MINUTES

Financial Accounting Standards Board

To:	Board Members
From:	Prince (x229)
Subject:	Minutes of the May 7, 2008 Board Meeting: Elements and Recognition: Phase B
Date:	May 23, 2008
cc:	Leisenring, Bielstein, Golden, MacDonald, Allen, Posta, Glotzer, Klimek, Lott, Gabriele, Sutay, Chookaszian, Project Team, FASB Intranet, Upton, Hickey, Clark, Crook, Lian, Hague, Villmann, Willis, Reese, Patton

The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue a final Statement, Interpretation, or FSP.

Topic:	Definition of a Liability: Distinguishing between a liability and risk and identifying stand-ready obligations
Basis for Discussion:	Memoranda A—C, dated April 9, 2008
Length of Discussion:	9:05 to 10:10 a.m.

Attendance:

Board members present:	Herz, Batavick, Crooch, Linsmeier, Seidman, Smith, and Leisenring (IASB)
Board members absent:	Young
Staff in charge of topic:	Villmann
Other staff at Board table:	Hague, Bielstein, T. Johnson, and Prince
Outside participants:	None

Summary of Decisions Reached:

The Board discussed the following two issues related to the working definition of a liability that is being developed in Phase B (Elements and Recognition) of the joint conceptual framework:

1. Distinguishing a liability from a business risk. The Board agreed that the existence of a present economic obligation distinguishes a liability from general business risks. The Board also generally agreed that, in concept, a present economic obligation exists when:
    a. An entity is committed to a particular action(s) that is capable of resulting in cash outflows
    b. There is a mechanism to enforce that economic obligation against the entity.

    The Board also agreed that laws and regulations are examples of mechanisms and are not, by themselves, present obligations.

2. Identifying a stand-ready obligation. The Board agreed that it is helpful to analyze 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 if an uncertain future event occurs. In situations where a conditional obligation is identified, it can be helpful to assess whether there is an accompanying unconditional obligation that presently requires the entity to perform. The Board also agreed that noncontractual scenarios can be analyzed to identify unconditional and conditional obligations.

The IASB separately discussed the above issues as part of joint work on its project on liabilities and equity (revisions of IAS 37) and the conceptual framework project, and reached similar conclusions.

Objective of Meeting:

The objective of this meeting was to have the Board 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 (1) distinguishing between a liability and risk and (2) identifying what constitutes a stand-ready obligation. The objective was met.

Matters Discussed and Decisions Reached:

ISSUE 1—DISTINGUISHING BETWEEN A LIABILITY AND A RISK

Staff Remarks—Liability and Risk

1. Ms. Villmann stated that both a risk and a liability can result in cash outflows. In the case of a liability, a third party can enforce an entity to make the cash outflow. In contrast, in the case of a risk, no third party can enforce the entity to make the cash outflow. Furthermore, the cash outflow associated with a risk may be avoided by taking actions to avoid or mitigate the effects of that risk.
2. Ms. Villmann asked the Board members whether they agreed that the existence of a present economic obligation distinguishes a liability from a risk.

Board Vote

3. The Board agreed that a present economic obligation distinguishes a liability from general business risks.

Board Comments

4. Mr. Linsmeier agreed that the existence of a present economic obligation was needed to meet the definition of a liability. He noted, however, that some risks also seem to be associated with present economic obligations. In other words, some liabilities arise from business risks. Ms. Bielstein noted that Mr. Linsmeier's comment regarding risk and liabilities overlapping could be depicted by a Venn diagram, wherein a circle representing risk would overlap the circle representing liabilities. The risks being discussed are general risks that do not overlap with liabilities. Mr. Smith observed that the existence of a present economic obligation effectively translates a business risk into a liability.

Staff Remarks—Further Analysis

5. Ms. Villmann asked the Board whether it had any comments or questions on the staff's analysis of the scenarios (the "Digger" and "Auto" examples) contained in the appendix to the Board handout, as well as the staff's conclusions drawn from the analysis.

Board Vote

6. The Board generally agreed with the staff's conclusions.

Board Comments

7. Mr. Herz commented that during previous discussions with the staff, he had raised the question as to how the staff's proposed model would be applied to employee benefits. He observed that the staff's model—specifically, the conclusions drawn from the "Digger" example—would not recognize a liability until an employee vests, whereas current practice is to recognize a liability prior to vesting.
8. Mr. Leisenring asked whether a stand-ready obligation exists in a situation where an entity promises pension benefits to its employees if they work for five years. Specifically, is the entity standing ready to provide the pension benefit prior to the employees completing their fifth year of employment? Mr. Linsmeier stated that he believed a stand-ready obligation would exist, as there could be other mechanisms to enforce the obligation, such as promissory estoppel. He noted, however, that the stand-ready obligation might be measured differently. Mr. Leisenring commented that further research may need to be done to determine whether there are substantive differences between the staff's "Digger" example and Mr. Herz's pension example.
9. Mr. Smith asked whether a stand-ready obligation exists in the "Digger" example if the entity fully intends to drill to the depth that obligates the entity to have to refill the holes. Mr. Leisenring noted that the entity's intent does not mean that someone has the right to rely on the entity digging further. There is no liability because no one can compel the Digger to dig deeper. Mr. Leisenring noted that intent does not usually obligate an entity to perform.
10. Mr. Batavick raised an example of an entity promising to pay its employees a bonus if the entity achieved $12 million in profit for the year. He asked whether the entity has a stand-ready obligation for the bonuses prior to achieving $12 million in profit, even

in situations where it is virtually assured that the entity will achieve its target. He commented that he believed the entity should be accruing a liability in those cases. Mr. Crooch disagreed with Mr. Batavick.

11. Mr. Linsmeier noted that a stand-ready obligation is when an entity is standing ready to do what a counterparty can require the entity to do versus standing ready to do what the entity intends to do.
12. Ms. Seidman noted that her concern is that the staff's analysis seems to be recognizing liabilities too early. For example, she thinks a stand-ready obligation does not exist in scenario 2A of the "Auto" example. (In this scenario, a company has mailed out irrevocable offers to provide car maintenance for a year to anyone who accepts the offer by returning a signed service agreement. The staff analysis indicated that the entity would have a liability in that scenario.) Ms. Seidman commented that she thinks an entity is not obligated to perform until someone accepts the entity's offer. Ms. Seidman does not think it would be appropriate to recognize an expense before the counterparty accepts the offer, to the extent that the offer will result in the exchange of unconditional promises.
13. Ms. Seidman commented that the existence of a liability seems to hinge on whether an entity has entered into an enforceable arrangement and whether an entity can avoid its obligation. She thinks the Board need not provide answers to whether those two conditions are met for different scenarios because the answer will depend on the facts and circumstances of the scenarios. Ms. Bielstein noted that the scenario assumes that the arrangement is enforceable.
14. Mr. Linsmeier stated that the discussion regarding stand-ready obligations in the "Auto" example may be more of a measurement issue than a recognition issue. Mr. Linsmeier further noted that the staff's analysis provides discipline on what would be considered a liability. Specifically, when an entity cannot avoid its obligation, a liability exists.
15. Mr. Herz stated that it appears that, in the examples discussed by the Board, if an entity makes an offer that is enforceable if the counterparty to that offer performs, then, conceptually, a stand-ready obligation exists. He further noted that whether the stand-ready obligation would be recognized and how it would be measured is another

issue. He added that a liability for a stand-ready obligation might be recognized for pensions prior to the vesting date.

16. Mr. Linsmeier noted that the counterparty's acceptance of an offer does not seem to drive whether or not a liability exists. Ms. Seidman thinks that the counterparty's acceptance would matter in cases where the offer was followed by an equal exchange of promises. She added that it is important to consider whether there are offsetting cash inflows and outflows when determining if a stand-ready obligation exists in revenue recognition situations.
17. Mr. Linsmeier noted that the unit of account issue may have some implications for recognition of assets and liabilities.

ISSUE 2—IDENTIFYING WHAT CONSTITUTES A STAND-READY OBLIGATION

Staff Remarks—Contractual Scenarios

18. Ms. Villmann stated that in the case of contracts or other binding arrangements, it is helpful for an entity to determine what types of obligations the entity presently has. Ms. Villmann noted that there are both conditional and unconditional obligations. An unconditional obligation requires performance now or over a period of time, whereas a conditional obligation requires performance if an uncertain future event occurs.
19. Mr. Hague noted that the staff's desire is to have entities look harder to identify potential unconditional obligations accompanying their conditional obligations.
20. Ms. Villmann asked the Board members if they agreed that analyzing a scenario for both conditional and unconditional obligations was helpful to identify all present obligations.

Board Vote

21. The Board generally agreed with the staff's recommended analysis.

Board Comments

22. Mr. Linsmeier agreed that the concepts were helpful; however, he noted that stand-ready obligations are not a distinct type of obligation. Rather, stand-ready obligations are a class of unconditional obligations.
23. Mr. Leisenring noted that standing ready to do something does not always indicate the existence of liabilities. For example, an entity opening its business is standing ready to serve its customers; however, that does not give rise to a liability.
24. Ms. Seidman stated that she does not find the staff's recommended analysis helpful in situations where an element is measured at fair value. She noted that the staff's analysis only becomes relevant when an entity is trying to account for the parts of an arrangement differently.
25. Mr. Batavick stated that he preferred using the terms *unconditional* and *conditional performance obligations*. He would not use the term *stand-ready obligation*.
26. Mr. Linsmeier stated that removing the term *stand-ready obligation* from U.S. GAAP and the Board's vernacular is unlikely; however, he thinks constituents would be best served if they were made aware that stand-ready obligations are a class of unconditional obligations.

Staff Remarks—Noncontractual Scenarios

27. Ms. Villmann stated that the staff has found the conditional/unconditional analysis to also be helpful in noncontractual scenarios. Ms. Villmann asked the Board whether it agreed that the staff's conditional/unconditional analysis could be helpful in noncontractual scenarios.

Board Vote

28. The Board agreed that the staff's analysis could be applied to noncontractual scenarios.

<u>Follow-Up Items</u>:

None.

<u>General Announcements</u>:

None.