MINUTES

Financial Accounting Standards Board

To:	Board Members		
From:	Gibbons (ext. 446), Zimmerman (ext. 298)		
Subject:	Minutes of the March 1, 2006 Conceptual Framework Board Meeting	**Date:**	March 9, 2006
cc:	Leisenring, Bielstein, Smith, Petrone, Mahoney, Polley, Lott, Gabriele, Carney, Sutay, Project Team, Moss, FASB Intranet, Upton, Rees, Hague, Villmann, Hickey, Crook, Willis, GASB: 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 or Interpretation.

Topics:	Elements 3: Asset Definition Elements 2: Liability Definition
Basis for Discussion:	FASB Memoranda 21 and 22
Length of Discussion:	8:00 a.m. to 10:00 a.m.
Attendance:	
Board members present:	Herz, Batavick, Crooch, Schipper, Trott, Seidman, and Young
Board members absent:	None
Staff in charge of topics:	Hague and Bullen
Staff at Board table:	Bielstein, T. Johnson, Bullen, Bossio, Abbate, Gibbons, and Zimmerman
Other participants:	by phone: Hague and Villmann

Summary of Decisions Reached:

The Board continued its deliberations on the joint FASB/IASB conceptual framework project by discussing the working definitions of an asset and a liability. The staff also reported an Exposure Draft of a Concepts Statement on objectives of financial reporting and the qualitative characteristics of decision-useful financial reporting information is now expected to be issued in the second quarter of 2006.

Definition of an Asset

1. The Board discussed the following proposed working definition of an asset that reflects revisions resulting from Board decisions reached in December 2005:

   An asset of an entity is:

   - *a. Cash held by the entity*
   - *b. A present right of the entity to cash*
   - c. *A present right, or other present privilege, of the entity to a resource that is capable of generating economic benefits to the entity, either directly or indirectly.*

2. The Board agreed that:

   a. The notion of “other present privilege of the entity” is better than “other access” (as proposed in December 2005)

   b. The phrases “cash held by the entity” and ”a present right of the entity to cash” are not necessary because those items meet part (c) of the definition, as modified

   c. The words “either directly or indirectly” should not be included in the definition but rather explained in amplifying text.

3. The proposed working definition should be tested by applying it to certain accounting issues that have been difficult to resolve in the past.

4. The Board provided other suggestions and clarifications for further consideration, including particular wording for the definition and its amplifying text.

Definition of a Liability

5. The Board discussed the following working definition of a liability:

> *A liability of an entity is its present obligation to one or more other entities that compels potential outflows or other potential sacrifices of economic benefits.*

6. The Board agreed that:

    a. *Liability* should continue to be defined directly, with reference to assets
    b. It is the present obligation, not the future sacrifice, that is the liability
    c. An obligation to forgo a cash inflow or to stand aside can be a liability, or perhaps a reduction in an asset
    d. Only an obligation to one or more other entities can be a liability
    e. The notion in the current definition of little or no discretion to avoid a future sacrifice should be replaced, perhaps by a notion of legal or equivalent compulsion
    f. The definition need not include “probable” or other notions of likelihood, which instead belong in recognition criteria or measurement
    g. Explicit reference to past events is unnecessary—redundant—because a present obligation can only have arisen from past events

6. The Board provided other suggestions and clarifications for further consideration.

<u>Objective of Meeting</u>:

The Board discussed the working definitions of an asset and a liability. The objective of the meeting was to obtain decisions on and confirmation of future direction for the working definitions. The objectives of the meeting were met.

<u>Matters Discussed and Decisions Reached</u>:

Definition of an Asset

1. Mr. Hague began the discussion by stating that it is the second discussion on the definition of an asset and that it builds on the discussions from the December 2005 meeting. The staff has re-evaluated the working

definition and proposed a number of modifications based on suggestions made by FASB and IASB Board members at that meeting. The staff developed the following revised working definition of an asset:

An asset of an entity is:

a. Cash held by the entity

b. A present right of the entity to cash

c. *A present right, or other present privilege, of the entity to a resource that is capable of generating economic benefits to the entity, either directly or indirectly.*

The staff is seeking feedback from the Board on the key changes to the working definition.

2. Mr. Hague asked whether the asset should be defined in the context of the entity. The staff's view is that the notion "of an entity" is more beneficial as it focuses the definition on assets that an entity is likely to put on its balance sheet. Those opposed to defining an asset of an entity argue that it introduces recognition criteria into the asset definition. However, there are items that satisfy the working definition that may not be recognized, and recognition criteria that have not yet been deliberated. During the February 23, 2006 IASB Board meeting, discussion on this point was very slight and no IASB Board members objected to the staff recommendation.

3. Ms. Seidman and Mr. Batavick agreed with the staff. Ms. Schipper expressed a concern with including in the definition the quasi-recognition criterion and not others. Ms. Schipper stated that if recognition criteria are to be included in the definition, there are other criteria that she considers candidates for inclusion. Ms. Seidman stated that she does not view "of the entity" as a recognition condition, but rather as a scope issue. She drew a parallel to the process chart for considering the qualitative characteristics of accounting information, where the analysis is narrowed to the phenomena that are relevant to the entity. Ms. Schipper further disagreed, stating that a recognition condition exists because one first

identifies the item that is an asset before one identifies who recognizes it, if anyone.

4. Mr. Hague stated that at the December meeting, the staff proposed the notion of “other access” to capture assets that do not arise from legal rights. At the March 1, 2006 meeting, the staff proposed replacing “other access” with “other present privilege of the entity” to denote a privilege beyond the common advantage of others. At the IASB meeting, Board members expressed preference for a phrase such as “rights, or other privileged access”.

5. Mr. Trott stated that he does not find the notion of “other present privilege” significantly more useful than “other access”. There is a fine line between the two notions and the definition will have to be tested with accounting situations, such as customer relationship assets. Mr. Trott suggested the staff consider the definition of an asset from the perspective of both parties to a transaction. Amplifying text will be necessary to ensure that the definition applies appropriately to certain accounting issues that have been difficult in the past. For example, the staff should consider a deep in-the-money call or an assembled work force. Ms. Schipper agreed with Mr. Trott, stating that it is necessary to test the definition to see if it provides a clearer, sharper, and more discriminatory way of thinking about difficult accounting issues. Mr. Herz agreed with the idea to test the definition against examples. Mr. Hague stated that the staff will test the proposed definition to determine if it is an improvement.

6. Ms. Seidman stated that the notion of “privileged access” is a marginal improvement over “other access”; it communicates more effectively the idea that the holder of the access can restrict others to it. However, limiting the definition of an asset to a “right or privilege” could create a communication issue because it seems to exclude simple situations in which an asset is owned outright. She stated that other standard-setting projects distinguish between rights to use an item and owning an item. In order to be consistent, she proposed adding the phrase “a present

resource or present right to a resource" to the definition. Mr. Trott stated that it is interesting that the working definition of an asset refers to a "present right to an economic resource", rather than the resource itself, while the working definition of liability asserts that the liability is the obligation to make the sacrifice, rather than the sacrifice itself. Mr. Bullen stated that owning an asset is equivalent to having a set of rights, and many accounting issues can be covered in the term *right*. Not all accounting situations can be covered by the term *right*, which is why the staff proposes the term *privilege*, which may capture assets that do not arise from legal rights. Mr. Herz agreed that a right can be an ownership right and suggested the notion of "present ownership or other right". Mr. Trott stated the suggestion proposed by Mr. Herz might lead to problems with the definition of ownership.

7. Ms. Schipper stated that the attempts to eliminate the problems that arose due to the inclusion of the word *control* in the current definition could give rise to a new and different set of problems that will create recurring issues in standard setting. She suggested that the staff consider whether better solutions will be derived by using this new definition than in the past when applying the word *control*. If new and worse problems arise, she questions the value in changing the definition in this way.

8. Mr. Batavick stated that the definition of an asset should strike a balance between the definition and the amplifying text. It should not require vast amounts of amplifying text in order for it to be understood. Mr. Trott agreed with Mr. Batavick, but added that amplifying text is needed given the diverse backgrounds of the readers.

9. Mr. Trott stated that the amplifying text proposed by the staff—"control is unnecessary when one has a present right, or other access"—is apt to confuse rather than amplify and Mr. Crooch agreed. Mr. Hague agreed that the amplifying text was ambiguous and stated it is the staff's intention to clarify in the amplifying text that the word *control* is no longer needed in the definition and is being replaced by "present right or other access".

10. Mr. Trott and Ms. Seidman agreed with the IASB recommendation to remove “either directly or indirectly” from the definition. Ms. Schipper stated that the phrase “either directly or indirectly” temporarily replaced the phrase “either alone or in combination with other items”. Mr. Hague stated that “either directly or indirectly” does not exclude anything and that the concept can be discussed better in amplifying text.

11. Mr. Hague stated that the staff proposes removing the terms *existing* and *economic* from the December 2005 working definition of an asset. The term *existing* may exclude certain futures contracts from the scope of the definition. Removing *economic* will improve the focus on the “right or other privilege” aspect of the definition.

12. Ms. Schipper asked what the restrictions are on the word *resource* and the staff intent in using the word. Mr. Hague stated the clause “with the ability to generate economic benefits to the entity” is the restriction on *resource*. Ms. Schipper questioned circularity in the definition, since *asset* is often used in defining *resource*. Certain arrangements, such as a deep in-the-money call option, have been vexatious in the past. She asked if a contract, which may become onerous to a counterparty, could be a resource. If so, does one have an asset if one writes a call that is deep in-the-money, but the counterparty is almost sure to exercise? Mr. Herz stated that a loan commitment is a similar situation. Mr. Johnson stated that there is a unit of account question; if you are the exposed party, you cannot have an asset for that piece. There may be a family of items consisting of both assets and liabilities. Ms. Schipper stated that in the past, the word *control* has been used to resolve issues and that the staff is now proposing a definition without the notion of control. Mr. Trott and Ms. Seidman stated that the staff should now be able to consider the symmetry between the asset and liability definitions both in concept and terminology.

13. Ms. Seidman, Ms. Schipper, and Mr. Trott agreed that “cash held by the entity” and ”a present right of the entity to cash” should be removed from the definition since they would meet part (c) of the definition, as modified. Mr. Young stated the discussion on the definition of an asset includes baggage of prior issues brought to the Board and that he would look at it with a fresh and unbiased view. He would define an asset as “cash, or an item that will generate a cash inflow or avoid a cash outflow”. Investors, users, and analysts want to know what the “economic benefit” is; the “economic benefit” should be simplified as cash inflows or avoided cash outflows.

14. Mr. Bossio stated that the staff will consider the suggestions of the Board in moving forward and continue working on the definition of an asset. He noted the concern as to whether the staff is correcting current problems or simply introducing and substituting new ones.

Definition of a Liability

15. Mr. Bullen continued the discussion by stating that this is the first discussion of the definition of a liability. In developing the working definition, the staff considered the following:

    a. The IASB *Framework for the Preparation and Presentation of Financial Statements*

    b. FASB Concepts Statement No. 6, *Elements of Financial Statements*

    c. Conceptual frameworks of other standard setters

    d. Whether the definition of liabilities should differ from the general usage of the term.

    The staff developed the following working definition of a liability:

    > *A liability of an entity is its present obligation to one or more other entities that compels potential outflows or other potential sacrifices of economic benefits.*

16. Mr. Bullen stated that the staff's approach is to build the working definition by defining liability directly, with reference to assets. This approach is consistent with the current IASB and FASB definitions and the definitions of other standard setters.

12. The Board agreed with the staff's approach, but raised certain concerns. Ms. Schipper pointed out a difficulty with a parallel approach to defining assets and liabilities. In the asset definition, the phrase "the ability to generate economic benefits" is the same as the phrase "the ability to generate cash inflows" for business enterprises. The liability definition does not mirror the asset definition if a liability is an obligation to transfer economic benefits in the form of the entity's equity securities. In other words, "economic benefits" appears to be used differently in the asset and liability definitions. Ms. Seidman asked whether the ability to settle a liability in an entity's own shares is a change in strategy; in her view, it is a significant change in strategy. Mr. Bullen stated that this is a potential change in strategy, but that the Board will not be able to decide on that before considering the distinction between liabilities and equity at a future meeting.

13. Ms. Schipper questioned whether a liability has to be an asset *to an entity*; in her view there are liabilities that are not assets of other entities (for example, asset retirement obligations). Mr. Bullen stated that the use of the word *entity* is a challenge because the conceptual framework project has not concluded whether *entity* includes natural persons, for example, the people who are to receive retirement benefits. In the asset and liability definitions, *entity* includes natural persons. He further noted that a liability does not arise from owing something to oneself; a liability must be owed to another party or society at large. Ms. Schipper stated that the liability definition, as well as the asset definition, should be tested against contentious issues.

14. Mr. Bullen stated that the phrase “potential outflows or other sacrifices of economic benefits” in the working definition conveys the notion that, in the staff’s view, a foregone cash inflow and a stand-ready obligation are liabilities. Mr. Trott proposed explicitly including those items in the liability definition as opposed to in the amplifying text for the definition. The phrase “compel potential outflows or other sacrifices of economic benefits” is not parallel with the asset definition, in his view.

15. Ms. Schipper questioned whether a stand-ready obligation is the same as an arrangement that would compel the potential foregoing of a cash inflow. If so, she asked whether that means a heavily subordinated receivable is a liability rather than an impaired asset. Ms. Seidman stated that it is an asset and that the value may be uncertain. Mr. Herz stated that subordination would be priced into the receivable. Mr. Bullen stated that a covenant not to compete is the example in Memorandum 22 of an obligation to stand aside or forego a cash flow. Ms. Schipper stated that in her view, that is an impairment of an asset. There is a difference between *standing ready* (that is, agreeing to pay if and when a condition is satisfied) and *standing aside* (that is, agreeing not to be paid). Considering a stand-aside obligation to be a liability would elevate the notion of an opportunity cost to the level of a liability recognized. Mr. Herz agreed with Ms. Schipper on this point. Mr. Bullen stated that a covenant not to compete may be an impairment of an asset (that is, earning power), but since this asset is not recorded, accountants may instead treat the covenant not to compete as a liability.

16. Ms. Schipper stated that recording an intangible asset associated with prior service cost is an enhancement of an unrecorded asset. If there are enhancements to items that would have been recorded as assets under a different set of recognition criteria, it would seem possible to also record an impairment of an unrecognized asset. Mr. Bullen stated that this is possible, but that double entry bookkeeping would make this challenging because a negative asset would result.

17. Ms. Seidman stated that she is concerned with the phrase "compel potential" because it has a probability connotation; she would prefer to parallelize this with the definition of an asset by using the phrase "has the capacity to compel". Mr. Crooch agreed.

18. Mr. Bullen began discussing the notion of compulsion by explaining that the staff introduced this concept to avoid the problems with the phrase "little or no discretion to avoid" in the current liability definition. People have questioned what constitutes "little" and whether "discretion" is a useful term. The staff recommends that constructive obligations can be liabilities only if the legal system would construe a liability. Legal compulsion creates a liability, but economic and moral compulsions do not. The staff's proposal would result in a narrower definition of liability.

19. Mr. Herz questioned whether accepting the staff's view would implicitly predetermine measurement such that liabilities would be measured at the amount for which the legal system would enforce the liability. For example, does this imply that there is no liability if employee benefits have not vested? Mr. Bullen stated that it does raise that possibility, but that it would depend on the facts and circumstances. A pension obligation can be viewed as a group of obligations, only some of which are liabilities. This idea may be helpful in considering measurement of that family of obligations. Mr. Bossio stated that in the case of employee benefits that do not vest for 10 years, if the employer fires an employee 2 days before the employee vests, the court may still enforce a liability. Mr. Bullen stated that if the Board allows economic compulsion to create a liability, it is a slippery slope. For example, people may feel economically compelled to achieve an earnings per share target—that should not be a liability.

20. Ms. Schipper asked Mr. Herz whether he is concerned that confining liabilities to legal obligations may limit the use of fair value measurements. For example, in a class of arrangements that has a dispersion of possible outcomes based on forward-looking information, a market participant would be interested in outcomes other than the one that would be

imposed by a legal settlement. Mr. Herz stated that is his concern and that economic compulsion may factor into the measurement of a liability. Mr. Trott asked whether including a "separately contractual" notion in the amplifying text would be helpful. Mr. Trott observed that income tax is a legal requirement that is not contractual. Mr. Bullen agreed that not all legal obligations arise from contracts. The supporting text for the definition may provide examples of items that could be enforced at law. Ms. Seidman agreed with this approach.

21. Mr. Herz stated that he is concerned that *compel* implies a point in time and that it may indicate that liabilities should be measured at a liquidation value. Ms. Seidman stated that the phrase "has the capacity to" addresses this concern because it does not necessitate a cash outflow and does not imply timing for settlement of the liability. Mr. Bullen stated that *compel* draws a line between an obligation today and an obligation that will arise in the future.

22. Mr. Trott asked whether the notions of conditional and unconditional obligations and rights can be incorporated. Mr. Bullen stated that the words "compel potential" are intended to capture those ideas. Ms. Seidman stated that the Board will need to reach an agreement on what constitutes a conditional obligation. Warranties and guarantees (see examples in FASB Memorandum 21) are contractual in nature, but there are items that are not contractual and more ambiguous in the FASB Invitation to Comment, *Selected Issues Relating to Assets and Liabilities with Uncertainties*, that the Board will need to consider.

23. Mr. Bullen stated that he heard support for the staff's proposal that it is unnecessary to specify that there be a past event and that probability is an issue for measurement. He stated that liability and equity issues will be considered at a future meeting.

Follow-up Items:

The staff agreed to test the asset and liability definitions against issues that have been difficult to resolve in the past.

General Announcements:

Mr. Bossio reported on the project plans for the coming months, including the timing for the release of the Phase A Exposure Draft on objectives of financial reporting and the qualitative characteristics of decision-useful financial reporting information. Its release is now expected in the second quarter of 2006.