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International Accounting Standards Board

INFORMATION FOR OBSERVERS
WORLD STANDARD SETTERS MEETING, SEPTEMBER 2007, LONDON

Round-Table Discussion: Element Definitions, Recognition and Measurement

Part 1— Liability Definition

INTRODUCTION

1. As part of Phase B of the Conceptual Framework project, the IASB and FASB (the Boards) are working on developing improved and converged definitions of an asset and a liability. A proposed working definition of an asset was discussed at the World Standards-Setters Conference last year. During the last year, the Boards conducted additional consultations on the proposed working definition of an asset and amplifying text. Over the next few months, the Boards will consider further improvements to that definition, based on the feedback received and the application of the definition to different situations. We will provide a brief update on that feedback at this year's World Standards-Setters Conference.

2. At this year's Conference, we propose to focus on aspects of the definition of a liability.

Purpose of World Standard-Setters' Discussion

3. The objective of this discussion is to inform, and solicit views of, World Standard-Setters about the proposed working definition of a liability and, in particular, how the definition should be applied when uncertainties are present. The issues to be discussed are relevant not only for the Conceptual Framework project, but also for the IASB's standards-level work on liabilities—to improve IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

Purpose of this Paper

4. This paper summarises the proposed working definition of a liability being developed in the Conceptual Framework project and provides examples of situations with uncertainties that the Boards are currently considering. Round-table participants are requested to review this paper, so as to be familiar with the proposed working definition of a liability and the facts of the examples, in order to be prepared for a discussion of the application of the proposed working definition to those examples.

Structure of the Paper

5. The remainder of this paper is structured as follows:

   (a) Definition of a liability—the need for change and current proposal

   (b) Examples and questions for discussion

DEFINITION OF A LIAIBLITY—THE NEED FOR CHANGE AND CURRENT PROPOSAL

The need for change

6. The IASB Framework presently defines a liability 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 entity of resources embodying economic benefits. [IASB Framework, paragraph 49]

7. World Standard-Setters might recall a presentation by Jim Leisenring at the September 2004 meeting, during which, among other things, he pointed out some of the shortfalls of the

current definitions of a liability in the existing IASB and FASB frameworks.[1,2] The shortfalls include the following:

(a) Misinterpretation of *likelihood* ("expected" in the IASB and "probable" in the FASB).

(b) Placement of undue emphasis on past transactions and events.

(c) Inappropriate focus on future outflows of economic benefits, rather than the thing that presently constitutes an economic burden.

(d) Lack of clarity as to how the definition applies to contractual promises.

(e) Lack of explicit link between the liability definition and the objective of financial reporting.

8. *Likelihood:* Some misinterpret both the IASB and FASB liability definitions as implying that there must be a high likelihood of future outflows of economic benefits for the definitions to be met. That is not the intent of the existing definitions. The terms *expected* and *probable* were included to reflect that the item in question need not be certain to meet the definitions. To avoid these continued misinterpretations, the working definition does not depend on assessing a degree of likelihood to ascertain whether the definition has been met.

9. *Past transactions and events:* The references to "past transactions and 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. Instead, the working definition focuses on whether the item (economic burden) and mechanism that links the item to the entity (an obligation) *exist* at the financial statement date.

10. *Future outflows of economic benefits:* The existing FASB definition focuses on identifying a future outflow of economic benefits to demonstrate that a liability exists. As balance sheets report on items that exist (sometimes referred to as *stocks*) rather than on changes in those items (sometimes referred to as *flows*), the working definition focuses instead upon stocks.

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1 This presentation was recorded and a CD-ROM is available from the IASC Foundation.
2 See the Appendix to this paper for the existing definitions of a liability.

11. *Contractual promises:* The existing IASB and FASB frameworks are not as clear as they could be regarding the application of the definitions to contractual promises. The proposed liability definition and amplifying text will explain that non-conditional promises qualify as present economic burdens when their performance is presently required (although performance is, perhaps, not yet due).

12. *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 decisions that they make in their capacity as capital providers, such as information to assess the timing and uncertainty of future cash flows. This link is made more explicit in the proposed definition of economic burden.

13. The proposed working definition of a liability seeks to overcome the problems identified in the previous paragraphs. It also draws on more recent thinking by national standards setters, and seeks to converge the existing IASB and FASB definitions.

Current proposal

14. At this stage of our work, the following working definition of a liability has been proposed, which is a near-mirror image of the proposed working definition of an asset:

> 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).

15. When defining any term, one of the hardest tasks is selecting the words which best communicate the underlying concepts. Further work on how to better express the proposed working definition of a liability is planned. Therefore, we ask that the discussion at the meeting focus on applying the concepts in the definition. There are three key concepts:

    i. An economic burden exists—this might be viewed as something that is unfavourable;

    ii. The entity has a present obligation for the burden—this is what links, or binds, the unfavourable thing to the entity; and

    iii. The economic burden and obligation exist on the date of the financial statements.

16. The following example demonstrates the application of the concepts in the proposed liability definition to a relatively simple situation. A business receives the delivery of a machine on November 20, 20X1 and agrees to pay for it in 60 days. At December 31, 20X1, the business has not yet made the payment and, therefore, owes the supplier for the machine. At that balance sheet date, there is a present economic burden—a contractual promise to pay the supplier—because the business received the machine (a past event) for which it has promised to pay cash, but has not yet done so. By accepting the machine, the business agreed to the terms of the contract: thus, the business is obligated by its contractual promise to pay the supplier. From the supplier's perspective, they have the ability to enforce the business to pay for the machine, or possibly to return the machine. Therefore, this accounts payable of the business meets the definition of a liability.

EXAMPLES AND QUESTIONS

17. To identify how uncertainties could be dealt with in the conceptual framework, the following examples with uncertainties challenge whether the proposed working definition of a liability is met. Uncertainties result from situations where evidence is lacking, facts are unclear, or interpretations are involved. When ascertaining whether an item meets the definition of a liability, uncertainties can affect whether:

(a) an item is an economic burden;

(b) the entity is obligated for the economic burden; or

(c) the economic burden and the obligation of the entity is present.

Uncertainty can affect one, some or all of the requirements of the definition.

18. As with the asset definition, the development of the liability definition is the first step of a multi-step process to determine how to account for a liability. This paper, and the Boards' discussions to date, focuses on the existence of a liability and NOT on whether it should be recognised (for example, given practicality concerns) or how it should be measured. Therefore, conclusions reached as to what meets the definition of a liability do not necessarily mean that all liabilities (as defined) will be recognised in financial statements.[3] In accounting for liabilities we are seeking to report in a manner that is a relevant, and faithful representation (including being complete and neutral) of an entity's real-world, present economic burdens.

Example 1 – Digger

19. 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.

[3] Recognition is part of Phase B and is scheduled for discussion by the Boards at a later date.

20. 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.

21. On December 31, 2007, the balance sheet date, Digger has mined five shafts in Jurisdiction A and five shafts in Jurisdiction B. Each shaft is 5 metres deep.

22. **Question:** Does this situation meet the proposed working definition of a liability in Jurisdiction A and/or Jurisdiction B? If yes, what is the liability for? If not, why not and how should uncertainties be reported?

Example 2 - Shopkeeper

23. Shopkeeper opens a shop for business on December 31st. The shop is located in a jurisdiction that has health and safety laws or regulations that state that a person injured from unsafe shop floors should be paid. A person enters the shop and is not limping. The shop floor is wet.

24. The shopkeeper walks into the back storage area and hears a crash in the shop. The shopkeeper does not see the person slip, but returns to see blood on the wet floor. The person is limping.

25. The health and safety laws or regulations do not impose a fine on owners for having unsafe floors—only if someone is injured as a result. The shopkeeper has no past experience, practice or custom of paying persons injured on shop premises.

26. **Question:** Does this situation meet the proposed working definition of a liability? If yes, what is the liability for? If not, why not and how should uncertainties be reported?

Example 3A – Hamburger Vendor

27. Vendor sells hamburgers in a jurisdiction where the law stipulates that the vendor must pay each customer that purchases a contaminated hamburger. On 31 December 200X (the balance sheet date), Vendor has sold one hamburger to Customer.

28. Past experience indicates that one in a hundred thousand hamburgers sold by Vendor is contaminated. No other information is available.

29. **Question:** Does this situation meet the proposed working definition of a liability? If yes, what is the liability for? If not, why not and how should uncertainties be reported?

Example 3B – Hamburger Vendor

30. Facts as in example 3A, except that on 31 December 200Y, Vendor has sold two hundred thousand hamburgers.

31. **Question:** Does this situation meet the proposed working definition of a liability? If yes, what is the liability for? If not, why not and how should uncertainties be reported?

Example 4 – Hospital

32. A hospital carries out a specific form of operation to correct a sight defect. During a recent operation, a patient died. Such deaths are rare. If it was the result of negligence by hospital staff, the law stipulates that the hospital will have to pay compensation to the patient's relatives.

33. Whether the hospital staff have been negligent will be judged by reference to the findings of an investigation. However, the investigation has not yet started. The hospital's past experience is that three deaths in ten have been attributed to negligence by its staff.

34. **Question:** Does this situation meet the proposed working definition of a liability? If yes, what is the liability for? If not, why not and how should uncertainties be reported?

Example 5 – Newspaper Publisher

35. A newspaper publishes many articles exposing information about people in the public eye. The people exposed sometimes sue for libel. The law states that publishers of libellous statements must pay affected persons.

36. There are currently ten claims being progressed against the publisher in respect of articles published before the balance sheet date. Having examined the evidence available, the publisher expects two of the claims to be successful.

37. **Question:** Does this situation meet the proposed working definition of a liability? If yes, what is the liability for? If not, why not and how should uncertainties be reported?

APPENDIX
Existing Liability Definitions

IASB	A **liability** is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits. (paragraph 49)
FASB	**Liabilities** are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. (paragraph 35)
Australia	**Liabilities** are the future sacrifices of economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events. (paragraph 48)
Canada	**Liabilities** are obligations of an entity arising from past transactions or events, the settlement of which may result in the transfer or use of assets, provision of services or other yielding of economic benefits in the future. (paragraph 32)
Germany	A **liability** is a present obligation to an external party arising from past events. The outflow of resources is expected as a result of the settlement of the obligation. (paragraph 70)
Japan	**Liabilities** are obligations or their equivalents to give up or deliver the economic resources that the reporting entity controls, as a result of past transactions or events. (paragraph 5, footnote reference omitted)
New Zealand	**Liabilities** are the future sacrifices of service potential or of future economic benefits that the entity is presently obliged to make to other entities as a result of past transactions or other past events. (paragraph 7.10)
United Kingdom	**Liabilities** are obligations of an entity to transfer economic benefits as a result of past transactions or events. (paragraph 4.6)
CFA Institute – Comprehensive Business Reporting Model (pg 19)[4]	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 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.

[4] *A Comprehensive Business Reporting Model: Financial Reporting for Investors*, CFA Centre for Financial Market Integrity, September 2005. Note that this definition mixes both the definition of a liability and the criteria for recognizing it. This definition is not repeated in the July 2007, final report. Rather, that report comments on the IASB/FASB working definition as follows, "… we believe that the definitions proposed by the staffs of the FASB and IASB for assets and liabilities, which are currently under consideration by the two boards, provide a sound starting point for addressing recognition."

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Round-Table Discussion: Element Definitions, Recognition and Measurement

Part 2—Measurement Phase

What Do We Mean by Historical Cost?

INTRODUCTION

1. The measurement phase of the joint IASB/FASB conceptual framework (CF) project is being conducted in three parts called milestones. During Milestone I, the Boards agreed to a set of measurement basis candidates (see Appendix A). Those candidates are currently being evaluated in Milestone II for their ability to satisfy the objective of financial reporting. In Milestone III, the Boards are expected to select one or more of the basis candidates to formulate conceptual measurement guidance for accounting standard setting.

2. Outside the CF project, most of the debate about measurement bases is in terms of historical cost and fair value. Within the project, there has been an attempt to avoid those terms because their meanings are not clear. Indeed, neither historical cost nor fair value appears on the list of basis candidates. Depending on one's point of view, either fair value

or historical cost might be interpreted as one of the measurement basis candidates or a combination of two or more of those candidates.

3. Recent developments have contributed to clarifying the meaning of fair value. The FASB issued FAS 157, *Fair Value Measurements,* in September 2006, and the IASB issued a Discussion Paper, *Fair Value Measurements,* in November 2006, which was a "wraparound" of FAS 157. However, fair value is still not a clear, unitary concept. The FAS 157 concept of fair value is primarily an exit price notion, but includes a notion of "in-use valuation" as well. It also incorporates both measurements and estimates in the overall concept. At the writing of this memo, the IASB is summarizing and analyzing comment letters on its Discussion Paper. Thus, much work remains to be done on the IASB's part. However, earlier deliberations and questions raised in the Discussion Paper suggest that two current price notions may emerge from the IASB project, an exit price and an entry price.

4. Whereas the Boards and their constituents have focused considerable attention on the meaning of fair value, little attention has been paid to the meaning of historical cost. There seems to be a pervasive assumption that historical cost has a single meaning and that everyone knows and understands that meaning. However, early work in the measurement phase of the CF project suggests that assumption is false.

5. The purpose of the breakout round-table session at the World Standard Setters (WSS) Meeting is to explore the meaning of historical cost. The staff does not expect the round-table discussion to resolve that meaning. However, the staff hopes that the discussion, coupled with consideration of the current state of the fair value concept, will raise awareness about the problems of framing the accounting measurement debate in terms of historical cost versus fair value.

ROUND-TABLE QUESTIONS

6. The organisers of this year's WSS Meeting have limited participation in each round-table session to fifteen individuals who have expressed a particular interest in that session's topic. The relatively small number of participants and the selection process are intended to

promote preparation before the meeting and active participation at the meeting. Therefore, the CF staff asks that each participant in the CF round-table discussion come prepared with responses to the following discussion questions:

a. ***How would you define historical cost?*** Please compose a definition in one or two sentences that relies on your own understanding rather than wording from a dictionary, conceptual framework, standard, or other accounting literature.

b. ***What is the principle upon which your concept of historical cost is based?*** Again, please answer from your own understanding rather than a published discussion of historical cost.

c. Company X purchases specialized manufacturing equipment from an equipment dealer. In addition to the purchase price, the company pays VAT. The company also pays external vendors for transport of the equipment to its manufacturing site, installation of the equipment, and testing of the equipment. Several of the company's personnel were involved in the acquisition of the equipment, including the president, the vice-president for manufacturing, the manufacturing foreman, a purchasing agent, and a number of laborers. ***What is the historical cost of the equipment, in concept? Does your answer change if the transportation, installation, and testing of the equipment are done by Company X employees?***

d. Company X pays £50,000 today for a one-year option to purchase a jet airplane for £15,000,000. Eight months later, when the purchase option is worth £200,000, Company X exercises its option and pays the £15,000,000. ***What is the historical cost of the airplane?***

e. ***What is an impaired historical cost?*** Refer to question c. ***How would you determine the impaired historical cost of the equipment some years later, if it became necessary?***

f. ***What is the historical cost of a zero coupon bond?***

g. ***Does the concept of historical cost apply to liabilities as well as assets?***

h. Assume the answer to question *g* is yes. ***What is the historical cost of a zero-coupon bond from the perspective of its issuer?***

i. ***What is the historical cost of a lawsuit liability?***

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This document is provided as a convenience to observers at the World Standard Setters meeting, to assist them in following the discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

Note: These notes are based on the staff papers prepared for the World Standard Setters meeting. Paragraph numbers correspond to the paragraph numbers in the staff papers.

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Round-Table Discussion:
Appendix A

Measurement Basis Candidates by Time Frame
With Their Variations

PAST

1. ***Past entry price***
   a. without related prices
   b. with related prices

2. ***Past exit price***
   a. without related prices
   b. with related prices

3. ***Modified past amount***
   a. accumulated
   b. allocated
   c. amortized
   d. combined

PRESENT

4. ***Current entry price***
   a. without related prices
   b. with related prices

i. identical replacement
ii. identical reproduction
iii. equivalent replacement
iv. productive capacity replacement

5. Current exit price
a. without related prices
b. with related prices

6. Current equilibrium price

7. Value in use

FUTURE

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8. Future entry price
a. without related prices
b. with related prices

9. Future exit price
a. without related prices
b. with related price