# Conceptual Framework

# Elements 2: Liability Definition

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## Introduction

1. This paper is for the second discussion of the "elements" phase of the joint IASB/FASB conceptual framework project. It focuses on the definition of liabilities.

2. This paper first identifies similarities in and differences between the definitions of liabilities in the IASB *Framework for the Preparation and Presentation of Financial Statements* (IASB *Framework*) and the FASB Concepts Statement No. 6, *Elements of Financial Statements* (CON 6), as well as differing aspects of the definitions of liabilities in conceptual frameworks of other standard setters. The paper then considers whether our definition of liabilities should differ from the general usage of the term. Finally, the paper considers the essential characteristics of liabilities and develops a proposed working definition.

3. Like December's paper on assets, this paper attempts to reason from first principles.[1] It also attempts not to "peek ahead"[2] and, therefore, does not consider the consequences of the definition for particular conclusions reached in current accounting standards projects. It also does not consider most liability-equity issues and certain other important matters identified in cross-cutting issues; they will be considered in separate papers, expected to be developed for discussion in April and June 2006. This paper also does not consider the effects of uncertainty, which are scheduled for discussion later in 2006.

4. This paper discusses the cross-cutting issues as they arise, rather than in numerical order. Cross-cutting issues addressed in this paper are as follows:

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[1] Precept No. 2.
[2] Precept No. 8.

EL.16 What is the past transaction or event that gives rise to the present obligation?

EL.17 If entity agrees to forego a cash inflow or has an obligation to stand aside, is that a liability?

EL.18 What are equitable or constructive obligations - Are they promises that a court of law would enforce or something broader than that? Eg preference share dividends, employee bonuses, projected benefit obligation, other unvested benefits. Are there constructive obligations that are not legally enforceable? Do these notions work across different jurisdictions (eg "equitable" obligations, "promissory estoppel")?

EL.19 Can economic compulsion give rise to a present obligation and, if so, what does it mean?

EL.20: Is the liability the future sacrifice itself or the obligation to make that sacrifice?

EL.21: Could the entity have little or no discretion to avoid a future sacrifice but have no present obligation?

EL.24: Does a future commitment (eg to pay next-year's salaries) give rise to a present obligation?

EL.25: Should there be a distinction between liabilities and equity?

5. A summary of the issues and staff recommendations is at the end of the paper, together with an appendix summarizing cross-cutting issues remaining to be considered, relating to the definition of a liability (Appendix A). For convenience, the proposed working definition of a liability also is set out here:

> *Liabilities* of an entity are its present obligations to other entities that compel potential outflows or other sacrifices of economic benefits.

## Existing Definitions of a Liability

### IASB and FASB Definitions

6. The IASB *Framework* defines a liability in the following manner:

> A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.[3]

[3] IASB *Framework*, paragraph 49.

CON 6 defines liabilities as follows:

> Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.[4]

**Similarities**

7. The two definitions contain a number of common characteristics (disregarding the singular/plural difference):

    a. Each definition is derived from, and is in many respects a mirror image of, the definition of an asset.

    b. Each definition includes “present obligation.”

    c. Each definition makes reference to “economic benefits.”

    d. Each definition requires that the liability result from “past (transactions or) events.”

    e. Each definition includes a degree of likelihood (IASB—“expected,” FASB—“probable”.)

**Differences**

8. However, there also are a number of differences between the two definitions, including:

    a. The FASB definition talks of the obligation “to transfer assets or provide services.” The IASB *Framework* talks of the settlement resulting in an “outflow” of “resources embodying economic benefits.” It lists five ways by which an an obligation might be settled—payment of cash, transfer of other assets, provision of services, replacement with another obligation, or conversion of the obligation to equity—and also notes that an obligation might be extinguished by a creditor waiving or forfeiting its rights.

    b. The IASB *Framework* focuses on the “obligation” of the enterprise, then on its “settlement.” The FASB definition focuses on “future economic sacrifices”, then on the “obligations” from which the sacrifices arise. (see paragraph 36 et seq.)

[4] CON 6, paragraph 25, footnote references omitted.

c. The FASB definition explicitly requires obligations to be "to other entities," but the IASB *Framework* does not.

d. The FASB definition explicitly includes "future", but the IASB *Framework* only implies that in saying "the settlement of which is expected to result."

e. Just as with assets, the IASB *Framework* focuses on past events, but the FASB definition focuses on "past <u>transactions or</u> events." (see paragraph 135-137)

f. Just as with assets, the IASB *Framework* focuses on "expected," but the FASB definition focuses on "probable". (see paragraphs 44-48.)

### Other Standard Setters

9. Some national standard setters have developed definitions of liabilities more recently than either the IASB or FASB. Those definitions are included in Appendix B to this paper, along with the standard setters' definitions of an asset. Those definitions have many similarities to the IASB and/or FASB definitions. But some differ in several key aspects, including the following which are discussed later in this paper:

a. The Japanese draft definition includes not only obligations but also "their equivalents."[5] (See paragraph 50)

b. The New Zealand definition refers not only to sacrifices of future economic benefits, but also to sacrifices of "service potential."[6] (See paragraph 23)

c. The Canadian definition refers not only to transfers of assets and provision of services, but also to "other yielding of economic benefits"[7] (See paragraph 25)

## Liabilities and Assets

10. As noted earlier, both the IASB and FASB definitions of liabilities are derived from, and are in many respects a mirror image of, their definitions of an asset. So are the definitions in the other national standard setters' frameworks, as can be seen in the table in Appendix B.

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5 Accounting Standards Board of Japan, Discussion Paper, *Elements of Financial Statements*, paragraph 5.
6 Other conceptual frameworks, including those of the FASB and Australia, also discuss the role of "service potential."
7 CICA *Handbook*, paragraph .32

11. That is no accident. As the staff will discuss in later papers, equity, income, expense, and other elements of financial statements are also defined in all the frameworks partly in terms of assets. In contrast, the present definitions of assets in all the frameworks are not based on the definition of liabilities or any other element of financial statements. Former FASB member Oscar Gellein dubbed this arrangement *conceptual primacy* and explained the need for it as follows:

> Every conceptual structure builds on a concept that has primacy. That is simply another way of saying some element must be given meaning before meaning can be attached to others. I contend that assets have that primacy. I have not been able to define income without using a term like asset, resources, source of benefits, and so on. In short, meaning can be given to assets without first defining income, but the reverse is not true.[8]

12. The discussion and working definition of an asset in the December paper implicitly assumed that this approach will be carried forward. This paper explicitly assumes that, but there are alternatives:

- We could attempt to **define liabilities directly, without reference to assets** or a synonym for assets. The staff is unaware of any attempts to do that that have met with success.
- We could attempt to **define liabilities by reference to what general practice or standard setters consider to be liabilities**. The U.S. Accounting Principles Board did that in its Statement No. 4. Their definition was "economic obligations of an enterprise that are recognized and measured in conformity with generally acceptable accounting principles. Liabilities also include certain deferred credits that are not obligations . . . ."[9] That definition was widely criticized as circular and useless as a guide for standard setters
- We could attempt to **define equity directly, and define liabilities as the residual** by subtracting equity from assets. The CFA Institute's recent white paper, *Comprehensive Business Reporting Model*, does that by including in its definition of liability the criterion that "It does not meet the definition of equity." See Appendix

[8] Oscar S. Gellein, "Primacy: Assets or Income? In *Research in Accounting Regulation*, vol.6, edited by Gary John Previts (Greenwich, Connecticut: JAI Press, 1992), page 198. Quoted in Reed K. Storey and Sylvia Storey, FASB Special Report, *The Framework of Financial Accounting Concepts and Standards*, (January 1998), page 79.

[9] *Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises*,1970, paragraph 132 (footnotes omitted.)

B for their full proposed definition. We will consider some related matters at a future meeting focusing on distinguishing liabilities and equity.

- We could **make no conceptual distinction between liabilities and equity**, leaving a single category of "equities". W.A Paton did that, defining equities as "the equitable assignment or distribution of the total of the assets among the parties having rights therein which are subject to statement in monetary terms" in *Essentials of Accounting*, (New York: MacMillan, 1938), page 27, and in other writings. However, Paton did divide equities into liabilities ("the equities of those who have, in the eyes of the law, the status of creditors") and proprietorship ("the interest of the owners in the narrow sense"), so he does not really avoid the problems of the liability-equity distinction. (That is also a cross-cutting issue: **EL.25: Should there be a distinction between liabilities and equity?** The staff sees no need for further discussion of not making such a distinction.)

13. However, unless otherwise directed, the staff does not plan to explore those fundamentally different alternatives. Concentrating on converging and fixing what's broken[10], this paper follows the lead of all the existing frameworks, confining itself to attempting to define liabilities directly, with reference to assets. The staff does plan to discuss the implications of the conceptual primacy of assets for the definitions of elements other than assets and liabilities at later meetings.

14. To summarize, the staff recommends that we confine ourselves to defining liabilities directly, with reference to assets, rather than exploring fundamentally different alternatives. Do the Boards agree?

## *Liabilities*—General Usage and Our Concept

### Liability and Obligation in General Usage

15. The *Oxford English Dictionary*[11] defines a liability as the condition of "being bound or obliged by law or equity" and also as "the condition of being exposed to or subject to, or likely to suffer from [something burdensome]."

16. Thus, in that general sense, if one were to start to list "liabilities," one might, intuitively, list items such as amounts payable for products or services received,

[10] Precept No. 1
[11] Oxford University Press, Second Edition (1971). Our definition here combines *liability* and *liable*.

products or services due to customers that have prepaid, duties to deliver or pay for products or services under contracts that are still fully executory, all sorts of financial instruments, taxes due now, taxes that will become due, pensions promised to workers, requirements to pay future salaries or termination penalties under employment contracts with executives or unions or the law, requirements to clean up known or unknown existing environmental hazards, requirements to clean up future environmental hazards, financial guarantees, product warranties, possible adverse outcomes from existing or potential litigation, and possibly obligations to issue shares or pay dividends, among many others. All of these would seem to make an entity exposed to or subject to, or likely to suffer from something burdensome, and thus seem to be candidates for a general definition of a liability. However, as discussed later in this paper, only some of the items on that intuitive list are economic phenomena that exist now in the real world, and thus eligible under our process to be represented as liabilities in financial reports.

17. The dictionary definition of liabilities leans rather heavily on being *bound or obliged*. *Bound* strikes the staff as a word with too many disparate meanings to be useful as a communication tool. That leaves *being obliged* or its noun equivalent *obligation*. The Oxford English Dictionary defines obligation as “a moral or legal tie binding to some performance.” That definition has *binding* in it, of course, but nonetheless *obligation* has a much narrower range of general meaning that makes it a better candidate for our definitional purposes.

**Does Our Concept of Liabilities Differ from the General Sense of Liabilities?**

18. With assets, the December paper asked whether accounting assets are different from economic assets. With liabilities, this paper asks the question a bit differently: is our concept of liabilities different from liabilities in the general sense suggested in the dictionary definition. It seems evident that there is a difference. Some duties or responsibilities to which that we are bound or obliged and are burdensome—to be a good citizen, to file tax returns on time, to treat employees fairly, to obey the law—surely are not liabilities for our purposes even though they are obligations of a sort (and may give rise to liabilities that meet our definition if not performed well.) Why not? The staff suggests it is because, although those duties or responsibilities are phenomena in the real world, (unless not performed), they are not real-world *economic* phenomena.

19. From general usage, one might identify a large number of things that the general public might consider to be liabilities. But are they economic phenomena? More particularly, do they have economic consequences for the obligor? Our objectives of financial reporting suggest we consider what questions to ask in order to focus on the kinds of economic obligations that present and potential investors and creditors want information about. The dictionary definitions of *liability* and *obligation* suggest three questions:

a. Does the obligation *expose* the entity to having to do *something economically burdensome*?

b. Is the entity *really* obligated?

c. Is the entity obligated *now?*

Those questions point toward the essential characteristics of liabilities and the accounting representations of them, which are expressed in more formal terminology and discussed in the remainder of this paper.

## Essential Characteristics of Liabilities

20. Most of the remainder of this paper considers what current conceptual framework definitions consider to be the three essential characteristics of liabilities:

d. A potential future outflow of economic benefits

e. Little or no discretion to avoid the future outflow (or sacrifice, or settlement)

f. Past events.

At the end of the paper we briefly comment first on the role of probability or expectations (likelihood) in recognition and/or measurement.

### Essential Characteristic1: Potential Outflows of Economic Benefits

21. Potential future outflows (sacrifices, transfers, conveyance) of assets are featured in both the IASB and FASB definitions of liabilities. The FASB framework's discussion amplifying the definition notes that in most liabilities the obligation is to pay cash, but with some it is "to convey other assets, to provide or stand ready to provide services, or to use assets."[12] The IASB also lists "replacement of that obligation with another

[12] CON 6, paragraph 36

obligation; or conversion of the obligation to equity"[13] and mentions extinguishment by waiver or forfeiture. Those refinements of the idea of future outflows to include some forms of settlement that are not clearly outflows, and clearly not outflows of assets, suggest considering some different way of expressing this idea, one that does not imply that there *will be* an outflow and that the outflow will be of *assets*. The Canadian concepts say "the settlement of which *may* result in the transfer or use of assets, provision of services, or *other yielding* of economic benefits (*emphasis* added).[14] Australia and New Zealand concepts avoid implying certainty by saying "sacrifices . . . that the entity is presently obliged to make . . ."[15] and the UK SOP also avoids implying certainty in yet another way. But none are clear about it, and considerable confusion has resulted.

22. One source of confusion is obligations that may or may not have to be settled depending on uncertain future events—which we often call conditional obligations. For example, casualty insurance written may require that the insurer make a cash payment if an insured event occurs, and currency options written may require an exchange on terms unfavourable to the writer if the currency moves adversely; if no insured event or adverse currency move occurs, the contracts will expire without any payment. Nonetheless, as the Boards have made clear in recent standards projects, there is an unconditional obligation to stand ready. There is more to uncertain future events than just that, and the various issues raised by uncertainty will be explored in a separate paper at a later meeting, but our working definition should avoid implying certainty of future outflows. The staff proposes that a way to do that for the time being might be to talk of *potential* outflows.

23. While the frameworks sometimes use a synonym (eg, economic benefits, resources, resources embodying economic benefits), all the frameworks make it clear that future outflow of economic benefits most often means future outflow of *assets,* and thus they base the definition of liabilities partly on the definition of an asset. [16] But the term *assets* is too restrictive to cover all future outflows to settle liabilities. (The New

[13] IASB *Framework,* paragraph 62.
[14] CICA *Handbook,* paragraph 1000.32.
[15] SAC 4, paragraph 48; NZICA Statement of Concepts, paragraph 7.10
[16] Obligations for future outflows (sacrifices, transfers) of economic benefits (resources) also are featured in the Australian, Canadian, German, Japanese, New Zealand, and UK definitions, and all of them effectively define liabilities in terms of assets.

Zealand framework sacrifices of "service potential"[17] in partial response to that concern) The December paper on assets considered *favourable cash flows* as alternative terminology for *economic benefits*, in part to tie more closely to the second objective of financial reporting. However, taking non-business sectors into consideration and considering some academic thinking on the matter, on balance the December paper recommended the term *economic benefits* rather than *favourable cash flows* in the definition of an asset, and the Boards did not raise problems with that usage. That suggests using that same term *economic benefits* in defining liabilities, and this paper does that. However, the paper on assets being discussed at this meeting (Agenda Paper 9, FASB Memorandum 21) proposes listing three distinct types of assets; if the Boards approve that proposal, the liability definition proposed in this paper might be further revised accordingly.

24. Some kinds of obligations are not satisfied by transferring or using assets, or by providing or standing ready to provide services. Instead, they are satisfied by *refraining* from engaging in certain types of activities or "standing aside." Examples include non-compete agreements entered into in business combinations and sales of professional practices. Those obligations to stand aside require *foregoing* a possible future economic benefit in the form of possible future revenues. Since those future revenues are not the obligor's assets because the obligor is not presently entitled to them, it is not required to sacrifice any of its present assets. Rather, the obligor is required to accept the opportunity cost of foregoing possible future assets. The IASB and FASB frameworks do not speak directly to non-compete agreements or other undertakings to forgo a possible future economic benefit, nor does the conceptual guidance of standard setters. (Interestingly, the first FASB exposure draft on elements did include such obligations, defining future sacrifice of resources as "a future transfer *(or a foregoing of a future receipt)* of cash, goods, or services,"[18] but the emphasized phrase did not appear in the final concepts Statement.) Such obligations seem to fit the general sense of liability, in that the obligor is subject to something burdensome. They also seem to fit the narrower concept of liability, in that the burden clearly has a cost—a foregone opportunity for future receipts. That constitutes a cross-cutting issue:

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[17] Other conceptual frameworks, including those of the FASB and Australia, also discuss the role of "service potential."

[18] FASB Exposure Draft, *Objectives of Financial Reporting and Elements of Financial Statements of Business Enterprises*, 1977. (paragraph 49, emphasis added.

**EL.17: If an entity agrees to forego a cash inflow or has an obligation to stand aside, is that a liability?**

25. The staff thinks that kind of agreement does result in a liability, and that the framework should make that clear. One way to do that is to refer in the definition to potential outflows *or other sacrifices* of economic benefits, and to illustrate that with an example, perhaps of a non-compete agreement. That wording would also include within liabilities an analogous obligation: one that might be settled not by an outflow of assets but by a reduced inflow, for example, a commitment to accept a below-market price on a future sale to the obligee, or the (conceptually quite similar) future rebate based on annual volume of purchases cited as a liability in paragraph 63 of the IASB *Framework*. Thus, potential outflows or other sacrifices include not only outflows of cash or other assets but also forgone inflows of cash or other assets. The staff thinks this is at least part of what the Canadian ASB had in mind in adding "other yielding of economic benefits"[19] to their definition.

26. Another consideration pointing towards using *economic benefits* here is that, even in businesses, the Boards may want to allow in the liability definition for obligations requiring outflows that are clearly not outflows of assets. Those would include outflows of equity instruments, for example, under obligations that can be settled by issuing shares. Whether to do that, and how exactly to do it, are subjects for consideration at later meetings when we will consider the distinction between liabilities and equity and related cross-cutting issues (EL.27: *How to distinguish liabilities and equity, eg shares puttable at fair value* and EL.31: *If settled in own shares (or other equity instrument) can an entity have gains or losses from transacting in own equity instruments*.) While outflows of an entity's own equity instruments cannot reasonably be said to be outflows of its assets, because equity instruments do not become anyone's assets until they are issued, it is not unreasonable to consider them to be outflows of economic benefits, should the Boards later decide that they should be so considered.

27. So we can suggest one piece of a proposed working definition of liabilities:

> Liabilities involve *potential outflows of cash or other sacrifices of economic benefits*

[19] CICA *Handbook*, paragraph .32

28. One other particular aspect of this working definition might be noted. This piece of the definition does not refer to "future" outflows of economic benefits. That seems redundant with the working term *potential*. Potential outflows or other sacrifices of economic benefits could hardly be in the past.

### Essential Characteristic 2: Little or No Discretion to Avoid the Potential Future Outflow

29. We briefly characterized the second issue for liabilities in paragraph 14 as, "is the entity *really* obligated? That five-word question raises two related but distinct issues:
    (a) Is it *really* an obligation?
    (b) Is *this particularly entity* obligated?

#### Is It *Really* an Obligation?

30. *Obligation*, generally defined in paragraph 12 as a moral or legal tie binding to some performance is a term used in all the existing frameworks, as well as the draft German and Japanese frameworks and the CFA Institute's Reporting Model.[20] The IASB Framework defines obligation as "a duty or responsibility to act or perform in a certain way." The FASB uses obligation "in its usual general meaning to refer to duties imposed legally or socially; to that which one is bound to do by contract, promise, moral responsibility and so forth," citing an American dictionary definition. To the staff, it seems that the term *obligation* can be used in that common sense without too much risk of misunderstanding.

#### Is *This Particular Entity* Obligated?

31. So far, we have considered what a liability is, only in the abstract. We have not related it to a particular entity. Ideally, a liability should appear in only one entity's financial reporting (although the same liability might appear in individual financial statements of a reporting and consolidated financial statements of a larger reporting entity containing those of the individual reporting entity.) Moreover, ideally, an entity should not include another entity's liabilities in its financial report (although particular contract or set of interrelated contracts might obligate two or more entities at the same time, for example, one entity might borrow funds from a lender and another entity might guarantee payment to the lender, in which case the objective should then be to reflect in its

[20] CFA Centre for Financial Market Integrity (September 2005), A Comprehensive Business Reporting Model: Financial Reporting for Investors, page 19.

financial report the distinct obligation that each entity has.) However, those ideals may sometimes be difficult to achieve, for example, in the case of an obligation that holds two entities jointly and severally liable, to which the staff will return at a future meeting.

32. If we are to determine what liabilities a particular entity must include in its financial reporting, we must consider what a liability <u>of an entity</u> is. This issue parallels an issue discussed in paragraphs 33 and 34 of the December paper on assets. With assets, "control" is the traditional way in which an asset is associated with a particular entity, while the working definition replaced control with having rights or other access. With liabilities, control, rights, and access do not apply. But there is a mirror-image concept—compulsion. Leaving "a particular entity . . . little or no discretion to avoid the future sacrifice" is the way the FASB puts it in Concepts Statement 6 (CON 6), paragraph 36, and the IASB *Framework* gives an example of a substantial penalty that leaves "the enterprise with little, if any, discretion to avoid the outflow of resources to another party."[21] However, talking of *little* discretion leaves the reader wondering how little is little, while to talk only of *no* discretion seems to open an escape hatch whereby an highly unlikely possibility of avoiding a future sacrifice could be used as an excuse for disregarding a liability.

33. "Little or no" is not the only semantic difficulty here. Much depends on how *discretion* is interpreted. In the context in which CON 6 uses the term, it means *freedom of choice* or *option.* Since CON 6 and the IASB *Framework* both use the term in the negative (that is, in the form of little or no discretion to avoid), it is useful to consider the antonym. The antonym of option is *compulsion.* Thus, an entity that has little or no discretion to avoid the future sacrifice that an obligation imposes upon it is compelled to fulfill the requirements of the obligation or otherwise satisfy or settle the obligation. Conversely, an entity that has discretion to avoid the sacrifice is not compelled to fulfill the requirements. To *compel*, defined by the Oxford English Dictionary as "to urge irresistably, to constrain, oblige, force a person to do a thing,"[22] does not have a de minimis connotation but also does not open that escape hatch. Being "compelled" seems to express more clearly, and more concisely, what the previous frameworks were trying to convey with "leave little or no discretion to avoid."

[21] IASB *Framework*, paragraph 61
[22] Oxford University Press, Second Edition (1971)

34. That concept is addressed only in explanatory paragraphs, not in the one-sentence definitions in either the IASB Framework or CON 6. But it seems too critical a characteristic to leave it out unless it can be connoted clearly in some other way. The same issue needs to be reconsidered with respect to the definition of an asset. For the time being, we propose adding to our working definition:

> [Obligations] that <u>compel</u> potential outflows or other sacrifices of economic benefits.

**Legal, Equitable, and Constructive Obligations**

35. Two further issues need to be considered in relation to obligation and compulsion. Those are identified in two closely related cross-cutting issues:
    - EL.18--What are equitable or constructive obligations?
    - EL.19--Can economic compulsion give rise to a present obligation and, if so, what does it mean?

36. Liabilities often are described as arising from legal, equitable, or constructive obligations. However, there are differences in views as to whether liabilities arise from all or only some of those obligations. The following example may help to illustrate the differences in those classes of obligations and the issues involved.

***Illustrative Example***

37. Although retailers are not required by law in some jurisdictions to make cash refunds to their customers, some may elect to do so. Does that mean that those retailers have liabilities? It depends on the retailers' policies and practices, and on the Boards' views about legal, equitable, and constructive obligations.

38. Some cases are straightforward:
    - Retailer A has a written policy of making cash refunds for any products that its customers deem unsatisfactory, makes refunds in practice, and its customers are aware of that policy and practice. It seems clearly to have a legal obligation that compels it to make refunds on request and thus has a liability.

- Retailer Z has a written policy of "no refunds" that it adheres to strictly with no exceptions, and its customers are aware of that policy and practice. It seems clearly to have neither *obligation* nor *compulsion* and thus has no liability.

39. But some cases are less clear:
    - Retailer B—Has no written policy, but in practice it routinely makes cash refunds, and its customers are generally aware of that practice.
    - Retailer C— Has a written policy of "no refunds" and its customers are aware of that policy. However, Retailer C does occasionally make cash refunds to a few poorer customers, on a case-by-case basis.
    - Retailer D— Has a written policy of "no refunds" and its customers are aware of that policy. However, Retailer D does occasionally make cash refunds to its major customers to maintain good business relations, on a case-by-case basis.

***Concepts in Existing Frameworks***

40. The cases of Retailers B, C, and D are less clear because the obligations involved are constructive or equitable, not necessarily legal. CON 6 discusses this set of issues extensively, but not entirely conclusively. A footnote to the definition itself states that the "present obligations of a particular entity" refers not only to legal obligations but also to equitable and constructive obligations (footnote 22).[23]

41. Paragraph 40 of CON 6 accompanying the definition differentiates constructive and equitable obligations from what are termed "legally enforceable obligations" on the grounds that "they lack the legal sanction that characterizes most liabilities and may be binding primarily because of social or moral sanctions or custom." Thus, *legal obligations* are equated with being legally enforceable. The IASB framework also focuses initially on "obligations that are legally enforceable as a consequence of a binding contract or statutory requirement."[24]

42. *Equitable obligations* are described in CON 6 as stemming from "ethical or moral constraints rather than from rules of common or statute law, that is, from a duty to another entity to do that which an ordinary conscience and sense of justice would deem

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[23] It should be noted that the revised Exposure Draft explicitly mentioned legal, equitable, or constructive obligations in the definition itself. However, those words were relegated to the footnote in the definition finally adopted, presumably in order to streamline the definition without changing its meaning.
[24] IASB *Framework*, paragraph 60.

fair, just, and right—to do what one ought to do rather than what one is legally obligated to do." *Constructive obligations* are described as being "created, inferred, or construed from the facts in a particular situation rather than contracted by agreement with another entity or imposed by government." The IASB does not use the exact same terminology, but does say that "obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner."[25]

43. CON 6 acknowledges that it may be difficult to differentiate between those obligations:

> The line between equitable or constructive obligations and obligations that are enforceable in courts of law is not always clear, and the line between equitable or constructive obligations and no obligations may often be more troublesome because to determine whether an entity is actually bound by an obligation to a third party in the absence of legal enforceability is often extremely difficult. [paragraph 40]

Moreover, paragraph 40 further notes that:

> . . . the concepts of equitable and constructive obligations must be applied with great care. To interpret equitable and constructive obligations too narrowly will tend to exclude significant actual obligations of an entity, while to interpret them too broadly will effectively nullify the definition by including items that lack an essential characteristic of liabilities.

44. Thus, not all equitable and constructive obligations are to be regarded as liabilities, only those that stem from the "actual obligations of an entity." But what does "actual obligations of an entity" mean? Perhaps it is the second of the three essential characteristics of a liability, which in CON 6 is that "the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice" (paragraph 36). Therefore, if an obligation leaves an entity with little or no discretion, it has a liability; however, if the entity has discretion, it does not have a liability.

45. CON 6 gives only a few examples of equitable and constructive obligations. Paragraph 40 that "a business enterprise may have an equitable obligation to complete and deliver a product to a customer that has no other source of supply even though its failure to deliver would legally require only return of the customer's deposit." It also states that "an entity may create a constructive obligation to its employees for vacation pay or year-end bonuses by paying them every year even though it is not contractually bound

[25] IASB *Framework*, paragraph 60. The New Zealand treatment is similar to IASB's, while Canada and Australia explicitly discuss both equitable and constructive obligations. All seem to use the terms in much the same sense as CON 6.

to do so and has not announced a policy to do so," and that example is repeated in paragraph 203. The IASB framework cites one example, saying in paragraph 60 that a policy of rectifying product faults even after the warranty period has expired gives rise to liabilities.

***Applying Concepts to the Retailer Examples***

46. Retailer B may be said to have a *constructive obligation* because its practice of making refunds can be seen as conveying an implicit promise to its customers that they may infer from those actions. Courts in the United States, and perhaps other countries, would likely *construe* that implicit promise as enforceable. If, like Retailer A, it is thereby compelled to make refunds, Retailer B has liabilities arising from its constructive obligations.

47. In contrast to Retailers A and B, Retailer C has made no promises—either explicit or implicit—to its customers, and its practice is generally consistent with its written policy of no refunds. Thus, Retailer C may not seem legally compelled to make refunds. However, its practice of making a few refunds to poorer customers who otherwise might suffer suggests that it has an *equitable obligation* to them. In common law countries, a court might enforce that under the doctrine of equity, in which case Retailer B would have liabilities arising from those equitable obligations.

48. Like Retailer C, Retailer D also has made no promises—either explicit or implicit—to its customers, and its practice is generally consistent with its written policy of no refunds. Thus, Retailer D can be seen as not being compelled to make refunds generally. Although its practice of making a few refunds to major customers suggests that it believes it has little choice other than to accommodate those customers or else risk losing their future business, that is only Retailer D's inference. It does not appear to have a present legal, constructive, or equitable obligation to those customers and thus does not have liabilities.

49. The UK ASB Statement of Principles differs from the other existing frameworks, in making no mention of equitable obligations. It says that "a legal obligation is not a *necessary* condition: a liability can exist in the absence of legal obligations if commercial considerations create a constructive obligation" [paragraph 4.26, emphasis in original] but. It then adds that:

> A decision to transfer economic benefits does not, in itself, create a constructive obligation because the transfer can be avoided by changing the decision. On the other hand, a constructive obligation would be created if such a decision was coupled with an event that both created a valid expectation that the entity involved would implement that decision and meant that the entity could not realistically withdraw from it. For example, a constructive obligation may be created by communicating a decision to follow a particular course of action to another party. Such an obligation may also be created by an established pattern of past practice. [paragraph 4.27]

50. Although the *Statement of Principles* does not explain why equitable obligations are excluded, it appears to be on the basis that "an obligation implies that the entity is not free to avoid the outflow" (paragraph 4.25). That suggests an assumption that an entity that has an equitable obligation necessarily has the discretion to avoid the outflow of resources and thus does not have a liability. Under the UK's principles, therefore, liabilities would be regarded as arising from the legal and constructive obligations of Retailers A and B, respectively, but not from the obligations of Retailers C or D because they are neither legal nor constructive obligations. The Japanese draft concepts appear to lead to the same conclusion, by including obligations or their equivalents with ta footnote indicating that "equivalents to obligations include those similar to legal obligations (such as constructive obligations)." [26]

51. Use of the terms legal, constructive, and equitable obligations has led to confusion. One source of that confusion has been CON 6's statement that not all constructive or equitable obligations are "actual obligations." Its discussion of whether they are "actual obligations" points mainly to the need for the obligation to leave the entity with little or no discretion to avoid the future sacrifice. However, "little or no discretion" has weaknesses, as discussed earlier in this paper. The IASB framework provides no helpful elaboration either. But there are two unresolved cross-cutting issues. So we need to consider how to resolve this matter now.

***Legal, Moral, and Economic Compulsion***

52. In paragraphs 32-34, we tentatively replaced "has little or no discretion to avoid" with "is compelled." Given the difficulties associated with legal, constructive, and equitable obligations, as well as with little or no discretion to avoid, it may be useful to think in terms of compulsion.. Entities may be subject to at least three different types of

[26] Accounting Standards Board of Japan, Discussion Paper, *Elements of Financial Statements*, paragraph 5.

compulsion: (1) legal compulsion, (2) moral compulsion, and (3) economic compulsion.

53. With *legal compulsion*, an entity may be compelled by a court or by law to fulfill the requirements of the obligation or otherwise satisfy or settle it with the obligee. If the entity does not satisfactorily fulfill the requirements of a contractual obligation, the obligee may turn to the courts for redress. If the entity does not follow the law, regulatory authorities make take actions to force it to do so or cause it to suffer civil or criminal penalties for failure to do so. In our example, Retailer A is clearly in that position.

54. In addition, legal means have been developed for dealing with certain injustices that might otherwise be done by business enterprises and others absent legislation, regulation, or contractual relationships. In the common law, equity courts sometimes granted redress in such cases. More recently, American courts have developed the doctrine of *promissory estoppel*, which is grounded in significant reliance on a less-than-contractual promise by the promisee rather than the explicit terms of a contract.

55. Legal compulsion is therefore associated not only with what the existing frameworks call legal obligations but also with constructive obligations, because they are legal fictions that the law treats as if they were legal obligations

56. It is possible that an entity may not be legally compelled to satisfy an obligation that is legally enforceable, if such obligations are never enforced. Therefore, itt seems more fruitful to focus on legal compulsion rather than legal obligations. In the example, Retailers A and B can be said to be legally compelled to honor their obligations, unless perhaps there were evidence that the obligees would not exercise their ability to seek legal redress if needed. But retailers C and D are under no legal compulsion.

57. *Moral compulsion* relates to what one ought to do rather than what it is legally compelled to do. The action stems from what an ordinary conscience or sense of justice might deem to be fair, right, and just. It therefore differs from legal compulsion which emanates from forces external to the entity whereas moral compulsion is internal to it. Although Retailer B may not be legally compelled to make refunds, it may believe itself to be morally compelled to do so for its poor customers.

58. With *economic compulsion*, an entity finds it to be in its own best interests economically to take an action even though it is not legally or morally compelled to do so, because failing to do so would not be rational economically. Thus, for example, if the sacrifice associated with fulfilling the requirements of the obligation would be less than what the entity would otherwise lose or suffer economically by failing to fulfill those requirements, the entity would be economically compelled to honor its obligation.

59. Although Retailer D may not be legally or morally compelled to make refunds, it may feel economically compelled to do so if, for example, the major customers involved are ones that provide it with a lot of business, either directly or indirectly. Rather than risk losing their future business, Retailer D may believe it economically prudent to make refunds for any products that those customers find to be unsatisfactory. Thus, even though Retailer D cannot be legally compelled to make refunds, it may believe that it has no realistic alternative other than to do so and thus is economically compelled.

*60.* Moral compulsion and economic compulsion are both problematic, however. One reason is that it may not be possible to ascertain whether the entity *really* feels morally or economically compelled until it makes the sacrifice. Another reason is that judgment about moral or economic compulsion often lies in the eye of the beholder: a new owner of a business may feel compelled to make sacrifices the seller did not, or vice versa; management might feel morally or economically compelled to make certain refunds when economic times are flush, but not when times are tight; one entity might feel compelled to do something that another entity in similar circumstances might not feel compelled to do. Thus, defining liabilities based on moral and economic compulsion would likely to lead to reduced comparability.

61. With respect to economic compulsion, it should be noted that liabilities need to arise from obligations. However, in the case of Retailer D, there is no obligation to the purported obligee. Instead, Retailer D feels compelled to abrogate its written policy and make refunds to its major customers as a matter of sound business practice. Even though the likelihood that Retailer D will make those future sacrifices may be highly probable if not virtually certain, it is not obligated to do so. It has only inferred its "obligation." Thus, while Retailer D may be economically compelled to make the refunds, it does not have a liability because it does not have an obligation to its major customers. That of course is the key distinction between a liability and a deferred

credit, namely that the former are underpinned by obligations whereas the latter are not.[27]

62. Now consider an additional retailer in somewhat different circumstances:

- Retailer E— Has a written policy of "no refunds" and its customers are aware of that policy. However, Retailer F does occasionally make cash refunds to dangerous customers (one example would be the fictitious Mafioso Tony Soprano or his real-world counterparts; another example would be a notorious filer of spurious but ruinously costly litigation) who it fears may take actions to harm it, but does so only on a case-by-case basis.

Retailer E has made no legally enforceable promise of refunds, and its practice is generally consistent with its written policy of no refunds. However, it has some dangerous customers, and their threat of violence or ruinous legal defence costs strongly induces Retailer E to pay refunds to them. Is that an obligation? The customer thinks so. Is there compulsion? Retailer E thinks so. That compulsion may not be legal, it may even be illegal, but it may be just as forceful as legal compulsion. Unlike Retailer D, Retailer E is not paying refunds to obtain future business; Retailer E's seems to be paying to avoid a more onerous future sacrifice threatened by the present situation. If so, Retailer E appears to have a present obligation, a compulsion to satisfy it, and thus a liability.

63. To summarize, Retailer A's written policy and practice of giving refunds results in a legal obligation that legally compels it to pay, and thus a liability. Retailer B's unwritten practice of giving refunds to all who request it results in a constructive obligation that legally compel it to pay, and thus a liability, at least in some jurisdictions. Retailer C's unwritten practice of giving refunds to its poor customers results in an equitable obligation that morally compels it to pay, which might be legally enforceable in a court of equity in some jurisdictions, and therefore a liability, but not in other jurisdictions, and therefore not a liability. Retailer D's lack of obligation despite the economic compulsion it feels results in no liability, Retailer E faces extra-legal but equivalent compulsion from the obligation inferred by its dangerous customer, which results in a liability. And Retailer Z's policy and practice of no refunds result in no obligation, no compulsion, and no liability.

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[27] As noted in Part I of the paper, Board members who favored the revenue and expense view tried to revise the liabilities definition to emphasize "probable future sacrifices" by equating liabilities with them rather than obligations and thus to de-emphasize (or even eliminate) obligations from the definition.

The relevant components of the foregoing analysis are also summarized in Table A.

**TABLE A**

| Retailer | Refund Refund Policy | Refund Refund Practice | Customer Awareness of Practice | Nature of Obligation | Nature of Compulsion |
|---|---|---|---|---|---|
| A | *Written policy of refunds* | *Refunds made* | *Aware* | *Legal* | *Legal* |
| B | *No written policy* | *Refunds made* | *Generally aware* | *Construed, by the courts* | *Legal* |
| C | *Written policy of no refunds* | *Refunds made only to poorer customers* | *Not Generally aware* | *Equitable (only for poorer customers)* | *Moral (only for poorer customers)* |
| D | *Written policy of no refunds* | *Refunds made only to major customers* | *Not generally aware* | *Inferred, by the retailer* | *Economic (only for major customers)* |
| F | *Written policy of no refunds* | *Refunds made only to dangerous customers* | *Not generally aware* | *Inferred, by the customer* | *Extra-legal but of equivalent force (only for danger-ous customers)* |
| Z | *Written policy of no refunds* | *Refunds not made* | *Aware* | *None* | *None* |

64. Based on that analysis, the staff recommends incorporating in our framework the notions of legal, moral, and economic compulsion, together with the explanation of why liabilities should be limited to those items for which there is legal compulsion or other compulsion of equivalent force. In addition, the discussion of obligations should be limited to describing legal and constructive obligations as those that reporting entities are legally *or equivalently* compelled to honor. At least one staff member would further limit the framework to legal compulsion only, because the idea of extra-legal compulsion of equivalent forcefulness to legal compulsion might be difficult to make clear and difficult to distinguish from economic compulsion; that staff member would call such a coerced refund an expense for protection or insurance, or simply a loss.

65. Thus, the proposed response to our first cross-cutting issue:

- EL.18--What are equitable or constructive obligations?

is to limit liabilities to obligations that an entity can be legally or equivalently compelled to honor, and to include in the framework a summary of what is discussed paragraphs 40 to 65 in this paper.

And the response to our second cross-cutting issue:

- EL.19--Can economic compulsion give rise to a present obligation and, if so, what does it mean?

is *no*.

66. The concepts of legal and equivalent compulsion and legal and constructive obligations will have to be communicated primarily in amplifying discussion rather than in the definition of liability itself. However, one aspect of obligation that may seem obvious to some should be communicated in the definition: the obligation needs to be to another entity. One sometimes hears "I owe it to myself" or "we are obligated to ourselves" or "we owe it to the stockholders" to take some action. Perhaps so, in general usage, but not in financial reporting. The discussion of obligation and compulsion above make clear that the obligation needs to be to an entity outside the reporting entity, and the compulsion needs to originate outside as well. That is, among other things, a significant aspect of the relationship between liabilities and assets: every liability is the asset of another entity or entities. (The reverse is not true: many kinds of assets are no one's liabilities, for example, land, buildings, and inventories.) The requirement that a liability be to another entity can be conveyed with the following addition to our working definition, building on paragraph 34:

> [Obligations] <u>to other entities</u> that compel potential outflows or other sacrifices of economic benefits.

**What is the Liability?**

67. Once we understand what an obligation is, we need to consider what the entity is obligated for. This is cross-cutting issue EL.20: *Is the liability the future sacrifice itself or the obligation to make the sacrifice?* (That issue parallels EL.3, *What is controlled—the resource/right that gives rise to future economic benefits or the future economic benefits themselves?*" an issue discussed in paragraph 36-38 of the December paper on the definition of an asset.)

68. On this point, the IASB and FASB definitions differ. The FASB definition[28] takes the view that it is the future sacrifice of economic benefit that is the liability. The history of that wording may be of interest: in a 1977 exposure draft the FASB initially proposed beginning its definition with "Liabilities are financial representations of obligations . . ."[29] That was changed in the final concepts Statement to "Liabilities are probable future sacrifices . . ." which had the effect of de-emphasizing obligations and placing greater emphasis on a probable future outflow. The change was made largely in response to some Board members' suggestions that, for example, discharging "a clear business need has the same effect on an enterprise's assets as discharging an enforceable claim." That suggestion would not require any obligation to another entity, opening the door to the "what-you-may-call-its" permitted under the definition in APB Statement No. 4. While the final CON 6 language taken as a whole does not allow that kind of interpretation as proposed by some Board members, the "future sacrifice" language they favored survived. In contrast, the IASB takes the view that the obligation is the liability, in response to which resources embodying economic benefits are expected to flow out.[30]

69. The IASB view is more compatible with the definition that we have been developing so far—an existing obligation to making a future sacrifice. It is not the outflow of economic benefits that represent a liability; that is the future sacrifice that is expected to settle the liability. Rather, the liability is the existing obligation that compels the entity to make that future sacrifice. Accordingly, the staff thinks that the liability definition needs to begin with the obligation that gives rise to the potential outflows of economic benefits, rather than the outflows of economic benefits, themselves.

70. Thus, our proposed working definition of liability, building on paragraph 67, becomes:

> Liabilities of an entity are its <u>present obligations</u> that <u>compel</u> potential outflows or other sacrifices of economic benefits.

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[28] As does Australia and New Zealand.

[29] FASB Exposure Draft, *Objectives of Financial Reporting and Elements of Financial Statements of Business Enterprises*, December 29,1977, para. 49.

[30] Canada also refers to assets as economic resources from which future economic benefits may be obtained.

## Essential Characteristic 3: Past Events

71. Both the IASB and FASB definitions of an asset state explicitly that a liability arises as a result of past (transactions or) events.[31] The IASB *Framework* explains this aspect of the definition by saying that "liabilities result from past transactions or other past events." [32] The FASB framework says that "the transaction or other event obligating the entity has already happened."[33]

### Is It an Obligation *Now*?

72. This issue can be stated more casually as whether the obligation exists at present or will only become an obligation later. This issue is traditionally a critical one in many standard-setting situations as indicated by a cross-cutting issue:

- EL.16 *What is the past transaction or event that gives rise to the present obligation?*

73. The IASB gives three examples suggesting which past event gives rise to the present obligation:

> Thus, for example, the acquisition of goods and the use of services give rise to trade payables (unless paid for in advance or on delivery) and the receipt of a bank loan results in an obligation to repay the loan. An enterprise may also recognize future rebates based on annual purchases by customers as liabilities; in this case, the sale of the goods in the past is the transaction that gives rise to the liability.[34]

74. The FASB framework discusses this issue in an appendix. Its examples of past transactions or other events that give rise to present obligations also include trade payables and bank loans. FASB also cites events that obligate an entity a increasingly over time, citing accrual of interest and per-unit royalties, and obligations imposed by governments rather than incurred in transactions, citing taxes and required restoration after strip-mining.

75. None of that is as specific as some might desire on some of the issues often characterized as "critical event" issues. And the other frameworks are not very specific either. For example, the Australian framework says only that "the existence of a present obligation is easily established in most cases. . . . In the absence of a clear legal

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[31] The Australian, Canadian, German, Japanese, New Zealand, and UK definitions all include this fact as well.
[32] IASB *Framework*, paragraph 63.
[33] CON 6, paragraph 36
[34] IASB *Framework*, paragraph 63.

responsibility, the existence of a present obligation is a matter for determination from the evidence available."[35] The Australians do go on to clarify that mere intentions and plans do not result in liabilities.

76. Two related cross-cutting issues delve further into this area:

- EL.24 *Does a future commitment (eg to pay next-year's salaries) give rise to a present obligation?*
- EL.21 *Could the entity have little or no discretion to avoid a future sacrifice and have no present obligation?*

77. The idea of a "future commitment" is curious. It would seem that either an entity is committed or it is not. The example of next year's salaries may be instructive. If the entity could discharge its employees today and need to pay them nothing more than the salaries earned to date, it seems clear (at least to the staff) that there is no present obligation for next year's salaries. However, individual employment contracts with executives, collective contracts with labor unions, or government statutes often require extra payments upon discharge or continued payments for extended periods after discharge. In those latter cases, the employer is conditionally obligated and legally compelled to pay its workforce regular salaries (if they continue working) and conditionally obligated and legally compelled to pay the payments required on discharge (if they are discharged), but it is *unconditionally* obligated and legally compelled to pay either salaries or discharge payments. It seems at least arguable that there is a *present* obligation, a sort of stand-ready liability that might be recognized, even though the employees have not been discharged. Of course, such obligations are not typically recognized in current practice. However, the staff notes (with some trepidation) that such obligations would seem to meet the existing definitions of liability and this aspect of the liability definition we are constructing. In contrast to those existing commitments, commitments that have not yet been made but may be made in the future do not meet the present definitions and should not meet our updated definition either.

78. The idea of not having a present obligation even though there is little or no discretion to avoid a future sacrifice (in the terminology of our proposed working definition, even though something compels potential outflows or other future sacrifices) is also curious. Examples that some might cite include the need to re-stock bare shelves, replace

[35] SAC 4, paragraph 58

deteriorated or obsolete equipment, or meet future payrolls, all of which are necessary for the entity to continue to operate as it has been operating. But those are the entity's intentions and plans, not its present obligations, and they can be changed, and thus the entity is not compelled to make the related future sacrifices. Conversely, if there is compulsion to make a future sacrifice, some past event must have occurred to put the entity in that position, that is, must have created a present obligation.

79. That discussion uses the term *past event*, reminding us of the topic of this section. In the December paper on definition of an asset, we suggested that "this aspect does not seem essential in our proposed working definition. . . . if we define an asset to represent "present rights or other access," it seems unnecessary, in addition, to specify that there must have been a past transaction or event. Those rights or other access must exist today — so they can't be ones that will not arise until the future."[36] That view seems equally appropriate in the case of liabilities. If a present obligation exists, whatever events were needed to bring it into existence must already have occurred. Therefore, while it is essential for the definition to say something like "present obligation," it would be superfluous for the definition to include a requirement for there to have been a past event.

80. Therefore, the working definition already accommodates the concerns raised by these cross-cutting issues and the concern about past events, and needs no further change from:

> Liabilities of an entity are its <u>present obligations</u> to other entities that <u>compel</u> potential outflows or other sacrifices of economic benefits.

**Likelihood**

81. Both the IASB and FASB definitions include some degree of likelihood in the definition of liabilities. The IASB definition states that, "… the settlement of which <u>is expected</u> to result in an outflow."[37] The FASB definition states that, "Assets are <u>probable</u> future economic sacrifices …."[38] Only the Canadian definition includes a similar notion ("<u>may be</u> obtained"). The Australian, German, Japanese, New Zealand,

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36 IASB December 2005 Agenda Paper 2A, FASB Memorandum 19, paragraph 56 (footnote reference omitted.)
37 IASB *Framework*, paragraph 49.
38 CON 6, paragraph 35, footnote reference omitted.

and UK definitions do not include any degree of likelihood in the definition of liabilities.

82. The inclusion of likelihood in the definition of liabilities by the FASB and the IASB has caused many difficulties in interpretation. As it did for assets, the FASB notes that, "*probable* is used with its usual general meaning, rather than in a specific accounting or technical sense … and refers to that which can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved.… Its inclusion in the definition is intended to acknowledge that business and other economic activities occur in an environment characterized by uncertainty in which few outcomes are certain…."[39] But, this does not seem to have alleviated the difficulties (perhaps no one reads the footnote!). A 1998 FASB Special Report by Reed Storey and Sylvia Storey[40] explains that, "The first Exposure Draft did not contain the word probable. … The Board received many comment letters that said, in essence, "almost nothing can ever be an asset or liability because you have said that it has to be certain, and everything except cash is uncertain." The Board thus inserted "probable" into the definition. … Probable is not an essential part of the definitions; its function is to acknowledge the presence of uncertainty and to say that the future economic benefits or sacrifices do not have to be certain to qualify the items in question as assets and liabilities, not to specify a characteristic that must be present."

83. The staff thinks it unnecessary to include any notion of *likelihood* in the definition of liabilities. Instead, as discussed in paragraph 17, we propose to discuss *potential* outflows. Using potential is not intended to connote any degree of likelihood but rather to communicate, as the FASB attempted to do in a different way, that something can be a liability even if, ultimately, there is no outflow. If there is any question of degree of likelihood to be considered, that might be in assessing criteria for whether an asset qualifies for recognition (see the next paragraph) or in measurement—not in the definition of an asset.

[39] CON 6, paragraph 25, footnote 18.
[40] Storey, Reed and Storey, Sylvia, (January 1998), FASB Special Report, *The Framework of Financial Accounting Concepts and Standards*, page 131.

**The Role of Recognition**

**84.** Cross-cutting issue EL6(b) asks: *"Is it preferable to have a broad set of assets at the elements level that is refined at the recognition level?"* No equivalent issue was stated for liabilities, but the parallel is clear. Rather than revisiting the discussion in paragraphs 18-22 of the December agenda paper 2A (FASB Memorandum 19), we suggest that that paper's conclusion concerning recognition of assets applies also to liabilities: certain things that meet the definition of a liability for accounting purposes might, nonetheless, not be recognized for practical reasons.

## Working Definition

85. Our working definition from paragraph 81 above, is now as follows:

> *Liabilities* of an entity are its present obligations to other entities that compel potential outflows or other sacrifices of economic benefits.

86. We have also identified several other aspects of liabilities that would need to be explained in supporting material. These include explaining that:

(a) Potential outflows and other sacrifices includes more than direct cash outflows, extending to transfers of other assets, providing services, standing ready to do those things, and perhaps issuing an entity's own equity securities (see paragraphs 22-26)

(b) Legal and constructive obligation with legal and equivalent compulsion give rise to liabilities, while equitable obligation and moral compulsion without legal or equivalent compulsion do not (see paragraph 67)

(c) There is no necessity for a past event. (see paragraph 80)

(c) Likelihood is a matter for recognition or measurement, not definition (see paragraph 84)

87. That raises a question, as with an asset, as to whether we should strive for a relatively brief definition of liabilities that is relatively easy to remember, but requires amplifying guidance to fully understand it, or a more comprehensive definition that encompasses all essential features? We continue to think that the former is preferable.

88. We also note that the IASB defines “a liability” (singular), while the FASB defines “liabilities” (plural). We understand that the FASB may have adopted that approach for ease of drafting, and in fact we found the drafting of this paper easier in the plural. Do Board members have any preference as to whether we should use singular or plural?

**SUMMARY OF STAFF RECOMMENDATIONS**

Working definition of a liability:

> *Liabilities* of an entity are its present obligations to other entities that compel potential outflows or other sacrifices of economic benefits

For purposes of comparison, the working definition of an asset discussed in December was:

> An *asset* of an entity is a present right, or other access, to an economic resource with the ability to generate favourable cash flows to the entity.

while the working definition of an asset now proposed in Agenda Paper 2 (FASB Memorandum 21) is:

> An asset of an entity is:
>
> (a) cash held by the entity;
>
> (b) a present right of the entity to cash; or
>
> (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 working definition needs to be supported by material explaining that:

(a) Potential outflows and other sacrifices includes more than direct cash outflows, extending to transfers of other assets, providing services, standing ready to do those things, and perhaps issuing an entity's own equity securities (see paragraphs 22-26)

(b) Legal and constructive obligation with legal and equivalent compulsion give rise to liabilities, while equitable obligation and moral compulsion without legal or equivalent compulsion do not (see paragraph 67)

(c) There is no necessity for a past event. (see paragraph 80)

(c) Likelihood is a matter for recognition or measurement, not definition (see paragraph 84)

Cross-cutting issues discussed in this paper and our responses to them are:

EL.16 What is the past transaction or event that gives rise to the present obligation?

If there is a present obligation, some past event must have given rise to it. However, it would be superfluous for the definition to include a requirement for there to have been a past event. (see paragraph 40)

EL.17 If entity agrees to forego a cash inflow or has an obligation to stand aside, is that a liability?

That is a liability, and that the framework should make that clear (see paragraph 25)

EL.18 What are equitable or constructive obligations - Are they promises that a court of law would enforce or something broader than that? Eg preference share dividends, employee bonuses, projected benefit obligation, other unvested benefits. Are there constructive obligations that are not legally enforceable? Do these notions work across different jurisdictions (eg “equitable” obligations, “promissory estoppel”)?

Liabilities are limited to obligations that an entity would be legally or equivalently compelled to honor. The framework should include a summary of what is discussed paragraphs 40 to 65 of this paper

EL.19 Can economic compulsion give rise to a present obligation and, if so, what does it mean?

No. (see paragraph 66)

EL.20: Is the liability the future sacrifice itself or the obligation to make the sacrifice?

The liability is the obligation to make the sacrifice. (see paragraphs 68-70)

EL.21 Could the entity have little or no discretion to avoid a future sacrifice and have no present obligation?

No. (see paragraph 79)

EL.24 Does a future commitment (eg to pay next-year’s salaries) give rise to a present obligation?

No. But a *present* commitment to pay in the future may exist and if so does give rise to a present obligation. We would avoid using the curious term *future commitment*. (see paragraph 78)

**APPENDIX A**

**Cross-Cutting Issues about Liabilities Remaining to Be Addressed**

EL.27 How to distinguish liabilities and equity, eg shares puttable at fair value

EL.28: Should all elements be defined (if so, will anything fall through the cracks between the definitions) or should one be a residual, (if so, which one)?

EL.29 Should equity (once determined) be divided into various sub-classes (eg reporting of parent and non-controlling interests – investor's perspective as well as issuer's)? If so, is that division for presentation purposes only, or does it have broader implications?

EL.30 Should minority interests be part of equity?

EL.31 If to settle in own shares (or other equity instrument) – can entity have gains or losses from transacting in own equity instruments?

**APPENDIX B: Existing Definitions**

| Definer | Asset | Liability |
|---|---|---|
| IASB | An **asset** is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. (paragraph 49) | A **liability** is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits. (paragraph 49) |
| FASB | **Assets** are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events. (paragraph 25) | **Liabilities** are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. (paragraph 35) |
| Australia | **"Assets"** are future economic benefits controlled by the entity as a result of past transactions or other past events; and "control of an asset" means the capacity of the entity to benefit from the asset in the pursuit of the entity's objectives and to deny or regulate the access of others to that benefit. (paragraph 14) | **Liabilities** are the future sacrifices of economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events. (paragraph 48) |
| Canada | **Assets** are economic resources controlled by an entity as a result of past transactions or events and from which future economic benefits may be obtained. (paragraph 29) | **Liabilities** are obligations of an entity arising from past transactions or events, the settlement of which may result in the transfer or use of assets, provision of services or other yielding of economic benefits in the future. (paragraph 32) |
| Germany | An **asset** is a resource controlled by an enterprise as a result of past events. The inflow of future economic benefits is expected as a result of the utilisation of that asset within the enterprise or as a result of its disposal. (paragraph 66) | A **liability** is a present obligation to an external party arising from past events. The outflow of resources is expected as a result of the settlement of the obligation. (paragraph 70) |
| Japan | **Assets** are economic resources or their equivalents that the reporting entity controls as a result of past transactions or events. (paragraph 4) | **Liabilities** are obligations or their equivalents to give up or deliver the economic resources that the reporting entity controls, as a result of past transactions or events. (paragraph 5, footnote reference omitted) |

| | | |
|---|---|---|
| New Zealand | **Assets** are service potential or future economic benefits controlled by the entity as a result of past transactions or other past events. (paragraph 7.7) | **Liabilities** are the future sacrifices of service potential or of future economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events. (paragraph 7.10) |
| United Kingdom | **Assets** are rights or other access to future economic benefits controlled by an entity as a result of past transactions or events. (paragraph 4.6) | **Liabilities** are obligations of an entity to transfer economic benefits as a result of past transactions or events. (paragraph 4.6) |
| CFA Institute – Comprehensive Business Reporting Model (pg 19)[41] | An enterprise must recognize an economic resource as an **asset** in the financial statements when all of the following conditions are met:<br>a. The resource is a present right or other access to a future benefit that will flow to the company and will contribute directly or indirectly to future net cash inflows;<br>b. The right to the future benefit is controlled by the company;<br>c. There is a nonzero probability that the benefit will occur;<br>d. The right to the future benefit is separable from the company; that is, it can be transferred to an external party;<br>e. The right to the future benefit is the result of past events; and<br>f. The fair value of the right to future benefits can be measured. | An economic obligation must be recognized as a **liability** in the financial statements when all of the following conditions are met:<br>a. The obligation exists currently;<br>b. There is a nonzero probability that the obligation will be settled by an outflow of assets, issuance of another liability, or other settlement that will result in a change in the share of net assets available to current shareowners;<br>c. There are sufficient penalties to the enterprise from nonperformance that the enterprise has no realistic alternative to settlement;<br>d. It does not meet the definition of equity; and<br>e. The economic attributes and fair value of the obligation can be measured. |

[41] *A Comprehensive Business reporting Model: Financial Reporting for Investors*, CFA Centre for Financial Market Integrity, September 2005. Note that these definitions mix both the definition of the element and the criteria for recognizing it.

## APPENDIX C

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