



Federal Accounting Standards Advisory Board

June 8, 2005

TO: Members of FASAB

FROM: Penny Wardlow, Consultant

THROUGH: Wendy Comes, Executive Director

SUBJECT: **Elements: Liability Characteristics – TAB B, Paper 2**

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INTRODUCTION

At the March 2005 meeting, the Board considered a draft of a liabilities section for a possible concepts statement on elements. The section was similar in structure to a draft of an assets section that the Board had previously reviewed. Deliberations on the liabilities section were extensive and included some suggestions for changes to the substance or wording of the essential characteristics of liabilities and the subsequent elaboration of those characteristics in the draft.

The **Attachment** to this memo is a revised draft. I have attempted to incorporate the suggestions that the Board made at the March meeting (but, have not always succeeded). I have added a tentative definition of *liability* based on revisions to the essential characteristics of liabilities that were included in the March draft. This memo provides comments on the revisions and other issues discussed at the March meeting.

Also at the March meeting, several members indicated that they wished to give some consideration to recognition criteria before continuing deliberations on the

definitions of elements. TAB B, Paper 1 for this meeting addresses that request and is intended to be discussed before this memo and its Attachment. This memo and the Attachment assume agreement with a basic premise underlying Paper 1 – namely, that the definitions of elements and recognition criteria are separate concepts or steps. That is, meeting a definition is a necessary but insufficient condition for recognition; the other recognition criteria also must be met.

An item that meets the definition of, say, a liability is a liability, even if it does not meet the recognition criteria – for example, it may not be reliably measurable. This concept is covered in **Paragraph L5** of the draft (Attachment), which I have strengthened by adding a reference to the possibility of disclosure of liabilities that do not meet the recognition criteria. If the Board disagrees with the premise in paragraph L5, portions of the Attachment and, possibly, the approach to developing definitions of elements, would need to be changed. At past meetings, I believe that most Board members have agreed with the premise but some Board members have not – or they have been uncertain whether they agreed. If the Board is divided on this issue, it may be appropriate to take a Board vote so that needed changes to the draft can be identified.

MEETING GOAL

The goal of this meeting is to reach agreement on the essential characteristics of liabilities, on the substance of the discussion of the essential characteristics, and, if possible, on the definition of a liability. In meeting that goal, it may be useful for the Board to vote on certain basic issues that have divided the Board at previous meetings, if those issues continue to hinder consensus on the liability definition and characteristics. One of those issues (the distinction between definition and recognition criteria) is mentioned in the previous paragraph. Other recurring issues are identified below in the discussion of the relevant paragraphs of the Attachment.

A list of suggested issues for a Board vote is included at the end of this memo. A vote on those basic issues would provide direction for the Board and staff in addressing dependent issues and should increase the rate of progress in the Elements project.

COMMENTS ON THE REVISED DRAFT ON LIABILITIES (ATTACHMENT)

Paragraph A1 (pages 1 and 2 of the liabilities draft). The Board has previously reviewed this paragraph and I made no changes. It would precede the definition of assets. I have reproduced it in the revised draft of the liabilities section as a reminder that the elements need to be defined in relation to a particular “entity”

that has assets, liabilities and other elements. Thus, the definition of *federal entity* as “the federal government or a component unit of the federal government” is significant to understanding the definition and discussion of the characteristics of liabilities.

Liabilities

Legal Framework

Paragraphs L1 through L3 are intended to provide coverage of the issue of the “legal basis” for liabilities and also the issues of “constructive liabilities” and “legal enforceability.” The changes I have made in paragraph L2 are to address the Board’s concern that the previous language concerning obligations that are not legally enforceable appeared to focus on social insurance and similar programs. The new language removes the reference to benefits and thus broadens the applicability of the paragraph to other programs. I have also added a reference to accrual-basis accounting and to the costs related to liabilities as issues that an entity should consider when determining whether a liability has been incurred.

The Board has discussed at previous meetings whether federal liabilities should be limited to those obligations that are legally enforceable. The conclusion of the majority of the Board has been that the activities of federal entities are “legally based” in the sense that they operate within a framework of laws. In that sense, federal liabilities are legally based, but they are not necessarily legally enforceable. Also, the majority of the Board has not wished to restrict the definition of liabilities to those that are contractual in nature or are specifically mentioned in statutes.

Based on those discussions, I have retained in the revised draft the placement of the discussion of the legal framework at the beginning of the section on liabilities, to set the stage for the discussion of the definition of a liability and its essential characteristics. The discussion of the legal framework includes a more restricted version of constructive liabilities than the FASB has. The version I propose would include them in the legal framework but indicate that judgment is needed to decide whether or when a liability exists. That judgment should be based on the totality of the circumstances as well as consideration of the essential characteristics of a liability and related costs, and the principles of accrual-basis accounting.

Paragraph L3 states that “legal enforceability may provide additional evidence that a liability exists, but it is not a prerequisite.” Prior to the March meeting, I believe that a majority of the Board agreed with that concept – that legal

enforceability is not an essential characteristic of a liability. However, at the March meeting there was renewed interest by some members in limiting liabilities to obligations that are legally enforceable. I have nothing new to add to the debate of previous meetings and I believe that agreement is fundamental to the liability definition. Therefore, if there continues to be a diversity of views on the Board on this topic, I recommend that the Board take a vote so that progress can be made on other issues.

Definition of "Liability" and Essential Characteristics of Liabilities

Paragraph L4 includes a proposed definition of *liability*, based on revisions I have made to the essential characteristics listed in **Paragraph L7**. No definition was proposed in March, pending further discussion and, it was hoped, agreement on the substance of the essential characteristics. The Board did not reach agreement on all aspects of the essential characteristics. Moreover, some of the discussion referred to the characteristics as if they were the definition. Although the definition should capture the characteristics, it does not have to repeat them in their entirety. In fact, a more succinct version may be easier for the Board, preparers, and users, than a longer and wordier version, which would then be repeated in the more precise identification and discussion of the characteristics. The definition in paragraph L4 is a one-sentence definition with these goals in mind.

The full list and subsequent discussion of the characteristics begins in paragraph L7. As the Board has previously discussed, it is important that readers be alerted to the need to read the discussion of the characteristics in order to understand and apply the definition of liability. **Paragraph L6** is intended to encourage readers to read the discussion of the characteristics and provides a link between the definition of a liability and the discussion of the underlying characteristics.

The March discussion of the characteristics focused on two suggestions by Board members: (1) that a notion of probability should be added to the characteristics and this could be achieved by adding the word "could," as had been proposed for the asset definition, and (2) that a concept similar to the FASB's notion of the entity having "little or no discretion" to avoid settlement should be added to the characteristics. Several members preferred the approach under (2) to the previous language, which referred to the entity being "required to settle" the obligation.

I was unsuccessful in incorporating both suggestions. First, the two concepts contradict each other. If, as the Board proposed, a liability is a present obligation that *could* result in the provision of assets or services to another entity, it also

might not have such a result. “Could,” as the Board is aware and intended, would broaden the definition to include items that might have a low probability of settlement. Several Board members have indicated that, for both assets and liabilities, they favor a definition that would “cast a wide net.” In that view, a narrowing should occur at the recognition and measurement stage, so that liabilities with a low probability of settlement might not be recognized.

However, if one broadens the definition to include obligations with a potentially low probability of settlement, then it would be contradictory to say that another essential characteristic is that the entity has “little or no discretion” to avoid settlement. That phrase would indicate that for an obligation to be a liability, there would have to be a high probability of settlement.

Second, I believe that the phrase suggested at the March meeting – “A liability is a present obligation that could result in the provision of assets or services” (or similar) – is confusing, because it implies that the result could be the provision of something else or some other result entirely. In contrast, I believe the definition should indicate the *nature* of the obligation – what the entity is obligated for – which is that *it is an obligation to provide assets or services*. My proposed wording of the definition in L4 captures that point.

The characteristics of liabilities listed in paragraph L7 parallel the definition in L4, but I also have included the concept (characteristic c) that “the obligated entity has very little possibility of avoiding settlement.” Although this fits the definition (when “could” is not included), I did not include that phrase in the definition itself because it seemed to overcomplicate the definition. (This is the same approach taken by the FASB, who referred to “little or no discretion” in the characteristics but not in the definition.)

I suggest that “very little *possibility* of avoiding settlement” is a more appropriate notion to the federal environment than “little or no *discretion* to avoid settlement.” The latter phrase indicates that the entire possibility of failure to settle is a choice of the obligated entity. However, in the federal environment, it is possible that Congress will change the law or take other action that might absolve the entity of its obligation and that action may be known and imminent at the time the existence of the liability is under consideration. This is a “possibility” of avoiding settlement that is not within the “discretion” of the entity.

The probability of settlement could be addressed only in the recognition criteria, as discussed in Tab B, Paper 1. I believe that approach is preferable to attempting to include it in the liability (or asset) characteristics. This also is a topic that has received Board discussion at several meetings. If there continues

to be a lack of agreement at the current meeting, it may be an issue that should be the subject of a vote, because it affects the definition of recognition criteria as well as the identification of the essential characteristics and, potentially, the definitions of elements.

Present Obligation

Paragraph L8 defines *obligation* and *present obligation* and **Paragraph L10** further interprets characteristic (a). **Paragraph L9** explains why there need to be separate entities (external to each other) for a liability to exist. “External” does not necessarily mean “outside the federal government.” It means any entity other than the one for which financial statements are being prepared.

I made some modifications to paragraph L8: a clarification that the “duty or responsibility” is to another entity (discussed in paragraph L9); the addition of cash equivalents to the description of assets that could be provided; and a rewording of the example of a nonexchange transaction (last sentence). The latter change is to address the Board’s concern at the March meeting that the previous language appeared to address the point at which a liability is incurred in, say, a grant program. The new language is intended to be less specific – to indicate that at some point an agreement between the entities has been met, at which point the first entity would be obligated to follow through. What that point would be in various programs might vary according to the requirements of the program and paragraph L8 is not intended to address that.

The Board has previously discussed the importance of explaining that obligations may be liabilities, but expressions of intent are not. **Paragraph L10** attempts to do that, based on the need established in L9 for the involvement of two separate entities for a liability to exist. I have eliminated the paragraph L11 that was in the previous draft. That paragraph dealt with “commitments” as somewhat distinct from “intent” and it also referred to the point at which a liability might be incurred in a nonexchange program. Some members thought that the distinction between commitment and intent was not clear and that the points were covered in L10. Also, the Board thought the reference to the incurrence of an obligation in a nonexchange setting seemed more like a possible standard than a concept. I believe the points that should be made about intent (or commitments) are adequately made in paragraph L10 and the coverage of nonexchange in paragraph L8 may be sufficient.

Settlement of the Obligation

As discussed earlier, I removed the “required to settle” language from the characteristics and replaced it with “very little possibility of avoiding

settlement.” (See characteristic c in paragraph L7.) **Paragraph L11** (previously L12) has been reworded accordingly. I also changed the latter part of the paragraph to remove the language about “adverse social, political, or economic consequences” of failure to settle, that a majority of the Board did not favor. The new language follows the suggestion of a Board member to capture the notion that, even though an obligation is not legally enforceable, there may be “other consequences” to the entity of not settling that may encourage settlement.

Paragraph L12 (previously L13) has practically no changes. I believe it is an important paragraph because it explains that accounting and financial reporting are based on events that already have occurred. Thus, in considering the definition of a liability, reference is made to existing conditions, rather than contemplating changes that might occur in the future, such as Congress considering a future change in the law.

As the Board has previously discussed, in the context of the asset definition as well as the characteristics of liabilities, the question of whether potential future changes in the law or other circumstances should affect conclusions about the existence of liabilities is an issue of distinguishing between an item meeting the definition of a liability and whether it also meets the criteria for recognition. A likelihood of a future change in the amount of the liability (including a change to zero) might affect the measurement of the item and/or the decision as to whether or not to recognize the liability, but it should not affect whether an obligation *currently* meets the *definition* of a liability.

The changes to **Paragraphs L13** and **L14** (previously L14 and L15) are for clarification. With respect to paragraph L13, a Board member indicated in March that the reference to “unilateral” changes in the selection of the settlement date was not clear. I would suggest that, whether the transaction is a contract or other exchange or nonexchange transaction, there is an explicit or implicit agreement between the parties as to their relative duties and responsibilities and an understanding about when settlement should occur or what triggers the need for settlement. The absence of any agreement, explicit or implicit, and the ability of the obligated entity to defer settlement indefinitely indicate that the entity has no liability.

ISSUES FOR POSSIBLE VOTE OF THE BOARD

In successive meetings' discussions, several basic issues have continued to surface, despite apparent tentative agreements or acceptance of majority views at previous meetings. This situation suggests that there may be a fundamental difference of views on some issues that needs to be addressed by a vote of the Board, rather than continuing to attempt to reach a consensus. The following are some of the issues that I believe may need to be addressed by a vote, if agreement on them is not reached at the June meeting. A vote would provide direction for the Board and staff on how to address other issues that are affected by decisions on the basic ones.

1. **Can federal entities have assets and liabilities that are not recognized in the financial statements – that is, they meet the definition of an asset or liability but they do not meet the other recognition criteria?** (In that case, they might be disclosed in the notes or as supplementary information.)
2. **Is legal enforceability an essential characteristic of a federal government liability?** (An obligation that is not legally enforceable would not meet the definition of a liability.)
3. **Should the ability of Congress to change existing laws affect the *definition* of a liability? Or, should it potentially affect only *recognition* and/or *measurement* of the liability?**
4. **Is the existence of an appropriation or other form of funding an essential characteristic of a liability? That is, can an entity have a liability, even though currently there are no funds available to settle it?**
5. **Should a notion of probability of future inflows or outflows of economic benefits or services be *expressly* included:**
 - (a) **In the definitions of assets and liabilities?**
 - (b) **In the identification of the essential characteristics of assets and liabilities?**
 - (c) **Only in recognition criteria (recognition and measurement)?**