



**International
Accounting Standards
Board**

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

These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IASB Meeting: 20 June 2008, London (Agenda Paper 11D)

Project: Conceptual Framework

**Phase B: Elements and Recognition – Liability
Definition Examples**

INTRODUCTION

1. In December 2007, IASB Agenda Paper 14B applied the proposed working definition of a liability, as well as the existing IASB and FASB definitions, to various situations and identified issues arising from the application of those definitions. A list of those situations is provided in the Appendix to this paper.
2. This paper analyses additional situations, based on examples that were suggested at the December 2007 meetings, or subsequently. As with the December 2007 analysis, Board members might wish to be selective in the examples they review. Therefore, even though the analysis is sometimes repetitive, we have tried to be as complete as possible in the analysis of each example.
3. The existing IASB and FASB definitions of a liability, as well as the proposed working definition of a liability are on the last page of this paper, so that they can be detached for reference purposes.

OBJECTIVE

4. The objective of this paper is to illustrate how the working definition of a liability would apply in additional situations so as to help Board members evaluate whether the working definition is sufficiently robust.

5. Does the Board agree with the analysis of the following examples?

EXAMPLES

6. The following comprises a list of the examples analysed in this paper.

Examples that Meet the Working Definition of a Liability

Ex1. Stadium naming

Ex2. Cumulative preference share dividends

Examples that Do Not Meet the Working Definition of a Liability

Ex3. Non-vested employee benefits (discretion to avoid)

Ex4. Legal requirement to install air filters at a future date

Ex5. Discretionary participation feature of an insurance contract

Liability	Proposed Working Definition	IASB Definition	FASB Definition
Ex1. Stadium naming (Contractual promise to keep an advertiser's name on a stadium for a period of five years)	<i>Economic obligation:</i> Unconditional contractual promise to provide benefits—which is capable of resulting in cash outflows to maintain the name and reduced cash inflows from other possible naming of the stadium. In order to remove the obligation	[Analysis omitted from Observer Notes]	[Analysis omitted from Observer Notes]

Liability	Proposed Working Definition	IASB Definition	FASB Definition
	<p>an outflow of cash would probably be necessary.</p> <p><i>Enforceable against the entity:</i> Contract identifies the entity as the obligor and is enforceable at law.</p> <p><i>Present:</i> Economic obligation—the contractual promise—is set out in contract. The other party can presently enforce the promise.</p>		
<p>Comments: The entity is obligated to keep the advertiser’s name on the stadium for the five-year period. If it does not do that, then it might need to return to the advertiser some or all of the payment made to purchase the right. The entity’s liability is, therefore, for its contractual promise to keep the name on the stadium, thus forgoing alternative cash inflows, or to return payments previously received in exchange for the naming rights, if the name does not remain on the stadium. The refund aspect of this situation is very similar to that of “advances from customers” in December 2007.</p>			
<p>Ex2. Cumulative preference share dividends (Promise to pay cumulative dividends on preference shares before paying any dividends on ordinary shares)</p>	<p><i>Economic obligation:</i> Unconditional contractual promise to pay a specified rate when conditions are met.</p> <p><i>Enforceable against the entity:</i> Contract identifies the entity as the obligor and is enforceable at law.</p> <p><i>Present:</i> Economic obligation is set out in contract.</p>	<p>[Analysis omitted from Observer Notes]</p>	<p>[Analysis omitted from Observer Notes]</p>
<p>Comments: Note that the liability is based on the unconditional promise to stand ready to make payments when the conditions are met—it is an unconditional obligation associated with a conditional obligation. Eventually, over the life of the entity, it will have an obligation to distribute any residual interest, with the cumulative dividends on preference shares taking priority. The likelihood and timing of the conditions being met are factors that might be taken into account in measuring the liability, but not in determining its existence.</p>			

<u>Not a liability</u>	Proposed Working Definition	IASB Definition	FASB Definition
<p>Ex3. Non-vested employee benefits (For example, promise to pay benefits only after an employee has been employed for a specified period of time. The specified period of time has not yet passed and the entity can terminate the employee with no consequence.)</p>	<p><i>Economic obligation:</i> Unconditional contractual promise to provide benefits in the future if conditions are met—which is capable of resulting in cash outflows.</p> <p><i>Enforceable against the entity:</i> Contract identifies the entity as the obligor and is enforceable at law.</p> <p><i>Present:</i> Economic obligation—the contractual promise—is set out in the contract. However, the other party cannot presently enforce the promise.</p>	<p>[Analysis omitted from Observer Notes]</p>	<p>[Analysis omitted from Observer Notes]</p>
<p>Comments: The primary issue here is whether there is a present <i>enforceable</i> obligation. When the entity has the ability to terminate the contract with the employee, with no consequence, before the vesting date, then there is no enforceable economic obligation. However, if there would be consequences of terminating the contract—for example, other requirements in a jurisdiction might prevent an entity from terminating such a contract without cause very shortly before vesting—then the entity has an enforceable unconditional obligation to make payments, and the employee can hold the entity to that promise. Thus, a liability exists. The measurement of that liability is a separate issue, which might take into account the likelihood of the benefits being paid.</p>			

<u>Not a liability</u>	Proposed Working Definition	IASB Definition	FASB Definition
Ex4. Legal requirement to install air filters at a future date	<p><i>Economic obligation:</i> Law requires installation of air filters, which would require outflow of cash in the future to install.</p> <p><i>Enforceable against the entity:</i> The lack of air filters makes the entity the obligor, which can be enforced in accordance with the law.</p> <p><i>Present:</i> Other party cannot presently enforce anything. Law takes effect only in the future.</p>	[Analysis omitted from Observer Notes]	[Analysis omitted from Observer Notes]
<p>Comments: In each case, there is no present obligation, and hence, no liability. In contrast to the non-vested employee benefits when there are consequences of terminating the employee contract (Example 3), in this example there are no consequences to the entity before the effective date of the legal requirement. No other party can require the entity to do anything resulting in cash outflows before the date that the legal requirement becomes effective. Presumably, the air filters are to be attached to an asset. Although there is no liability, there might be a separate question as to whether the asset is impaired by virtue of not having air filters installed—the originally anticipated useful life of the asset without air filters and its residual value might be affected by the legal requirement.</p>			
Ex5. Discretionary participation feature of an insurance contract (For example, terms of an insurance contract providing the right for a policyholder to receive additional returns from a linked asset pool, at the	<p><i>Economic obligation:</i> Discretionary payments are capable of resulting in cash outflows. However, that is not required unless the entity's past practices or actions create a valid expectation.</p> <p><i>Enforceable against the entity:</i> No enforceable obligation—another party cannot require entity to make payments (unless past practices or actions</p>	[Analysis omitted from Observer Notes]	[Analysis omitted from Observer Notes]

<u>Not a liability</u>	Proposed Working Definition	IASB Definition	FASB Definition
sole discretion of the insurer.)	deem so). <i>Present:</i> Not applicable. No enforceable obligation.		
<p>Comments: We think that this is no different from Example 20, in December 2007— Discretionary Employee Bonuses. In question in this example, is whether there is an economic obligation. In some cases, it might be held under legal doctrines such as promissory estoppel, that the entity’s actions are sufficient to create a valid expectation on the part of policyholders that discretionary payments will be paid. These might, for example, be based on past history of the insurer in making such payments, or on announcements by company officials that payments will be made. In those instances, a present economic burden or requirement to which the entity has a present enforceable obligation, and hence a liability, will exist. Note that, even if the entity feels “economically compelled” to make payments, because, say, it thinks that it will be unable to retain policyholders, or obtain new business, without making payments, that is not sufficient to create a liability.</p>			

APPENDIX

Index to Examples Analysed in December 2007

Examples that Meet the Working Definition of a Liability

- Ex1. Bank overdraft by depositor
- Ex2. Account payable
- Ex3. Advances from customers
- Ex4. Property lease (lessor perspective)
- Ex5. Easement written
- Ex6. Warranty written on machinery
- Ex7. Loan guarantee written
- Ex8. Written contract to deliver future music revenues from the sale of copies of *existing* recordings
- Ex8A. Written contract to deliver future music revenues from the sale of copies of *future* recordings of music yet to be written
- Ex9. Written non-compete agreement
- Ex10. Lottery ticket (lottery perspective)
- Ex11. Insurance coverage written
- Ex12. Lease contract with rent based only on future sales (lessee perspective)
- Ex13. Forward contract to purchase corn
- Ex14. Oil spill remediation
- Ex15. Refunds to customers—stated policy
- Ex15A. Refunds to customers—no stated policy
- Ex16. Announced redundancy plan
- Ex17. Announced product recall

Examples that Do Not Meet the Working Definition of a Liability

Ex18. To obey the law

Ex19. Future purchases by an established business

Ex20. Discretionary employee bonuses

Ex21. Legal requirement to install air filters at a future date

EXISTING AND PROPOSED WORKING DEFINITIONS—FOR REFERENCE

Existing IASB and FASB Definitions of a Liability

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]

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.]

Proposed Working Definition of a Liability

A **liability** of an entity is a present economic obligation that is enforceable against the entity.

- a. *Present* means that the economic obligation exists on the date of the financial statements.
- b. An *economic* obligation is something that is capable of resulting in cash outflows or reduced cash inflows, directly or indirectly, alone or together with other economic obligations.
- c. Obligations link the entity with what it has to do because obligations are *enforceable* against the entity by legal or equivalent means.