Conceptual Framework

Phase B: Elements & Recognition—Working Draft Liability Definition and Amplifying Text

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This working draft is provided solely for reference purposes. Staff do not intend that it be discussed at the July meetings.

Introduction

1.1 In April 2006, the staff prepared a proposed working draft definition of a liability and amplifying text for the Conceptual Framework and then, in November 2006, staff included in the paper on the definition of an asset a revised working definition of a liability that paralleled the proposed working definition of an asset. At those meetings, the Boards' discussions focused on the working definition of an asset and few comments were received on the proposed definition of a liability and amplifying text. This paper has been developed by staff based on the liability portions of that April 2006 paper, but it has been refined and expanded to include matters arising from consultations on the definition of an asset with the World Standard Setters, the FASB's Financial Accounting Standards Advisory Council and the FASB's Small Business Advisory Committee, and at the American Accounting Association/FASB Financial Reporting Issues Conference in December 2006 and the National Standard Setters in March 2007. This paper continues to be a work-in-progress.

1.2 In February 2006, the Boards affirmed the approach of defining a liability directly with reference to assets. This is how a liability is currently defined in the Boards' and many other standard setters' existing frameworks today. Thus, to the extent appropriate, the working definition proposed in this paper parallels the proposed working definition of an asset.

1.3 This paper does not consider the liability-equity issues identified in cross-cutting issues. Nor does it consider the effects of uncertainty on determining the existence of a liability (element uncertainty)—a topic on which deliberation remains underway. .

1.4 Part 1 of this paper sets out the existing and proposed definitions of a liability. Part 2 compares the proposed working definition of a liability with the existing IASB and FASB definitions, summarizes the need to change and improve on those definitions, and discusses each of the key aspects of the proposed working definition that will achieve the desired improvements. Part 3 sets out a working draft of the amplifying text proposed to support the definition of a liability in a revised Conceptual Framework.

1.5 This material has been developed by staff, and has not previously been reviewed by the Boards. This material remains a work-in-progress. **It is provided solely for reference purposes. Staff do not intend that it be discussed at the July meetings.**

Part 1—Existing and Proposed Definitions of a Liability

1.1 The existing IASB and FASB definitions of a liability are as follows:

> A **liability** is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits. [IASB *Framework*, paragraph 49(b)]
>
> **Liabilities** are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. [CON 6, paragraph 35; footnote references omitted.]

1.2 The following draft definition of a liability demonstrates that it is possible to draft a definition that is a near parallel to the asset definition in approach.

Definition of a Liability

A liability is a present economic burden for which the entity has a present obligation.

a. *Present* means that both the economic burden and the obligation exist on the date of the financial statements.

b. An *economic burden* is something that has negative economic value. It is capable of requiring the sacrifice of economic resources. An economic burden can result in cash outflows or reduced cash inflows, directly or indirectly, alone or together with other economic burdens. Economic burdens include non-conditional contractual promises that the entity makes to others, such as promises to pay cash, deliver goods, or render services. Rendering services includes standing ready to perform or refraining from engaging in activities that the entity could otherwise undertake.

c. An *obligation* requires the entity to bear the present economic burden directly or indirectly. Obligations are enforceable by legal or equivalent means (such as by a professional association).

1.3 Using a parallel approach with the asset definition, the liability definition focuses on the *capability* of requiring cash outflows (or reducing cash inflows), rather than on the cash flows themselves that might result.

1.4 In application, the liability definition does not completely parallel the asset definition because not all assets give rise to corresponding liabilities. Even though "obligation" in the liability definition may be seen as the counterpart to "right or other privileged access" in the asset definition, it does not fully mirror those terms because rights include property rights and other privileged access includes similar items (such as a secret formula) for which there is no corresponding obligation.

Part 2—Need to Change the Existing Definitions

2.1 The existing liabilities definitions parallel the existing assets definitions in many respects, as illustrated in the table below:

	Assets Definitions	**Liabilities Definitions**
1.	Expected or probable	Expected or probable
2.	Past transactions or events	Past transactions or events
3.	Resource from which economic benefits flow or future economic benefits	Outflow of resources embodying economic benefits or future sacrifices of economic benefits
4.	Control	Obligation

2.2 As a result, the existing liabilities definitions share some of the same shortcomings in the words used in the one-sentence assets definitions. Therefore, the issues associated with "expected or probable," which is referred to as "likelihood" and "past transactions or events" (in rows 1 and 2 of the table above) are exactly the same as those with the assets definitions. The aspects of the liabilities definitions that differ somewhat from those in the assets definitions are their focus on "outflow of resources embodying economic benefits or future sacrifices of economic benefits," which refer to future outflows of economic benefits, and "obligation" (rows 3 and 4 of the table above).

2.3 The following paragraphs outline some of the shortcomings of the existing IASB and FASB definitions of a liability and explain how the proposed working definition seeks to mitigate those shortcomings. The discussions of likelihood and past transactions and events are very similar to those on the assets definitions, except that they are reproduced here in the context of a liability.

2.4 *Likelihood*—Likelihood ("expected" in the case of the IASB and "probable" in the case of the FASB) was included in the existing definitions in response to constituents' concerns on earlier proposals that the definitions would require that a thing be certain in order to qualify as a liability. Since few things in life are certain, the Boards observed that few things that

are commonly thought to be liabilities would qualify in accordance with the definitions. Accordingly, the Boards included likelihood in the existing definitions with the intent of indicating that the thing in question need not be certain (that is, it could be less than certain) to meet the definition.

2.5 Both the IASB and FASB definitions have been misinterpreted as implying that there must be a high likelihood of future outflows of economic benefits for the definition to be met. Thus, some think that when there is a low likelihood of future outflows of economic benefits, the liability definition is not met. That is not the intent.[1]

2.6 To avoid this continued misinterpretation, the working definition of a liability clarifies that it does not depend on an assessment of a degree of likelihood. We think it is sufficient that an economic burden be capable of resulting in cash outflows or reduced cash inflows—that is, the probability of negative cash flows is greater than zero. If there is any question of likelihood to be considered, that might be a factor in assessing whether a particular liability (or liability class) qualifies for recognition or in determining its measurement, not in the definition of a liability.[2]

2.7 *Past transactions or events*—We think that references to "past transactions or events" were included in the definitions primarily to exclude future liabilities from meeting the definitions. However, in applying both the IASB and FASB definitions, some place undue emphasis on identifying the past transactions or events that give rise to a liability. Though that identification might be helpful, it can be a distraction and lead to debates about which event is the triggering event instead of focusing on whether the economic burden and the obligation that links the economic burden to the entity exist at the financial statement date. How the economic burden and the entity's obligation to it were incurred does not affect whether it meets the definition of a liability at the present time. Although an observed transaction or other event might provide a signal that a liability might be present and provide a clue as to its nature, the failure to observe such a transaction or other event does not demonstrate the absence of a liability. Conversely, just because a transaction or other

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[1] A footnote to the FASB definition in CON 6, paragraph 35, footnote 21, attempts to explain that, but perhaps not as effectively as it might.

[2] Recognition and measurement will be considered in later parts of the conceptual framework project.

event has occurred, that does not mean a liability has resulted from it. For example, a cash inflow could have occurred from sacrificing an asset rather than incurring a liability.

2.8 To avoid undue emphasis on seeking out past transactions or events, the working definition focuses on what is necessary for a liability to exist 'at the present' (i.e., a *present* obligation for a *present* economic burden). This also has the advantage that the economic burden and obligation for it must exist today—so they cannot be an economic burden, or an obligation for it, that will not arise until the future or that existed in the past, but no longer exists at the financial statement date. For example, for a warranty provider, the focus should be on the warranty provider's present promise to protect the product purchaser from future repair costs, and not on the uncertain future event of whether the product breaks and the warranty provider will have to fix it.

2.9 *Future Outflows of Economic Benefits*—As with the assets definitions, this notion, used in both the IASB and FASB definitions, focuses on identifying a future outflow of economic benefits to demonstrate that a liability exists. We think this is the wrong focus. Financial statements can be viewed as reporting on things that exist (sometimes referred to as *stocks*) and changes in things that exist (sometimes referred to as *flows*). We think that the definition of a liability should focus on stocks—the things that are capable of resulting in cash outflows or reduced cash inflows. A liability is not an outflow of value, but rather an outflow of value may result from it. The outflow of value may occur in different ways, for example, as a result of creating and providing a service or a good. The value to be provided to settle a liability may or may not be a valuable thing that now exists or is now recognized in the financial statements. The liability is a stock—a negative thing that exists today. The problem is that the existing FASB definition defines a 'stock' by reference to a 'flow.'

2.10 Additionally, a liability is something that exists in the present rather than in the future. However the wording in the existing definitions suggests otherwise by equating the liability with *future* outflows of economic benefits. This is sometimes misinterpreted as meaning that the liability is the ultimate future outflow. This can lead to a conclusion that some things, such as a loan guarantee, are not liabilities, because the *future* outflows of economic benefits is associated with a future event—being the default of the debtor which requires

the guarantor to pay off the loan. Such an approach focuses on the eventual outcome of the guarantee, when in fact the guarantor has a present stand-ready liability for the guarantee. The guarantor could not be released from its guarantee today without either paying or providing other consideration to be released from the guarantee or compensating a third party to legally assume the guarantee.

2.11 To avoid this misinterpretation, we think that the working definition should replace *future outflows of economic benefits* with a term that is parallel to “a present economic resource” in the definition of an asset, such as *present economic burden*. The use of *economic burden* rather than *future outflows of economic benefits* indicates that the thing is a stock, rather than a flow, and use of *present* rather than *future* indicates that the thing must presently exist.

2.12 Some are concerned with the use of the word *burden*. In particular, some have expressed a preference to refer instead to the “outflow of economic resources” or “the presence of outbound cash flows (or reduction of inbound cash flows)”. These wording suggestions would focus the liability definition on the future outflow of value—a flow, rather than a stock. As explained, we think that the definition should focus on stocks—the things that are presently capable of resulting in cash outflows or reduced cash inflows.

2.13 In light of concerns about the word *burden*, we have sought out alternative words, but have found none that better captures the idea we wish to express and yet parallels the use of resource in the asset definition. The closest alternatives might be economic “onus,” “responsibility,” “exposure,” “encumbrance,” “condition” or “disadvantage.” However, we do not think these terms are any more helpful. We think these alternatives do not capture all the things we think of as liabilities or may have different meanings depending on the facts and circumstances. For example, an exposure does not include accepted or known things. Encumbrance is often interpreted from a legal perspective which is defined in *Oxford English Dictionary Online* as “a mortgage or other charge on property or assets.” Therefore, we propose to continue to use the word “burden” and include in part b. of the definition the explanation that an economic burden “is something that has negative economic value.”

2.14 *Obligation*—Even though the reference to "obligations" in the liabilities definition parallels the reference to "control" in the existing assets definition, that reference does not create the problem that the reference to control does. That is because, unlike control, obligation does not generally have different meanings in other parts of the authoritative literature or common usage.

2.15 The replacement of control in the assets definition with "right or other privileged access" would make that definition more parallel to the liabilities definition since a right is generally seen as being the counterpart to an obligation. Whether there is a need for a counterpart to "other privileged access" in the context of a liability is considered later in this paper.

2.16 Though obligation does not have the same interpretation problems as control does, the amplifying texts accompanying the existing IASB and FASB definitions do no not fully consider which types of obligations give rise to liabilities. Obligations include those that are legal, constructive, equitable, moral and economic in nature. Compared to the amplifying text for the existing definitions, the proposed working definition of a liability limits obligations to those which are enforceable by legal or equivalent means (see part c. of the proposed working definition). As a result, moral obligations and those arising when an entity is economically motivated to provide another entity with an economic resource to improve its own interests (sometimes referred to as economic compulsion), would not generally create liabilities in accordance with the proposed working definition (refer to paragraphs 3.38-3.39 of the proposed amplifying text).

2.17 *Contractual promises*—The amplifying texts accompanying the existing IASB and FASB definitions are not as clear as they could be regarding the application of the definitions to contractual promises. The IASB Framework is silent on this matter. In contrast to its discussion of inbound contractual promises in the context of assets, Concepts Statement 6 is clearer about whether contractual promises that the entity makes to others (an "outbound contractual promise") would meet the liabilities definition. For example, it states that "Most liabilities stem from human inventions—such as financial instruments, contracts, and laws— … and are commonly embodied in legal obligations and rights (or the

equivalent) with no existence apart from them" (paragraph 37). It later adds that "… most liabilities result from agreements between entities …" (paragraph 39).

2.18 The Boards have discussed inbound contractual promises and whether they qualify as assets in other projects such as Revenue Recognition. The Boards have observed that such promises may be:

a) *Conditional*—Performance of the promise is subject to an event that is not certain to occur.
b) *Unconditional*—Nothing other than the passage of time is necessary for performance of the promise to occur.
c) *Mature*—Performance of the promise is not subject to any event, including the passage of time.

2.19 With regard to the asset definition, the Boards have concluded that inbound contractual promises that are conditional are not present economic resources because their performance is not presently required. Thus, it would follow that in the context of the liability definition, outbound contractual promises that are conditional would not be economic burdens because their performance is not presently required—performance is presently required only if and when the uncertain future event occurs. However, outbound contractual promises that are unconditional or mature (that is, non-conditional) may qualify as present economic burdens because their performance is presently required.[3]

2.20 In doing so, the Boards observed that conditional promises commonly are accompanied by an unconditional promise and, in those cases the unconditional contractual promise may be a present economic burden even though the conditional promise is not a present economic burden.

2.21 For example, a fire insurance policy on a home may be seen as involving two promises from the insurance company. One is an unconditional promise to provide insurance coverage during the policy's term, and the other is a conditional promise to pay damage claims *if* a fire occurs. Unless a fire occurs, the insurance company only has a liability relating to the unconditional promise of coverage for the remainder of the policy term.

[3] Later in this project, we will assess whether a "concurrently conditional promise" is an economic burden or not. A *concurrently conditional promise* is one where the performance of one promise is subject to the performance of the other exchanged promise— both parties must perform at the same time.

However, if a fire occurs, the insurance company has two liabilities, one for payment of the claim for fire damage, and another for coverage for the remainder of the policy term.

2.22 As with the proposed working definition of an asset, to be clear about whether outbound contractual promises may be liabilities, we think the amplifying text should explicitly indicate that economic burdens encompass non-conditional promises (i.e., those that are unconditional or mature). The reason for doing so is to clearly communicate that non-conditional promises are economic burdens and conditional promises are not.

2.23 The fire insurance example illustrates an unconditional promise that does not require the promisor or the insurance company to take a particular action, but rather to stand ready to do so. Specifically, the promise to provide insurance coverage for the policy term is a contractual promise to stand ready. FASB Concepts Statement 6 describes those promises in the context of liabilities (paragraph 36). The IASB has also explored this idea in its project to amend IAS 37, Provisions, Contingent Liabilities and Contingent Assets. That acknowledgement is retained in the proposed working definition of a liability (see part b. of the proposed working definition).

2.24 As well, if inbound contractual promises that require the promisor to refrain from taking specific actions are to be viewed as economic resources to the promisee in the context of assets, it follows that such outbound contractual promises also should be viewed as present economic burdens to the promisor.

2.25 *Cash Outflows*—Neither the IASB nor FASB frameworks explicitly tie the liability definitions to the objective of financial reporting to provide information useful to users in making resource allocation decisions, such as information to assess the timing and uncertainty of future cash flows. The IASB Framework does include the payment of cash as one of the number of ways a present obligation may be settled (IASB *Framework*, paragraph 62(a)). While FASB Concepts Statement 6 describes assets as having the capability to contribute to producing positive cash flows, it does not explicitly describe liabilities as having the capability of resulting in negative cash flows, although that notion is present in the discussion of liabilities. Thus, to better tie the liability definition to the

objective of financial reporting, that link is made more explicit (see part b. of the proposed working definition).

Part 3—Working Draft of Amplifying Text

Liabilities

3.1 A liability is a present economic burden for which the entity has a present obligation.

a. *Present* means that both the economic burden and the obligation exist on the date of the financial statements.

b. An *economic burden* is something that has negative economic value. It is capable of resulting in the sacrifice of economic resources. An economic burden can result in cash outflows or reduced cash inflows, directly or indirectly, alone or together with other economic burdens. Economic burdens include non-conditional contractual promises that the entity makes to others, such as promises to pay cash, deliver goods, or render services. Rendering services includes standing ready to perform or refraining from engaging in activities that the entity could otherwise undertake.

c. An *obligation* requires the entity to bear the present economic burden directly or indirectly. Obligations are enforceable by legal or equivalent means (such as by a professional association).

3.2 For an entity to have a liability there must be a present economic burden and the entity must have a present obligation to bear that economic burden. The economic burden is something that has negative value. The obligation establishes that the entity is linked to the economic burden. For example, an account payable comprises a present promise to pay cash to another party (something that has negative economic value) and an entity's present obligation is its link to that promise.

Present at the Financial Statement Date

3.3 Financial reports are prepared as of a particular date. Users of financial reports are interested in liabilities that exist at that point in time. Therefore, the definition of a liability requires that it exist at the financial statement date. That is, the liability presently exists.

3.4 This means that a liability might arise from past transactions or other past events. Often an entity incurs liabilities when it receives purchased assets or services, but other transactions or events also may give rise to liabilities. Examples include promising to do something in a contract, borrowing funds from another party and agreeing to repay, and owing taxes to a government as a result of the entity's past business activities. The means of incurring a liability does not affect whether something meets the definition of a liability (that is, the history of how the liability arose, or of how the entity incurred the liability, does not matter), although the means might provide evidence or a signal to help in the assessment as to whether the entity has a liability and what is the nature of the liability.

3.5 Expectations alone of future transactions or other events do not result in liabilities today. An intention, as opposed to an accepted offer, to purchase an asset does not meet the definition of a liability as an intention is neither a present obligation nor results in a present economic burden. Services to be rendered by employees next year do not result in liabilities today when payment is not owed to those employees until they render the services.

3.6 Similarly, expected future transactions or other events do not extinguish liabilities today. An entity has a present liability if the ultimate transactions or other events to settle or satisfy an entity's economic burden have not yet occurred. For example, a liability remains even if the entity has set aside cash for settlement of the liability in the future.

3.7 Both the economic burden and the entity's link to the economic burden must presently exist for an entity to have a liability. Thus, if an entity transfers its economic burden outright to another party and the entity extinguishes its obligation, then the entity no longer has a liability. In this situation the economic burden still exists. After the transfer, the other party is now presently obligated to bear that present economic burden. Also, in the case of an economic burden that may arise in the future (for example, a contract to make a payment

for goods if delivered), but the entity is presently obligated (by the contract), the entity does not yet have a liability to pay for the goods.

An Economic Burden

3.8 The definition of a liability requires that there is an economic burden—something that has negative economic value. An economic burden is intangible and many of them arise as a result of a contractual promise.

3.9 Something is of *value* when it is capable of being used to carry out activities such as production and exchange. Financial reporting concerns those things that have *economic* value—that is, those things that are capable of producing cash inflows to the entity or reducing cash outflows from the entity, or resulting in cash outflows from the entity or it receiving reduced cash inflows. Thus, something that is incapable of having value to others (for example, it has sentimental value only)—does not have *economic* value.

3.10 Cash flows can be direct or indirect, and can arise from a single resource or claim, or from a combination of resources and claims. As explained in paragraph OB20 of Chapter 1: *The Objective of Financial Reporting*:

> …many creditors' claims, such as accounts payable or outstanding debt instruments, are direct causes of future cash outflows. However, many of the cash flows generated by an entity's operations result from combining several of its economic resources to produce or provide and market goods or services. Although those cash flows cannot be identified with individual economic resources…, investors and creditors need to know the nature and quantity of the resources available for use in an entity's operations….

As long as the likelihood of negative cash flows is greater than zero, there is negative economic value.

3.11 Something that has negative economic value to an entity is capable of resulting in an entity providing economic resources to others. Many economic burdens result in an entity paying cash to one or more identified other entities. Economic resources might also be provided in a number of other ways, including by transferring assets other than cash, granting a right to use an asset, or rendering services.

3.12 Economic burdens are often documented in contracts or other agreements resulting from exchange transactions. Such documents can describe the nature of the economic burden and how it can be settled or fulfilled. The absence of a specified date or event to trigger settlement may cast doubt that an economic burden exists.[4]

3.13 Economic burdens can also result from requirements imposed upon an entity which have economic consequences. Statutes or judicial decisions might impose requirements on an entity to take actions or inactions. For example, a health and safety statute currently effective requires an entity to take actions to rectify unsafe working conditions. At the financial statement date, such a requirement is capable of resulting in the entity making cash outflows to have the unsafe condition fixed. On the other hand, if the entity is already in compliance with the health and safety statute, the entity is not presently required to take any actions, thus, it does not have an economic burden. [*We have not yet, but need to, distinguish between when a liability exists and when an asset is impaired.*]

3.14 To be an economic burden, the economic resources to be provided must be economic resources *of the entity*. For example, a broker acquiring property on behalf of a client might pay for the property with funds it holds in trust for the client. The broker does not have to give up its own economic resources in acquiring the property and does not, itself have an economic burden relating to the purchase of the property.

3.15 Economic burdens also include things that are capable of resulting in reduced cash inflows to the entity. [*We need to develop an example to demonstrate this point which is not an asset impairment. This point is parallel with the requirement in the asset definition.*]

3.16 In assessing whether something is capable of resulting in the entity making cash outflows to others, it is necessary to consider any cash inflows that result from the cash outflows. Thus, if something is capable of resulting in cash outflows while simultaneously producing equal or greater cash inflows, it is not an economic burden—and, therefore, it cannot be a liability. [*Again, we need to develop an example which reflects the exchange of cash flows versus a netting arrangement. For example, an entity may have a contractual obligation to*

[4] Last sentence is derived from CON 6, paragraph 194.

demolish a building and dispose of the waste. Certain of the waste may be recyclable for which the entity may receive payment. Thus, the entity's cash outflows to dispose of the waste may be offset by the cash inflows from material that is recyclable.]

3.17 Economic burdens include, among other things: to pay for goods or services received and to repay funds borrowed, usually with interest. The economic burden is the something that is capable of resulting in the entity making cash outflows (or receiving reduced cash inflows)—not the future cash flows themselves.

3.18 An economic burden can result from contractual arrangements. Contracts generally involve exchanges of promises. A promise is where one party *promises* to do a required action (or inaction) for the recipient of the promise. The *promisor* is the party required to undertake the action. The *promisee* is the holder or recipient of the promise. An outbound promise is when a promissor makes a promise to a promisee. Unlike an offer, a promise represents an offer made and accepted by both parities. The maker of a promise or original holder of a promise may lay it off, sell it or otherwise transfer it to another party.

3.19 Contractual promises may be:

a) *Conditional*—Performance of the promise is subject to an event that is not certain to occur.

b) *Unconditional*—Nothing other than the passage of time is necessary for performance of the promise to occur.

c) *Mature*—Performance of the promise is not subject to any event, including the passage of time.

3.20 In these contractual circumstances, the economic burden is the non-conditional outbound promise that the entity (the promissor) makes to others (the promisees) and which is capable of resulting in the entity making cash outflows or receiving reduced cash inflows. Such economic burdens include non-conditional promises by an entity to pay cash, deliver goods or render services to others. Promises to render services include promises to provide

others protection from a specified risk,[5] or refraining from engaging in activities that the entity could otherwise undertake. Contracts generally involve exchanges of promises—one party promises to do something in exchange for a promise from another party to do something else in return.

3.21 Outbound contractual promises that are conditional are not present economic burdens because their performance is not *presently* required—performance is presently required only if and when the uncertain future event occurs. However, outbound contractual promises that are unconditional and mature (that is, non-conditional) may qualify as present economic burdens. Conditional promises commonly are accompanied by an unconditional promise and, in those cases the unconditional contractual promise may be a present economic burden even though the conditional contractual promise is not a present economic burden.

3.22 For example, a fire insurance policy on a home may be seen as involving two promises from the insurance company (the promissor). One is an unconditional promise to provide insurance coverage during the policy's term, and the other is a conditional promise to pay damage claims *if* a fire occurs. Unless a fire occurs, the insurance company only has an economic burden relating to the unconditional promise of coverage for the remainder of the policy term. However, if a fire occurs, the insurance company has two economic burdens, one for payment of the claim for fire damage, and another for coverage for the remainder of the policy term.

3.23 A non-conditional contractual promise is an economic burden only when the promise is made to others. That is, the entity must make a promise to another party. Thus, a promise that the entity has received from others cannot be an economic burden because the entity is the promissee, not the promissor. Such a promise to the entity can only be an economic resource. Similarly, financial instruments that contain an entity's promise to others, such as the entity's debt, can only be economic burdens to the entity, not economic resources.

[5] Contractual promises include standing ready to provide the service of being prepared to take action.

3.24 Reacquired outbound promises such as when an entity purchases back its own previously issued debt, are not economic burdens, since there is no party external to the entity as promissee—thus, no promise. Hence, those instruments cannot be the entity's liabilities, even though they were liabilities to the (external) shareholders or debtholders immediately prior to the reacquisition by the entity. For the same reasons, an entity's own unissued shares or debt cannot be its economic burdens.

3.25 An entity might be required to stand ready to provide a service, such as being prepared to provide goods or services to another entity. In such a case, the entity has made an unconditional promise to provide a service if or when required. For example, when an entity provides a one-year warranty to a customer to correct any product problems that occur, the entity is promising to stand ready to provide the repair service if and when required. Even if no claims are made for repair and no repair services are rendered to the customer, the entity has an economic burden to protect the customer from the cost of repairs during the warranty period which the customer can require.

3.26 Sometimes an entity agrees to *refrain* from engaging in specified types of activities or to *stand aside*. In such circumstances, economic resources that might otherwise be obtained are forgone. Examples include agreements not to compete. For example, an entity might receive a payment not to engage in specified business activities that otherwise could generate future economic resources. In this situation, the entity is required not to take a specified action. Such requirements to stand aside require forgoing a possible future economic resource in the form of possible future cash inflows from revenues. Because the entity is not yet entitled to those future revenues, they are not its assets and, therefore, the entity does not have to sacrifice any of its present assets. Rather, the entity is required to forgo possible future assets and would be required to pay the counterparty if it breached the contract. For example, a low fare airline that has the capacity to expand into only one new market each year might enter into an agreement with a full service airline not to expand into the full service airline's home base for a year. In exchange for a cash payment from the full service airline, the low fare airline agrees to stand aside from accessing the other's home market, although it remains free to access other new markets. The low fare airline has

an economic burden—it has agreed to forgo economic resources that it might otherwise have obtained by entering the full service airline's home base.

Entity Is Obligated

3.27 The definition of a liability requires that the entity is obligated to bear the economic burden. The liabilities that are the focus of financial reporting are those that are relevant to the users' decisions about the entity. Therefore, the relevant economic burdens are those *of the entity*. In the context of financial reporting, the *Oxford English Dictionary Online* defines an *obligation* as "a moral or legal tie *binding* to some performance."[6] An entity that is bound to bear an economic burden is obligated to that burden. Obligation is what links an economic burden with the entity.

3.28 Obligations distinguish who bears an economic burden. An economic burden becomes associated with another party if that other party assumes the economic burden from the original obligor. The other party now is obligated to bear the economic burden. For example, when a business is sold, the seller relinquishes its outstanding economic burdens and the buyer assumes those economic burdens. The seller is no longer obligated. The buyer becomes obligated. The economic burden itself might not have changed.

3.29 In a financial reporting context, something is "binding" on an entity if it requires performance that is either legally enforceable or is enforceable by equivalent external means. "Performance" is what an entity is required to do (or refrain from doing) to satisfy the economic burden to which it is obligated.

3.30 A present obligation must be presently enforceable by others. That is, others must be capable of requiring that the entity is presently obligated to the economic burden. For example, it might be clear that damage to the environment has occurred, but there is no ability for others to link that environmental damage to actions (or inactions) of the entity. In this example, the entity does not have a present obligation—it does not have an obligation that is capable of enforcement by others. For a present obligation to exist, it is

[6] *Oxford English Dictionary Online*, accessed February, 2006.

sufficient that there is some capability of enforcement. Uncertainty as to the likelihood of enforcement does not affect the existence of a present obligation.

3.31 Owners acting in their capacity as owners are not *others.* Claims to residual interests in the entity that are capable of settlement with the entity only as a result of actions by the entity are not present obligations of the entity.

3.32 A promise to oneself cannot be an obligation. For example, in the absence of external requirements, an entity is not obligated to repair the roof of its building or maintain its plant and equipment. Although, the repair or maintenance might be a wise business move, the entity can defer such activities without incurring legal penalties or equivalent external enforcement.

3.33 Most obligations to economic burdens are legally enforceable. Legally enforceable obligations include those arising from binding contracts, agreements, rules, statutes, or other requirements that would be upheld by a judicial system or government, or are accepted by entities to avoid imposition by the justice system or government. Judicial systems vary as to type and form and include any such system that would enforce laws, statutes and regulations.

3.34 Obligations can be enforceable by other external means that are equivalent to legal enforceability. Such means must be capable of enforcing an obligation similarly to a legally enforceable obligation. For example, a self-regulatory body can impose and enforce requirements upon its members. If those requirements are enforced similarly to how legally enforceable obligations would be enforced, even though the consequences of enforcement might differ somewhat, they are regarded as the equivalent of legally enforceable obligations. As another example, in many wholesale diamond markets or other commodity markets throughout the world, exchanges are agreed upon based on oral discussions or non-verbal signals. Traders in such markets will only conduct business in that manner, with disputes settled by an arbitration process recognized by, and binding upon, the members of the market and affiliated markets. Obligations to economic burdens created under these circumstances may not be enforceable in court, but nonetheless may be enforceable by virtue of the rules and regulations of the trading organization. Traders that do not honour

such economic burdens might be excluded from membership and, thus, from conducting any future trades in that market, thereby losing their livelihood, or be subject to other fines or penalties imposed by the regulatory body, the threat of which is sufficient to enforce performance.

3.35 Most obligations to economic burdens arise from deliberate actions of the entity, such as exchange transactions with other parties to acquire the funds, goods, and services needed for the entity to operate. For example, borrowing cash obligates an entity to repay the amount borrowed; acquiring assets on credit obligates an entity to pay for them; using employees' knowledge, skills, time, and efforts obligates an entity to pay for their use, often including non-payroll benefits. Selling products with a guarantee or warranty obligates an entity to stand ready either to pay cash or to repair or replace products subject to the guarantee or warranty.

3.36 Obligations to economic burdens incurred in exchange transactions are contractual in nature. They are based on written or oral agreements which outline an entity's requirement to pay cash or to provide goods or services to specified or determinable other parties. Obligations are usually documented, including that it is the entity that is required to bear the economic burden. For example, contracts will usually specify the names of the parties to the contract, or will document a means of determining who is to bear economic burdens in accordance with the contract. The identity of the other party need not be known to obligate the entity before the time of settlement. Obligations for which another identifiable party might not be known include asset retirement obligations.

3.37 Some obligations to economic burdens require nonreciprocal transfers from an entity to one or more other parties. Such obligations include those arising from deliberate actions of the entity such as donations pledged to charitable organizations, and cash dividends declared but not yet paid.

3.38 Some obligations to economic burdens arise from constructive obligations. A constructive obligation might be created, inferred, or construed from the facts in a particular situation, rather than contracted by agreement with another entity or imposed by government. For example, an entity might pay its employees vacation pay or year-end bonuses every year

even though there is no specified contractual agreement to do so and the entity has not announced a policy to do so. Nonetheless, a court could construe that practice to have created a legally enforceable obligation.

3.39 Obligations to economic burdens might also arise as a result of actions taken by others that are binding on the entity, such as legislative actions (statutes such as those requiring the payment of income and sales taxes), judicial actions (such as court awards for damages), or executive actions (for example, regulatory requirements or fines). Even if some discretion is provided to the entity as to how it acts in response to that action, as long as the entity is required to take some action it has an obligation. For example, an entity might have a choice of remedying a breach of legislation or paying a fine. So long as others can require the entity to take one or the other action, the entity is obligated to an economic burden.

3.40 An obligation to an economic burden might appear to stem from ethical or moral compulsion, that is, from a duty of the entity to another party to do that which an ordinary conscience and sense of justice would deem fair, just, and right, i.e., to do what one ought to do rather than what one is legally required to do. For example, an entity may feel obliged to complete and deliver a product to a customer that has no other source of supply even though the entity’s failure to deliver would legally require only return of the customer's deposit. The entity in this example is not required by means equivalent to legal enforceability to complete and deliver the product (i.e., no external party can seek enforcement). Hence, in the absence of a further requirement to complete and deliver a product, no obligation to an economic burden exists beyond that to return the customer’s deposit.

3.41 An entity might be motivated to provide an economic resource to others to improve its own interests or to avoid expected future negative impacts on its own interest. This notion of acting in one’s own interests is sometimes referred to as *economic compulsion*. For example, an entity might decide to provide refunds to its major customers to encourage future sales or to deter the customers from seeking out an alternative supplier, although it has a written policy of not issuing refunds. However, the entity in this example is not required by any external party, either legally or by equivalent means, to provide refunds.

Hence, no obligation to an economic burden exists for financial reporting purposes. However, if the entity takes actions that raise expectations of others that refunds are to be provided, a constructive obligation might be construed.

3.42 Asserted claims often arise from events that do not involve any deliberate action (or inaction) of the entity. Examples include situations in which a claimant asserts that the entity was at fault or negligent. There might be doubt as to whether the entity is a valid party to the claim. Determining whether claims of that nature give rise to obligations of the entity requires assessment of the relevant facts to ascertain whether the definition has been met. [*Paragraph is incomplete. We need to evaluate how to distinguish a business risk from a liability or approach uncertainty about the existence of a liability.*]