provisions (Step 2) When the Strike Price of an Equity-Linked Financial Instrument Is Denominated In a Foreign Currency

The Task Force affirmed as a consensus the consensus-for-exposure that an equity-linked financial instrument (or embedded feature) would not be considered indexed to the entity's own stock if the strike price is denominated in a currency other than the issuer's functional currency (including a conversion option embedded in a convertible debt instrument that is denominated in a currency other than the issuer's functional currency). The determination of whether an equity-linked financial instrument is indexed to an entity's own stock is not affected by the currency (or currencies) in which the underlying shares trade.

The Task Force affirmed as a consensus the consensus-for-exposure that this Issue is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Earlier application is not permitted.

The Task Force affirmed that the guidance in this Issue shall be applied to outstanding instruments as of the beginning of the fiscal year in which this Issue is initially applied. The cumulative effect of the change in accounting principle shall be recognized as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that fiscal year, presented separately. The cumulative-effect adjustment is the difference between the amounts recognized in the statement of financial position before initial application of this Issue and the amounts recognized in the statement of financial position at initial application of this Issue. The amounts recognized in the statement of financial position at initial application of this Issue shall be determined based on the amounts that would have been recognized if the guidance in this Issue had been applied from the issuance date of the instrument(s). However, in circumstances in which a previously bifurcated embedded conversion option in a convertible debt instrument no longer meets the bifurcation criteria in Statement 133 at initial application of this Issue, the carrying amount of the liability for the conversion option (that is, its fair value on the date of adoption) shall be reclassified to shareholders' equity. Any debt discount that was recognized when the conversion option was initially bifurcated from the convertible debt instrument shall continue to be amortized.

The transition disclosures in paragraphs 17 and 18 of Statement 154 shall be provided.

Evaluation of how an issuer should account for market-based employee stock option valuation instruments

The Task Force affirmed as a consensus that market-based employee stock option valuation instruments are not considered indexed to the entity's own stock under the guidance in this Issue and that an exception should not be provided for these types of instruments.

2. Issue No. 08-3, "Accounting by Lessees for Nonrefundable Maintenance Deposits"—The Task Force affirmed as a consensus that the scope of this Issue is limited to nonrefundable maintenance deposits paid by a lessee under an arrangement accounted for as a lease. Payments to a lessor that are not substantively and contractually related to maintenance of the leased asset are not within the scope of this Issue. If at lease inception a lessee determines that it is less than probable that the total amount of payments will be returned to the lessee as a reimbursement for maintenance activities, the lessee shall

consider that when determining the portion of each payment that is not within the scope of this Issue.

The Task Force affirmed as a consensus the consensus-for-exposure that nonrefundable maintenance deposits shall be accounted for as a deposit asset. The Task Force reached a consensus that lessees should continue to evaluate whether it is probable that an amount on deposit will be returned to fund maintenance activities. When an amount on deposit is less than probable of being returned, it shall be recognized as additional expense. When the underlying maintenance is performed, the maintenance costs shall be expensed or capitalized in accordance with the lessee's maintenance accounting policy.

The Task Force affirmed as a consensus the consensus-for-exposure that this Issue should be effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Earlier application is not permitted.

The Task Force affirmed as a consensus the consensus-for-exposure reached that entities should recognize the effect of the change as a change in accounting principle as of the beginning of the fiscal year in which this consensus is initially applied for all arrangements existing at the effective date. The cumulative effect of the change in accounting principle shall be recognized as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that fiscal year, presented separately. The transition impact of applying this Issue should comply with the disclosure requirements of Statement 154 for changes in accounting principles.

3. Issue No. 08-4, "Transition Guidance for Conforming Changes to Issue No. 98-5"—

The Task Force affirmed as a consensus the consensus-for-exposure that the conforming changes made to Issue 98-5 that resulted from Issue 00-27 and Statement 150 shall be effective for financial statements issued for fiscal years ending after December 15, 2008. Early application is permitted. The impact, if any, of applying the conforming changes shall be presented retrospectively with the cumulative effect of the change being reported in retained earnings in the statement of financial position as of the beginning of the first period presented. Additionally, any transition effect of applying those conforming changes should comply with the disclosure requirements of Statement 154 for changes in accounting principles.

Task Force Consensus-for-Exposure:

Issue No. 08-5, "Issuer's Accounting for Liabilities Measured at Fair Value with a Third-Party Credit Enhancement"—The Task Force reached a consensus-for-exposure that this Issue should apply to debt that is issued with an inseparable third-party credit enhancement (for example, debt that is issued with a contractual third-party guarantee) that is measured or disclosed at fair value. The Task Force reached a consensus-for-exposure that the issuer of debt with a third-party credit enhancement that is inseparable from the debt instrument should not include the effect of the credit enhancement in the fair value measurement of the liability. The unit of accounting for the debt does not include the guarantee. That guarantee is obtained for the benefit of the investor and does not represent

an asset of the issuer. The Task Force agreed that this Issue does not apply to guarantees provided by the government or government agencies; for example, deposit insurance.

The Task Force reached a consensus-for-exposure that this Issue shall be effective on a prospective basis in the first reporting period beginning after the final abstract is posted to the FASB website, including interim periods. The effect of initially applying the guidance in this Issue shall be included in the change in fair value in the period of adoption. Earlier application is not permitted.

The Task Force reached a consensus-for-exposure that in the period of adoption an entity should disclose changes, if any, from the valuation techniques used in prior periods to measure liabilities within the scope of this Issue, including the nature of the change. The Task Force reached a consensus-for-exposure that an entity with outstanding debt within the scope of this Issue should disclose the existence of the credit enhancement.

Task Force Recommendation to Remove Item from its Agenda:

Issue No. 08-2, "Lessor Revenue Recognition for Maintenance Services"—The Task Force recommended that the FASB chairman remove this item from its agenda.