30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**20 March 2007, London**
Project:	**Liabilities - amendments to IAS 37**
Subject:	**IAS 37 Redeliberations: Distinguishing between a liability and a business risk (Agenda Paper 3B)**

INTRODUCTION

1. This paper presents the staff's analysis on distinguishing between a liability and a business risk. The analysis in this paper is presented in the context of the IAS 37 project but, as noted in agenda paper 3A, this paper was prepared in conjunction with the Conceptual Framework team.

2. This paper divides into the following sections:

Section 1: **Definitions & descriptions –** this section reviews the definitions and descriptions of liabilities and risks in existing IFRS literature.

Section 2: **Similarities and differences –** this section identifies the distinguishing features of liabilities and business risks.

Section 3: **Staff analysis –** this section applies the distinguishing features of liabilities and business risks to three scenarios to identify any tension points and potential inconsistencies.

In agenda paper 3C the staff goes on to consider how their tentative conclusions in this paper may help resolve issues associated with the notion of a stand ready obligation.

SECTION 1: DEFINITIONS & DESCRIPTIONS

Liability

3. The IASB *Framework* defines a liability as 'a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits'.[1]

4. The *Framework* goes on to explain that an *obligation* is a duty or responsibility to act or perform in a certain way. A *present* obligation is 'irrevocable' and leaves an entity with 'little, if any, discretion' to avoid an outflow of economic benefits. IAS 37 echoes this explanation, emphasising that a present obligation exists 'independently of an entity's future actions' meaning that an entity has 'no realistic alternative' to settling the obligation.[2]

5. The IASB's definition and description of a liability is consistent with the definitions and descriptions of a liability used by other standard setters. Appendix A summarises those definitions and descriptions.

Risk

6. IFRS literature defines specific types of risk. For example, IFRS 4 *Insurance Contracts* defines financial risk and insurance risk; IFRS 7 *Financial Instruments: Disclosures* defines credit risk, currency risk, interest rate risk, liquidity risk, market risk and other price risk; and IAS 17 *Leases* describes the risks associated with a leased asset.[3] Common to all of these definitions is uncertainty about the future that may impact an entity's current financial position.[4]

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[1] *Framework*, paragraph 49(b).
[2] *Framework*, paragraphs 60-61; and IAS 37, paragraphs 17 and 19.
[3] Complete definitions can be found in IFRS 4, appendix A; IFRS 7, appendix A; and IAS 17, paragraph 7.
[4] The staff acknowledges that, in other contexts, (i) risk conveys uncertainty about something other than an entity's financial position, and (ii) risk and uncertainty are considered to be two separate notions.

7. IFRS literature does not define business risk. The staff thinks that business risk is an 'umbrella' term that captures all risks faced by an entity as a result of its business activities, including the specific types of risks noted above.

8. Building on this assertion, the staff thinks that business risks result from where, when and how an entity conducts its business. Some business risks result from an entity's transactions: for example, selling goods in overseas markets might expose an entity to the risk of future cash flow fluctuations because of changes in foreign exchange rates. Other business risks result from an entity's operating environment: for example, operating in a highly specialised industry might expose an entity to the risk that it will be unable to attract sufficient skilled staff to sustain its operating activities.

9. The staff thinks that its description of business risk is reasonably consistent with general definitions of 'risk'. For example, Wikipedia defines risk as

> 'a concept that denotes a potential negative impact to an asset or some characteristic of value that may arise from some present process or future event. In everyday usage, "risk" is often used synonymously with the probability of a loss. In professional risk assessments, risk combines the probability of an event occurring with the impact that event would have and with its different circumstances.'[5]

However, the staff notes that this general definition of risk captures downside risk only, whereas the staff's definition of business risk and IFRS definitions of specific types of risk capture both upside and downside risk.

SECTION 2: SIMILARITIES AND DIFFERENCES

10. Based on the definitions and descriptions above, the staff thinks that both liabilities and present business risks arise from past events and both are capable of resulting in an outflow of resources embodying economic benefits.[6] (Risks are also capable of resulting in an inflow of resources embodying economic benefits (upside risk).)

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[5] http://en.wikipedia.org/wiki/Risk, accessed 1 March 2007.

[6] In May 2006 the Board tentatively concluded that the phrase 'expected to' in the definition of a liability does not require a particular degree of certainty that an outflow of resources embodying economic benefits will occur before the definition of a liability is satisfied. This tentative conclusion is the starting premise for this paper.

11. However, a *present obligation* must exist before the definition of a liability is satisfied. A present obligation does not remove uncertainty about the future, but it does mean that an entity is unable to avoid the consequences of that uncertainty. As IAS 37 explains, a present obligation exists 'independently of an entity's future actions' therefore an entity has 'no realistic alternative' to settling the obligation.

12. A business risk may exist on the balance sheet date and the entity may become obligated in the future as a result of that risk, but an entity is not *presently* obligated as a result of a business risk on the balance sheet date. This is because an entity can choose to take action to avoid or mitigate the impact of a risk. For example, an entity can choose to stop selling goods in overseas markets and therefore can avoid being exposed to the risk of future cash flow fluctuations because of changes in foreign exchange rates. Alternatively, the same entity can choose to mitigate the impact of changes in foreign exchange rates on its future cash flows by entering into a forward exchange contract or sourcing the materials for its goods in the same overseas markets.

Does the Board agree that the existence of a present obligation distinguishes a liability from a business risk?

13. Based on the analysis above, the distinction between a liability and a business risk might seem obvious. However, the constituents' remarks in their comment letters and at the IAS 37 round-tables suggest that the current description of a present obligation is not sufficiently clear. As a result, there is some confusion about when and why an entity is truly obligated, and therefore a liability exists.

14. For example, in their comment letters and at the round-tables, a majority of constituents agreed that (i) contracts give rise to obligations, (ii) a particular degree of certainty about the outflow of economic benefits required to settle a *contractual* obligation is not required before the definition of a liability is satisfied, and (iii) operating in a jurisdiction or industry subject to a particular law or regulation, by itself, does not satisfy the definition of a liability. But several constituents questioned the consistency of these conclusions. They

asked why an entity does not have an obligation to comply with an existing law when it does have an obligation to comply with an existing contract.

SECTION 3: STAFF ANALYSIS

15. In this section the staff analyses three scenarios to explain how, when and why an entity exposed to a business risk becomes presently obligated and therefore satisfies the definition of a liability. The staff thinks that these scenarios also illustrate the tension points and potential inconsistencies associated with this issue. Therefore, when appropriate, the analysis includes an alternative view.

SCENARIO 1

Example 1A

Digger has the right to mine in two jurisdictions.

In Jurisdiction A environmental rehabilitation laws state that all mine shafts deeper than 10 metres must be entirely filled in by 31 December 2020 or the mining company that dug the holes for the shafts will be fined £100,000 per unfilled hole.

Jurisdiction B has no environmental rehabilitation laws.

On the balance sheet date Digger has not decided to start mining in either jurisdiction.

The staff's view

16. On the balance sheet date Digger does not have a liability because:

- Digger is not committed to mining in either jurisdiction, and
- no external party has an enforceable right to call upon Digger to take an action as result of mining in either jurisdiction.

In other words, Digger can simply walk away from the status quo on the balance sheet date.

17. Digger is aware that there are potentially more costs associated with mining in Jurisdiction A. But a right to mine in a jurisdiction that is subject to environmental rehabilitation laws does not satisfy the definition of a liability.

Does the Board agree with the staff's conclusion? Are there any additional points the Board would like to incorporate in the analysis?

Example 1B

Facts as Example 1A, except that Digger has started mining in both jurisdictions.

The geologists' reports indicate that Digger will be able to extract significant quantities of ore for at least 20 years in both jurisdictions. The ore is located 15 metres below the surface in both jurisdictions.

On the balance sheet date Digger has mined five shafts in Jurisdiction A and five shafts in Jurisdiction B. Each shaft is 5 metres deep.

The staff's view

18. On the balance sheet date Digger does not have a liability in Jurisdiction A because each shaft is less than 10 metres deep. As a result:

- Digger is not committed to fill-in the shafts that already exist, and
- no external party has an enforceable right to call upon Digger to fill-in shafts that are less than 10 metres deep.

19. Based on the facts outlined in this example, it is highly likely that Digger will mine beyond 10 metres *in the future* and therefore will be obliged to fill-in each shaft. However, a present *intention* to mine beyond 10 metres in the future is not the same as a present *obligation* as a result of mining beyond 10 metres.[7] Digger can choose not to mine beyond 10 metres and no external party has an enforceable right to call upon Digger to mine beyond 10 metres. In other words, Digger can simply walk away from the status quo on the balance sheet date.

20. On the balance sheet date Digger does not have a liability in Jurisdiction B because there are no environmental laws requiring Digger to fill-in any mine shafts, no matter how deep Digger has mined or how deep Digger intends to mine in the future.

Does the Board agree with the staff's conclusion? Are there any additional points the Board would like to incorporate in the analysis?

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[7] The staff uses the word 'intention' in this paper because it comes from paragraph 18 of the IAS 37 ED ('… intention to incur and outflow of resources ...'). This could imply management intent. Therefore another way of explaining the staff's point is to say that the *likelihood* of Digger mining beyond 10 metres in the future, no matter how high, is not the same as a present *obligation* to mine beyond 10 metres.

Example 1C

Facts as Example 1B, except that each shaft is 12 metres deep on the balance sheet date.

The staff's view

21. On the balance sheet date Digger has a liability in Jurisdiction A because each shaft is more than 10 metres deep. A present obligation exists because:

    - Digger is committed to fill-in the five shafts that already exist deeper than 10 metres,
    - Digger has no realistic alternative to filling-in those five shafts (or paying the fine)[8], and
    - an external party has an enforceable right to call upon the Digger to fill-in the five shafts that already exist (or pay the fine).

    In other words, Digger can no longer walk away from the status quo on the balance sheet date.

22. A liability exists because filling-in those shafts (or paying the fine) is expected to result in an outflow of resources embodying economic benefits.

23. Based on the facts outlined in this example, it is highly likely that Digger will mine a further 3 metres *in the future* (to reach the ore) and therefore will be obliged to fill-in five 15 metre shafts. However, as noted in Example 1B, a present intention is not the same as a present obligation. Digger may choose not to mine a further 3 metres and no external party has an enforceable right to call upon Digger to mine a further 3 metres. Digger's liability is limited to that related to 12 metre holes.

24. Digger does not have a liability in Jurisdiction B, for the same reasons given in Example 1B.

Does the Board agree with the staff's conclusion? Are there any additional points the Board would like to incorporate in the analysis?

[8] The staff uses the phrase 'no realistic alternative' in this paper because it comes from paragraph 17 of IAS 37. However the staff has discussed the potential subjectivity arising from what is deemed to be a 'realistic' alternative. Another way of explaining the staff's point is to say that Digger *cannot avoid* filling-in those mine shafts.

Example 1D

Facts as Example 1C, except that the law in Jurisdiction A requires that all mine shafts deeper than 10 metres must be entirely filled in “when mining operations cease.”

The staff’s view

25. On the balance sheet date Digger has a liability in Jurisdiction A, for the same reasons given in Example 1C.

26. The staff acknowledges that Digger can choose *when* to cease mining each shaft and that no external party has an enforceable right to call upon Digger to fill-in the five shafts until he ceases mining. However,

- Digger is committed to fill-in the five shafts that already exist because they are already more than 10 metres deep,
- Digger has no realistic alternative to filling-in those five shafts in the future, and
- an external party has an enforceable right to call upon Digger to *either* continue mining *or* fill-in the five shafts that already exist.

27. In other words, Digger cannot walk away from the status quo on the balance sheet date, even though he can choose *when* to incur the outflow of resources embodying economic benefits to settle his obligation.

An alternative view

28. Some may argue that, on the balance sheet date, Digger does not have a liability because Digger is not committed to filling-in the mine shafts until he ceases mining and Digger can avoid filling-in the five mine shafts by continuing to mine.

29. The staff does not agree with this view because, presumably, there is a finite period to Digger’s mining activities, even though Digger believes that he will be able to extract ore for at least another 20 years. On the balance sheet date Digger may not be able to predict exactly when he will cease mining, but this does not affect the existence of an environmental rehabilitation liability.

30. Moreover, the staff thinks that its conclusion in Example 1D is consistent with its conclusion in Example 1B: that we cannot use a present intention to conclude that a liability exists. Logically, therefore, we cannot use Digger's present intention to continue mining to conclude that a liability does not exist on the balance sheet date.

Does the Board agree with the staff's conclusion? Are there any additional points the Board would like to incorporate in the analysis?

Example 1E

Facts as Example 1C, except that Digger has *offered* to apply the same standards as in Jurisdiction A to both existing and future mine sites in Jurisdiction B if the local municipal council extends his right to mine in Jurisdiction B for another 15 years. Digger's offer is not binding until accepted.

On the balance sheet date the municipal council has not accepted Digger's offer.

Assumption: There is no possibility that a court would enforce Digger's offer until the offer is accepted by the municipal council.

The staff's view

31. On the balance sheet date Digger does not have a liability in Jurisdiction B because the municipal council has not accepted his offer. As a result:

- Digger is not committed to fill-in the shafts that already exist and are deeper than 10 metres,
- Digger can avoid this commitment by withdrawing his offer, and
- no external party has an enforceable right to call upon Digger to fill-in shafts that already exist and are deeper than 10 metres.

An alternative view

32. Some may argue that, on the balance sheet date, Digger has a liability because he has not yet withdrawn his offer to the municipal council. Digger is not committed to fill-in the shafts that already exist and are deeper than 10 metres, but he is committed to honouring his offer. In other words, Digger is 'standing ready' to honour his offer until either the municipal council accepts the offer, or he withdraws the offer.

33. The staff acknowledges that Digger cannot simply walk away from the status quo on the balance sheet date – he must at least inform the municipal council that he is withdrawing his offer. However, the staff does not support this alternative view because, on the balance sheet date, no external party has an enforceable right to call upon Digger to leave his offer on the table and honour his offer. Moreover, the municipal council must (i) accept Digger's offer, and (ii) extend his right to mine in Jurisdiction B for another 15 years before the council has an enforceable right to call upon Digger to honour his offer.

Does the Board agree with the staff's conclusion? Are there any additional points the Board would like to incorporate in the analysis?

Example 1F

Facts as Example 1E, except that the municipal council has accepted Digger's offer.

34. On the balance sheet date Digger has a liability in Jurisdiction B to fill-in the five shafts that already exist and are deeper than 10 metres, for the same reasons given in Example 1C. Digger does not have a liability to fill-in future mine shafts, for the same reasons given in Example 1B.

35. In this example, the contract between Digger and the municipal council has the same effect as the law in Jurisdiction A because both the law in Jurisdiction A and the contract law in Jurisdiction B are mechanisms that establish an external party's right to call upon Digger to fill-in those shafts.

Does the Board agree with the staff's conclusion? Are there any additional points the Board would like to incorporate in the analysis?

SCENARIO 2

Example 2A

Auto sells car breakdown services. Auto's standard services agreement states that Auto will repair all listed cars that breakdown within 12 months from the date the agreement is signed. Auto reserves the right to inspect each car before entering into a services agreement. Once signed, the services agreement is non-cancellable.

Auto recently mailed standard services agreements to 50 drivers offering 12 months breakdown service, waiving his right to inspect each car if the driver returns a signed services agreement on or before 31 January 2011. Auto cannot withdraw his offer.

On 31 December 2010 no drivers have returned a signed services agreement.

Assumption: no signed services agreements are in the post.

The staff's view

36. On 31 December 2010 Auto has a liability because he has waived his right to refuse to enter into a services agreement. As a result:

- Auto is committed to accepted a signed standard services agreement if a driver returns a signed services agreement on or before 31 January 2011,
- Auto cannot avoid this commitment because he cannot withdraw his offer or influence each driver's decision to return a signed agreement, and
- each of those 50 drivers has an enforceable right to call upon Auto to sign a services agreement if they return a signed services agreement to Auto on or before 31 January 2011.

37. Based on the facts in this example, it is not certain if any of the 50 drivers will return a signed services agreement. However, in effect, Auto has written an option. As a result, Auto has no realistic alternative but to accept any returned, signed services agreements. In other words, Auto cannot simply walk away from the status quo on the balance sheet date and this offer is expected to result in an outflow of resources embodying economic benefits.

An alternative view

38. Some may argue that, on 31 December 2010, Auto does not have a liability because no drivers have returned a signed services agreement. Until a driver returns a signed services agreement, that driver has no enforceable right to call upon Auto to provide breakdown services.

39. The staff agrees that, on 31 December 2010, Auto does not have a liability to provide breakdown services. But the staff thinks that Auto does have a liability to honour his offer to those 50 drivers for the reasons outlined above. *Those drivers do have an enforceable right to call upon Auto to accept the signed services agreements.*

40. The staff thinks that its conclusion is consistent with Example 1E. In this example, Auto cannot withdraw his offer (the offer is irrevocable) therefore a liability exists. In Example 1E, Digger's offer to the municipal council was not binding until accepted and the council extends Digger's right to mine in Jurisdiction B for another 15 years, therefore no liability exists. However, in example 1F, Digger's offer has been accepted and is binding.

Does the Board agree with the staff's conclusion? Are there any additional points the Board would like to incorporate in the analysis?

Example 2B

Facts as Example 2A, except that on 31 December 2010 one driver has returned a signed services agreement listing one car used as part of his regular business operations. The period of the agreement is 1 December 2010 – 30 November 2011. On 31 December 2010 Driver's car does *not* require repair.

Assumption: it is certain that Driver's car does not require repair – there are no incurred but not reported (IBNR) break downs requiring repair.

The staff's view

41. On 1 December 2010 Auto made two promises to Driver. The first promise was to repair Driver's car if it breaks down on or before 30 November 2011. The second promise was to protect Driver against the risk that his car might break down on or before 30 November 2011. The services agreement does not resolve uncertainty about whether Driver's car will break down and require repair, but the agreement confirms that Auto has assumed that risk on Driver's behalf for a 12-month period.

42. On 31 December 2010 Auto's first promise (to repair if car breaks down) does not satisfy the definition of a liability because Driver's car does not require repair. However, Auto's second promise (to protect Driver against risk of break down) satisfies the definition of a liability because:

- Auto is committed to protect Driver against the risk that his car might break down for another 11 months,
- Auto has cannot avoid this commitment because the agreement is non-cancellable, and

- Driver has an enforceable right to call upon Auto to protect Driver against the risk that his car might break down for another 11 months.

In other words, Auto cannot simply walk away from the status quo on the balance sheet date.

43. Protecting Driver against the risk that his car might break down for another 11 months satisfies the definition of a liability because providing a service is an outflow of resources embodying economic benefits.

An alternative view

44. Some may argue that, on 31 December 2010, Auto has made just one promise to Driver—to repair Driver's car if it breaks down on or before 30 November 2011 (the first promise). Therefore, Auto does not have a liability because there is no outflow of economic benefits until Driver's car breaks down.

45. The staff does not agree with this view because the current IASB *Framework* clearly states that providing a service (such as risk protection) is an outflow of economic resources embodying economic benefits.[9] Moreover, the services agreement is non-cancellable therefore Auto has no realistic alternative to protecting Driver against the risk that his car might break down for another 11 months.

Does the Board agree with the staff's conclusion? Are there any additional points the Board would like to incorporate in the analysis?

Example 2C

Facts as Example 2B, except that Driver and Auto can both cancel the services agreement with one month's notice.

The staff's view

46. The staff continues to think that on 1 December 2010, Auto made two promises to Driver (the same as Example 2B). On 31 December 2010 the first

[9] *Framework*, paragraph 62(c) states that "settlement of a present obligation may occur in a number of ways, for example, by … provision of services …" This statement is also consistent with working definition of a liability in the Conceptual Framework project.

promise does not satisfy the definition of a liability, but the second promise is a liability.

47. However, there is one important difference in this example. In Example 2B, Auto's first promise was to repair Driver's car if it breaks down *on or before 30 November 2011*. Auto's second promise was to protect Driver against the risk that his car might break down *on or before 30 November 2011.* In this example both promises are for *1 month only*. This is because:

- Auto is only committed to protect Driver against the risk that his car might break down for the non-cancellable period of the services agreement,
- Auto can avoid his commitment to protect Driver against the risk that his car might break down for the remaining 10 months of the services agreement, and
- Driver has no enforceable right to call upon Auto to protect Driver against the risk that his car might break down beyond the non-cancellable period.

In other words, Auto cannot simply walk away from the status quo on the balance sheet date, but he can walk away after 1 month.

An alternative view

48. Some may argue that Example 2C is the same as Example 2B. In other words, Auto has a liability for his promise to protect Driver against the risk that his car might break down *for the full 12-month period.* This is because, on the balance sheet date, neither Auto nor Driver has given notice to cancel the agreement. Therefore, *any uncertainty about whether Auto will provide that service for the full 12-month period should be reflected in measurement*.

49. The staff does not support this alternative view because, on 31 December 2010, Driver has no enforceable right to call upon Auto to provide a service for the full 12-months. Moreover, the staff thinks that the alternative view is inconsistent with our conclusion in Example 1E.

50. (However, the staff thinks that it is important to note that *if* Driver can cancel the services agreement with one month's notice but Auto cannot, Auto has a liability for his promise to protect Driver against the risk that his car might break down for the full 12-month period. This is because, in effect, Auto has written an option: he is irrevocably committed to providing break down services *if* Driver wants them.)

Does the Board agree with the staff's conclusion? Are there any additional points the Board would like to incorporate in the analysis?

Example 2D

Facts as Example 2B, except that on 31 December 2010 Driver notifies Auto that his car requires repair. Auto will repair Drivers' car in 2011.

51. On 31 December 2010 Auto has a liability to repair Driver's car. A present obligation exists because:

- Auto is committed to repair Driver's car as a result of the services agreement,
- Auto has no realistic alternative to repairing Driver's car, and
- Driver has an enforceable right to call upon Auto to repair his car.

52. In other words, Auto cannot walk away from the status quo on the balance sheet date. A liability exists because repairing Driver's car is expected to result in an outflow of resources embodying economic benefits.

53. On the balance sheet date Auto also has a liability to protect Driver against the risk that his car might break down for another 11 months, for the reasons outlined in Example 2B.

Does the Board agree with the staff's conclusion? Are there any additional points the Board would like to incorporate in the analysis?

Example 2E

Facts as Example 2B, except that on 1 December 2011 Driver (i) notifies Auto that his car requires repair, and (ii) asks Auto to renew his services agreement for another 12 months.

Assumption: it is certain that Driver's car did not require repair on 30 November 2011 – no IBNR.

54. On 1 December 2011 Auto does not have a liability to repair Driver's car because:

- Auto is not committed to repair Driver's car if it breaks down after 30 November 2011,
- Auto can choose not to renew Driver's services agreement (Auto's offer to waive that right expired on 31 January 2011), and
- unless Auto agrees to renew his services agreement on 1 December 2011, Driver has no enforceable right to call upon Auto to either repair his car or protect him against the risk that his car will break down again in the next 12 months.

In other words, Auto can walk away from the status quo on the balance sheet date.

Does the Board agree with the staff's conclusion? Are there any additional points the Board would like to incorporate in the analysis?

SCENARIO 3

Example 3A

Vendor sells hamburgers in a jurisdiction with no minimum food hygiene standards. But the law of that jurisdiction stipulates that if a customer is hospitalised as a result of eating a contaminated hamburger, the supplier of that hamburger must pay compensation of £100,000 to the customer.

On 31 December 200X hamburgers are available for sale, but no hamburgers have been sold.

55. On the balance sheet date Vendor does not have a liability because he has not sold any hamburgers. As a result:

- Vendor is not committed to paying compensation if a customer is hospitalised, and
- no customer has an enforceable right to call upon Vendor to pay compensation.

56. Based on the facts outlined in this example, it is highly likely that Vendor will sell hamburgers *in the future*. However, a present *intention* to sell hamburgers (and therefore pay compensation if a customer is hospitalised as a result of hamburgers sold in the future) is not the same as a present *obligation* to pay compensation if a customer is hospitalised as a result of a hamburger that has already been sold. Vendor can choose not to sell hamburgers and no customer has an enforceable right to call upon Vendor to sell hamburgers in the future. In other words, Vendor can simply walk away from the status quo on the balance sheet date.

57. The staff thinks that this conclusion is consistent with Examples 1A and 1B (an ability to mine in a jurisdiction subject to environmental rehabilitation laws is not a liability, and a future intention to mine is not a liability).

Does the Board agree with the staff's conclusion? Are there any additional points the Board would like to incorporate in the analysis?

Example 3B

Facts as Example 3A, except that on 31 December 200X Vendor has sold one hamburger to Customer. Customer has eaten the hamburger, but is not hospitalised.

58. This example has provoked the most discussion and debate amongst the staff. All staff members agree that (i) selling a hamburger in this jurisdiction exposes Vendor to the *risk* that he has sold a contaminated hamburger, that a customer will be hosptialised and that Vendor will be required to pay compensation; and (ii) the sale of a *contaminated* hamburger is the event that creates a present obligation (not Customer's hospitalisation). However, as explained below, some staff members think that Example 3B illustrates uncertainty about the existence of a present obligation (element uncertainty) – an issue we plan to address later in the project. Other staff members think that

Example 3B illustrates the distinction between a liability and a business risk – the issue addressed in this paper.

The staff's view – element uncertainty

59. Some staff members argue that Example 3B is an example of element uncertainty. This is because selling a contaminated hamburger is a question of fact: Vendor either sold a contaminated hamburger to Customer, or he did not.

60. On the balance sheet date, *if* Vendor sold a *contaminated* hamburger a present obligation exists, regardless of whether Customer is hospitalised.

- Vendor is committed to paying Customer compensation because there is no doubt about how the law applies to this fact,
- Vendor has no realistic alternative to paying compensation if Customer is hospitalised as a result of eating that hamburger because he has already sold a contaminated hamburger (an irrevocable action), and
- Customer has an enforceable right to call upon Vendor to pay compensation if he is hospitalised.

61. Based on the facts in this example, it is not yet certain if Customer will be hospitalised. But, if Vendor sold *a contaminated hamburger*, he cannot walk away from the status quo on the balance sheet date.

62. However, *if* Vendor *did not* sell a *contaminated* hamburger a present obligation does not exist, regardless of whether Customer is hospitalised.

- Vendor is not committed to paying compensation to Customer because the law only applies to selling contaminated hamburgers (not all hamburgers), and
- Customer does not have an enforceable right to call upon Vendor to pay compensation.

In other words, Vendor can walk away from the status quo on the balance sheet date.

63. Vendor's past experience may provide a pre-balance sheet date indication of whether Vendor sold a contaminated hamburger. Similarly Customer's health

in January 200Y may provide a post-balance sheet indication of whether Vendor sold a contaminated hamburger. But these staff members think that this information is useful in addressing uncertainty about the existence of a present obligation rather than distinguishing between a liability and a business risk.

64. These staff members think that this conclusion is consistent with Example 1B – Digger mined to 5 metres, an action that takes him one step closer to being required to fill-in the mine shaft. But Digger does not have a liability until he mines deeper than 10 metres. In this example, selling hamburgers exposes Vendor to the risk that he may have to pay compensation. But he does not have a liability *unless he has already sold a contaminated hamburger*.

The staff's view – a liability

65. Some staff members argue that, by selling a hamburger in a jurisdiction subject to particular laws, Vendor made two promises to Customer. The first (explicit) promise was to pay Customer £100,000 compensation if Customer is hospitalised as a result of eating a contaminated hamburger supplied by Vendor. The second (implicit) promise was to sell Customer a hamburger that is not contaminated (therefore Customer can eat the hamburger safe in the knowledge that he will not go to hospital.). Neither promise removes uncertainty about whether Customer will be hospitalised as a result of eating a hamburger supplied by Vendor, but both confirm that Vendor bears the risk of Customer becoming hospitalised.

66. On 31 December 200X, Vendor's first promise does not satisfy the definition of a liability because Customer is not yet hospitalised. However, Vendor's second promise satisfies the definition of a liability because:

- Vendor is committed to sell Customer a hamburger that is not contaminated,
- Vendor has cannot avoid this commitment because he has already sold the hamburger and Customer has eaten the hamburger, and
- Customer has an enforceable right to call upon the Vendor to sell a hamburger that is not contaminated.

67. Based on the facts in this example, it is not certain if Vendor sold a contaminated hamburger. But, in effect, Vendor has written an option. As a result, Vendor has no realistic alternative but to pay compensation if Customer is hospitalised. In other words, Vendor cannot simply walk away from the status quo on the balance sheet date.

68. These staff members agree that Vendor's past experience and Customer's health in January 200Y may provide useful information. But these staff members think that this information is useful in *measuring* Vendor's liability, rather than addressing uncertainty about the *existence* of a present obligation.

69. These staff members think that this conclusion is consistent with the conclusion in Example 2B. In Example 2B Auto's second (implicit) promise was to protect Driver from the risk that his car might break down during the agreement period - service. In this example, Vendor's second (implicit promise) was to protect Customer from harm (and the cost of hospital cover) – also a service.

Does the Board agree with either of the staff's conclusion? If so which one? Are there any additional points the Board would like to incorporate in the analysis?

Example 3C

Facts as Example 3A, except that on 31 December 200X Vendor has sold one hamburger to Customer. Customer is hospitalised as a result of eating the hamburger. Vendor has not yet paid compensation to Customer.

Assumption: it is certain that Vendor's hamburger caused Customer to be hospitalised.

70. On the balance sheet date Vendor has a liability to pay compensation to Customer. A present obligation exists because:

- Vendor is committed to paying Customer compensation as a result of the law,
- Vendor has no realistic alternative to paying compensation because a contaminated hamburger has been sold, eaten and Customer is hospitalised, and

- Customer has an enforceable right to call upon the Vendor to pay compensation.

In other words, Vendor can no longer walk away from the status quo on the balance sheet date.

71. A liability exists because paying compensation is an outflow of resources embodying economic benefits.

Does the Board agree with the staff's conclusion? Are there any additional points the Board would like to incorporate in the analysis?

Example 3D

Facts as Example 3A, except that there is no law. However, the food industry itself encourages a minimum level of food hygiene standards by operating a voluntary accreditation system for industry participants. Vendor wishes to participate in this system.

On 31 December 200X Vendor's current food hygiene standards do not meet the minimum level required to receive industry accreditation. It aspires to do so in 200Y and expects that it will cost an additional £500,000 to meet the necessary standards.

72. On the balance sheet date Vendor does not have a liability because participating in the industry accreditation system is voluntary. As a result:

- Vendor is not committed to meeting the minimum level of food hygiene standards,
- Vendor can avoid spending the £500,000 required to meet the minimum level of food hygiene standards, and
- no external party has an enforceable right to call upon Vendor to meet the minimum level of food hygiene standards.

73. Based on the facts outlined in this example, it is highly likely that Vendor will incur additional costs improving its current food hygiene standards *in the future*. However, a present *intention* to incur additional costs to improve food hygiene standards in the future is not the same as a present *commitment* to incur additional costs to improve food hygiene standards. Vendor can choose not incur additional costs and no customer has an enforceable right to call upon Vendor to incur additional costs to improve its food hygiene standards in

the future. In other words, Vendor can simply walk away from the status quo on the balance sheet date.

Does the Board agree with the staff's conclusion? Are there any additional points the Board would like to incorporate in the analysis?

Summary of key points

74. The table below summarises the key points from the examples analysed above. Example 3B is omitted from this table because the staff has not reached a consensus view on this example.

Key point	**Examples**	**Conclusion**
Operating in a jurisdiction subject to a law (including contract law), statute or regulation, by itself, does not give rise to a present obligation and hence, does not satisfy the definition of a liability. An action or event is also required.[10]	1A, 1B, 3A and the first promise in 2B	A liability requires *both* an action/event *and* a mechanism that establishes an external party's right to call upon the entity.
An action or event, by itself, does not satisfy the definition of a liability. A mechanism that establishes an external party's right to call upon the entity is also required.	Jurisdiction B in 1B and 1C	
A *revocable* action or event does not satisfy the definition of a liability, even in a jurisdiction where a mechanism that establishes an external party's right to call upon the entity when that action is taken. An action or event must be *irrevocable*.	1E, 2C, 3D	A liability requires an *irrevocable* action or event that occurs *on or before the balance sheet date*.
Planning a future irrevocable action or event in a jurisdiction where there is a mechanism that establishes an external party's right to call upon the entity exists does not give rise to a present obligation and hence, does not satisfy the definition of a liability. An irrevocable action or event must occur *on or before* the balance sheet date.	1B, 1E	
Making or receiving an offer that can be refused because the offer is not legally binding does not give rise to a present obligation and hence, does not satisfy the definition of a liability.	1E, 2C, 2E	
An irrevocable past action or event resulting	1C, 1F, 2D, 3C	

[10] This language is consistent the phrase a 'past action or event' or an 'obligating event' currently used in IASB *Framework*, IAS 37 and the IAS 37 ED. The Conceptual Framework project is trying to focus on a present obligation with enforceable consequences (resulting from a past event) therefore we may need to revisit this language.

Key point	Examples	Conclusion
in a present breach of an existing law or regulation does give rise to a present obligation and, hence, may satisfy the definition of a liability.		
An ability to control *when* a liability will be settled does not change the fact that a liability exists.	1D	
Uncertainty about future events or the actions of others does not change the fact that a liability exists.	2A, 2B, 2C	

Tentative conclusions

75. Based on the analysis above, the staff has concluded that a business risk becomes a liability when a *present obligation* exists on the balance sheet date.

- A present obligation exists when an entity is **irrevocably** committed to a particular action(s) and it has **no realistic alternative t**o avoid taking that action(s).

- An entity has no realistic alternative to taking a particular action when **an external party has an enforceable right to call upon the entity to complete that action(s).** In other words, the entity cannot simply walk away from the status quo on the balance sheet date.

- Laws (including contract law) and regulations by themselves are not present obligations. But they are examples of **mechanisms** that establish an external party's right to call upon the entity to complete a particular action(s).

76. A present obligation is a liability when settlement is **expected to result in an outflow from the entity** of resources embodying economic benefits.[11] Examples of an outflow of resources embodying economic benefits include cash, the transfer other assets, the provision of services (including risk protection) and converting an obligation to equity.

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[11] See footnote 2 for the Board's tentative conclusion on the meaning of the phrase 'expected to' in the context of the IAS 37 project. This tentative conclusion is also consistent with the working definition of a liability in the Conceptual Framework project.

Does the Board agree with the staff's tentative conclusion? Are there any additional points the Board would like the staff to incorporate in this conclusion?

Links with the conceptual framework project

77. The working definition of a liability in the conceptual framework project is:

‘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 require cash outflows or reduce 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 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.

78. The staff does not think that the analysis in this paper would substantially change as a result of the Conceptual Framework team's working definition of a liability (although there may be differences in the words used to explain the analysis). This is because both the analysis in this paper and the working definition focus on whether the entity has a *present obligation* that economically burdens the entity.

APPENDIX A: Definitions and descriptions of liabilities

Organisation	Definition of a liability	Description of obligations and present obligations
IASB *Framework*	**Liabilities** are a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. (paragraph 49(b))	An **obligation** is "a duty or responsibility to act or perform in a certain way". A **present** obligation is "irrevocable" and leaves an entity with "little, if any, discretion" to avoid an outflow of economic benefits. (paragraphs 60-61)
FASB Concepts Statement No. 6	**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)	**Obligations** are "duties imposed legally or socially; to that which one is bound to do by contract, promise, moral responsibility, and so forth". A liability "embodies a present duty or responsibility that entails settlement". That present duty or responsibility **obligates** a particular entity because the entity "little or no discretion to avoid the future sacrifice". An entity has a **present** duty because "the transaction or other event obligating the entity has already happened". (footnote 22 and paragraph 36)
Australia Statement of Accounting Concepts No. 4	**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)	Most **obligations** are "legally enforceable in that stem from legally binding contracts or they are imposed by legally authorised bodies or government statutes". Obligations can also be equitable or constructive. A **present obligation** is "a duty or responsibility of the entity to act or perform in a certain way" and leaves the entity "little, if any, discretion to avoid the future sacrifice of economic benefits to another entity." (paragraphs 51-64)
Canada S1000	**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)	Liabilities embody a duty or responsibility to others that entails settlement at a specified or determinable date leaves the entity "little or no discretion to avoid"; and the transaction or event "has already occurred". (paragraphs 32-34)

Organisation	Definition of a liability	Description of obligations and present obligations
Germany Draft *Proper Accounting Principles (Framework*) 16 Oct 02	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. The recognition of a provision for deferred expenses where the obligation is only of an internal nature is not compatible with this definition. (paragraph 70)	No description of an obligation or a present obligation.
Japan Discussion Paper *Elements of Financial Statements* Sept 04	**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.[12] (paragraph 5)	No description of an obligation or a present obligation.
New Zealand Statement of Concepts	**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)	An **obligation** exists when an entity is “left with little, if any, discretion to avoid the sacrifice of service potential or future economic benefits”. A **present obligation** means that an “entity must have a duty or responsibility, which has not yet been satisfied, to act or perform in a certain way” and the obligation “must have occurred”. (Paragraphs 7.11-7.13)
United Kingdom Statement of Principles	**Liabilities** are obligations of an entity to transfer economic benefits as a result of past transactions or events. (paragraph 4.23)	“The notion of an **obligation** implies that the entity is not free to avoid the outflow of resources. For a liability to exist at the balance sheet date, the obligation to transfer economic benefits must have resulted from a past transaction or event.” (Paragraphs 4.25-4.32)
CFA Institute – Comprehensive Business Reporting Model	An economic obligation must be recognized as a liability in the financial statements when all of the following conditions are met: a. The obligation exists currently; b. There is a nonzero probability that the obligation will be settled by an outflow of assets, issuance of	No description of an obligation or a present obligation or obligation.

12 Equivalents to obligations include those similar to legal obligations (such as constructive obligations).

Organisation	Definition of a liability	Description of obligations and present obligations
	another liability, or other settlement that will result in a change in the share of net assets available to current shareowners; c. There are sufficient penalties to the enterprise from nonperformance that the enterprise has no realistic alternative to settlement; d. It does not meet the definition of equity; and e. The economic attributes and fair value of the obligation can be measured.	
FASAB ED *Proposed Statement of Federal Financial Accounting Concepts: Definition and Recognition of Elements of Accrual-Basis Financial Statements.* July 2006	A **liability** is a present obligation of the federal government to provide assets or services to another entity at a determinable date, when a specified event occurs, or on demand.	An **obligation** is a duty or responsibility to act in a certain way. A **present obligation** means that the obligation arose as a result of a past transaction or other event and has not yet been settled. A **present obligation** is distinguished from a mere expression of future intent, such as the government's announcement that it intends to acquire equipment. (paragraphs 40-44)
GASB ED *Proposed Statement of Governmental Accounting Standards Board on concepts related to Elements of Financial Statements* Aug 06	**Liabilities** are present obligations to sacrifice resources or future resources that the entity has little or no discretion to avoid. (paragraph 17)	An **obligation** is a duty, an enforced or burdensome task, or responsibility[13]. A **present obligation** is "a duty or responsibility to sacrifice resources or future resources that the entity has little or no discretion to avoid." A promise to do something in the future is not a present obligation because an entity is able to withdraw from the promise until a future event occurs. (paragraphs 18-22)

[13] The New Shorter Oxford English Dictionary, Volume 2, 1993, Oxford University Press Inc., New York.