REVISED DRAFT OF THE LIABILITIES SECTION OF A CONCEPTS STATEMENT ON ELEMENTS OF THE FINANCIAL STATEMENTS

Notes to Board:

(1) The section on liabilities would follow that on assets. A paragraph immediately before the assets section would cover the definition of "federal entity" that would apply to all the definitions of elements. That paragraph is included in this draft for ease of reference and because of its significance to evaluating the references to the federal entity in the discussion of liabilities.

(2) Introductory material would be provided in the concepts statement concerning its purpose and the approach taken to develop definitions of elements.

(3) The text is double spaced to aid the insertion of comments by Board members. Staff would welcome receiving a copy of those insertions.

DEFINITIONS OF ELEMENTS

A1. All elements are defined in relation to a particular federal entity, which may be the federal government or a component unit of the federal government. An item that qualifies under the definitions is a federal entity's asset, liability, revenue, expense, or so forth. An entity may comprise two or more affiliated entities and does not necessarily correspond to what may be described as a statutory or legal entity. The definitions may also refer to "other entity," "other entities," or "entities other than the federal entity," which may include individuals, business enterprises, not-for-profit organizations, other governments, and so forth. For example, employees, suppliers, customers or beneficiaries, taxpayers and other resource providers, other governments, and other federal entities are all "other entities" to a particular federal entity. A subsidiary entity that is part of the same entity as its parent entity in consolidated financial statements is an "other entity" in the separate financial statements of its parent entity.

Assets

A2. *[The definition of assets would appear here, followed by a discussion of their essential characteristics.]*

Liabilities

Legal Framework

L1. Federal entities are governed by and operate within a framework of laws. Thus, a federal liability must have its foundation in a law or the action that a federal entity takes under a law. Some federal liabilities result from discrete actions of an agency that are authorized by law but not explicitly required by law. Examples are liabilities that result from contractual arrangements, including amounts borrowed, amounts owed for purchased goods and services, and liabilities for providing goods or services to entities that have paid for them in advance. Other liabilities flow directly from a law and its implementing regulation that specifically require a federal entity to provide assets to another entity. Examples include formula grants and subsidies, claims owed under workers' compensation, and amounts owed for environmental clean-up.

L2. Although all federal liabilities have their foundation in law, some liabilities are construed or inferred to exist based on the totality of the conditions or facts of a particular situation, rather than specific legal or regulatory requirements. For example, in some situations, certain laws and regulations may have created a framework for a federal entity to provide assets or services to other entities when a certain event occurs, without explicitly mandating that response. An example of such an event is a natural disaster; similar events in the past may or may not have resulted in a response by a federal entity. In other situations, laws and regulations governing program administration may require the entity to provide assets or services to other entities after a certain date or event occurs. Consideration of all the relevant facts and circumstances, including the principles of accrual-basis accounting which underlie the preparation of financial statements, may suggest that, for some programs, the entity incurs a liability and related costs in periods before the specified date or event for the provision of assets or services.. In contrast, for other programs, the facts and circumstances may be such that the entity does not incur costs or liabilities until the provision of assets or services is legally required. In the circumstances described in this paragraph, the totality of the facts of the situation, including the legal framework, specific statutory or regulatory requirements, if any, relevant past precedents, and current conditions, should be assessed against the definition and essential characteristics of federal liabilities (discussed in paragraphs L4 through L15) and the principles of accrual-basis accounting, so that an informed judgment can be made as to whether or when a liability has been incurred.

L3. Settlement of a federal liability may be legally enforceable, as is the case, for example, with contracts. However, laws that create or support federal liabilities do not always confer legally enforceable rights on recipient entities. Legal enforceability may provide additional evidence that a liability exists, but it is not a prerequisite.

Definition of "Liability"

L4. A liability is a present obligation[1] that an entity has incurred to provide assets or services to another entity at a determinable date, when a specified event occurs, or on demand.

L5. The definition of liabilities addresses only whether a liability exists and not whether or when it should be recognized in a statement of financial position. Criteria for the recognition of liabilities are set forth in paragraphs XX through XX [OR will be set forth in a separate Statement]. Liabilities that do not meet the recognition criteria may be candidates for disclosure in the notes to financial statements or as supplementary information.

Essential Characteristics of Liabilities

L6. Similar to the definition of an asset in paragraph A2, the definition of a liability is derived from the nature of liabilities—the characteristics that are fundamental or essential to all liabilities. Paragraphs L7 through L14 identify and discuss those characteristics.

[1] The term *obligation* is used in this Statement with its general meaning of a duty or responsibility to act in a certain way. It is not intended to mean that an obligation of budgetary resources is required for a liability to exist in accounting or financial reporting.

L7. A liability of a federal entity comprises the following characteristics: (a) The federal entity has a present obligation to another entity, (b) the obligation is to provide assets or services to the other entity, and (c) the obligated entity has very little possibility of avoiding settlement at a determinable date, when a specified event occurs, or on demand.

Present Obligation

L8. As the term is used in this Statement, an obligation is a duty or responsibility to act in a certain way toward another entity. To have a *present* obligation means that the obligation arose as a result of a past transaction or other event and has not yet been settled. To qualify as a liability, a present obligation must entail the provision of assets (cash, cash equivalents, or goods) or services to another entity in the future. For example, an entity that has received but not yet paid for goods or services that it has agreed to purchase from another entity has a present obligation to settle the agreed amount. Further, when an entity agrees to provide funds to another entity if it meets certain conditions and the other entity has met those conditions, the first entity has a present obligation to provide the funds.

L9. For a present obligation to qualify as a liability, two separate entities must be involved, namely the federal entity that has the obligation and another federal or nonfederal entity (or entities) that is external to the obligated entity. Separate entities must be involved because the same entity cannot be both the recipient of settlement of a liability and the entity with the duty to settle. For example, a federal entity that operates machinery may have a duty or responsibility to maintain it. However, the entity does not have a liability for maintenance; the entity cannot have a liability to itself. In contrast, if the entity contracts for maintenance from another entity, it may have a liability to that other entity for the price of the maintenance services it has received.

L10. It is important to distinguish between a present obligation, which may be a liability, and an expression of future intent, which is not. For example, an entity may announce its intent to purchase assets in the future, or to provide financial assistance in the future to individuals that meet certain conditions. The announcement does not, of itself, create a present obligation. For a present obligation to be incurred requires the occurrence of an event that involves another entity, namely, in the examples, delivery of the purchased assets by the vendor, or evidence that proposed recipients have satisfied the required conditions for financial assistance..

Settlement of the Obligation

L11. For a present obligation to another entity to qualify as a liability, the entity must, under current circumstances, have very little possibility of avoiding settlement of the obligation. For some obligations, such as contractual obligations, the entity may not be able to avoid settlement because it is legally enforceable. As discussed in paragraph L3, legal enforceability is not a characteristic of all liabilities. However, other consequences of dishonoring the obligation may be such that the entity has no viable alternative but to make settlement.

L12. It is important that the assessment of the possibility of avoiding settlement be based on *existing* conditions**,** including current law, because an essential characteristic of a liability is that the entity has a *present* obligation. It is possible that conditions will change before settlement is due. For example, the Congress might change a law under which a federal entity has incurred a present obligation and erase the obligation or otherwise enable the entity to avoid settlement. Alternatively, the entity might be able in the future to renegotiate the obligation with the payee or recipient of the promised services. However, liabilities and all other elements of financial statements are based on transactions or events that already have occurred. Thus, the possibility of a future change in the conditions that gave rise to a present obligation does not mean that an entity currently can avoid settlement and therefore does not have a liability at the present time.

L13. An integral part of the essential characteristics of a liability is that settlement currently is anticipated at a determinable date, on the occurrence of a specified event, or on demand. Generally, the timing of settlement is part of a contract or other agreement between the entities. If the entity with the obligation can unilaterally specify or change the settlement date or event, it has no liability because it can avoid the future provision of assets or services by, for example, indefinitely postponing the settlement date.

L14. Frequently, an obligated entity will know which specific entities or individuals will receive settlement before settlement is due. However, such advance identification of specific recipients is not an essential characteristic of a liability. For example, an employer may have a present obligation for future long-term disability payments to employees without knowing the identity of each of the employees who ultimately will qualify for payment. The obligation would qualify as a liability if the other essential characteristics of a liability were present.