October 4, 2004

TO: Members of FASAB

FROM: Penny Wardlow, Consultant

THROUGH: Wendy Comes, Executive Director

SUBJECT: Elements of the Financial Statements: Liabilities

NOTE: FASAB staff prepares memos and other materials to facilitate discussion of issues at Board meetings. This material is presented for discussion purposes only; it is not intended to reflect authoritative views of the FASAB or its staff. Official positions of the FASAB are determined only after extensive due process and deliberations.

INTRODUCTION

The August 2004 meeting session on elements of financial statements was primarily an educational session. The Board received a staff paper that presented the FASB’s definition of a liability and compared it with the definitions of several other standard-setting authorities. The Board began a discussion of the essential characteristics of a liability identified by the FASB in its Concepts Statement No. 6. These characteristics are (par. 36):

(a) It embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand.

(b) The duty or responsibility obligates a particular entity leaving it little or no discretion to avoid the future sacrifice, and

(c) The transaction or other event obligating the entity has already happened.

The goal of the discussion, which was expected to continue at subsequent meetings, was to decide:
1. Whether the essential characteristics of liabilities identified by the FASB for private-sector entities also are essential characteristics of federal government liabilities.

2. Whether federal government liabilities have any essential characteristics that have not been identified for private-sector entities’ liabilities.

Staff also raised several more specific issues, resolution of which would contribute to resolution of the main issues. Three of those issues and the Board’s tentative conclusions are as follows.

A. Is a liability a present obligation\(^1\) to another entity or entities?

Members appear to agree that a liability is an obligation of a specific federal entity to another (different) entity or entity and that the obligation exists as a result of a past event. In that sense, the obligation is a “present” one, or an existing one, at the time an assessment of its existence is made.

B. Does the Board agree that, conceptually, the federal government may have a liability for the provision of goods and services, not just for financial obligations?

The Board did not complete its discussion of this issue. Some members were concerned that the notion of a liability for the provision of goods and services would include general commitments of the kind that underlie most government programs—for example, the government’s commitment to provide defense or education to the citizenry. In this paper, staff further explores this issue.

C. Does the Board agree that, to be a liability, a present obligation does not have to be legally enforceable? That is:

(a) Does the Board agree that constructive obligations may be liabilities?
(b) Does the Board agree that equitable obligations may be liabilities?

The Board has discussed constructive and equitable obligations within the Social Insurance project, and information about how other standard-setting authorities treat the issue was included in the August paper on elements of the financial statements. It appears that a majority of the Board has agreed that certain constructive obligations may be liabilities. However, it would be useful to clarify the characteristics of those constructive obligations that might qualify as liabilities versus those that would not. Also, some members were

\(^1\) In the August paper and in this paper, the term *obligation* is used with its general meaning of duty or responsibility and does not include its federal budgetary meaning. The Board has not yet discussed whether the term *obligation* should be used (with an appropriate definition and discussion of its scope) in its definition of a liability or in the wording of the essential characteristics of a liability, and the staff has not yet made a recommendation in that regard.
particularly concerned that certain equitable obligations might qualify as liabilities. The concepts of legal, constructive, and equitable obligations are discussed further in this paper.

The objective of the October meeting is to continue the discussion of the above issues, with a view to identifying the essential characteristics of federal government liabilities. The paper includes certain specific questions for the Board. On other issues, the staff presents information and some discussion but is not yet ready to make a recommendation.

LIABILITIES FOR GOODS AND SERVICES

Provision of Goods and Services to Suppliers

In the FASB’s framework, an entity may settle a liability through a transfer of assets, which may include cash or goods, or through the provision of services (Concepts Statement 6, par. 38). Settlements in cash may be the most common form; they include repayments of borrowings, payments of amounts owed to employees, and payments on account to vendors for purchases of goods and services. However, entities may incur liabilities as a result of prepayments to them by purchasers of goods or services and these liabilities normally would be settled with goods or services, rather than cash.

It would seem that a federal entity could incur liabilities to suppliers for goods and services. Does the Board agree?

Provision of Goods and Services to the Citizenry

More problematic than transactions with suppliers is whether the government can incur liabilities for the provision of goods and services to the citizenry. The provision of goods and services is part of the government’s mission, and the administration and legislators frequently announce that certain services or benefits will be provided, or that ongoing programs will be continued or expanded. Do these announcements give rise to liabilities? If the announcement alone is not sufficient, what actions following an announcement would give rise to a “present obligation” to provide goods and services?

As noted at the August meeting, other standards boards are considering these issues, including the United Kingdom’s Accounting Standards Board (UK-ASB) and the Public Sector Committee of the International Federation of Accountants (IFAC-PSC).

In its 2003 Proposed Interpretation for Public Benefit Entities (2003) of its Statement of Principles for Financial Reporting, the UK-ASB classifies commitments to provide public benefits into general versus specific
commitments. It defines a *general* commitment as “a general or policy statement of intention, that the entity stands ready to provide goods or services to certain classes of potential beneficiaries in accordance with its objectives” (par. 4.29).

The UK-ASB indicates that a general commitment would not result in a liability for the following reasons (par. 4.34, footnote omitted):

The commitments described at (a)(i) above [i.e. general commitments] are expected to include political commitments made by governments, for example the announcement of a forthcoming new initiative to provide cash benefits to members of the public meeting certain criteria. Political commitments are different from commercial contracts. Such political commitments (whether express or implied) are political promises; examples are the general promise to provide health-care or education. Governments make, and amend, such promises and policies as part of their ongoing political processes to manage the economy and redistribute wealth within or between periods and generations. As such they should not be viewed as constructive commitments.

Further (par. 4.35):

A general commitment to provide public benefits contrasts with an announcement by a profit-oriented entity where the announcement has created a valid expectation that the decision will be implemented such that the entity cannot withdraw from it, because a general commitment could be changed (or withdrawn).

On the other hand, the UK proposal also included the alternative view (par. 33) that:

... some general political promises are relied upon by individuals, for example in taking financial decisions about investments for the future, and therefore in these cases a liability has been created because the outflow of economic resources cannot be avoided.

Note that the inability to avoid the future outflow of resources is one of the defining characteristics of a liability for the UK-ASB, similar to the FASB’s essential characteristic (b): The duty or responsibility obligates a particular entity leaving it little or no discretion to avoid the future sacrifice.

In contrast to general commitments, the UK-ASB defines a specific commitment as follows (par. 4.29):
... a specific commitment, or promise, to provide specified goods
or services to a beneficiary that has met any necessary criteria,
such that the beneficiary is able to rely on the entity fulfilling its
promise (i.e., the general commitment has become specific as a
result of certain past events) meaning that the entity could not
realistically withdraw from it.

In the UK-ASB’s view, specific commitments create a liability because (par. 4.32):

... the general commitment has become specific and there is an
obligation to transfer economic benefits to an identified beneficiary
or group of beneficiaries as a result of past events. In general, the
definition of a liability does not require a reporting entity to know
the identity of the party to whom an obligation is owed. Nevertheless, in distinguishing between general and specific
commitments to provide public benefits, in order to identify the
point at which a general commitment becomes specific, identification of the beneficiary is usually necessary.

The UK-ASB proposal does not explain how a general commitment becomes
specific—that is, what the qualifying past events might be. Moreover, it is not
explained why, in distinguishing between general and specific commitments, it is
necessary to contravene one of the characteristics of a liability (in the FASB’s
definition as well as the UK-ASB’s)—namely, that it is not necessary to know the
identity of the claimant in order to conclude that an entity has a liability.

Possible obligating events

The identification of all general “political” statements or promises as liabilities
would seem too broad and too problematic. If the promise is merely a statement
of intent and the government can cancel or modify the promise without penalty,
then the promise is not an “obligating event,” and without such an event there is
no liability. Thus, it would seem that some additional action is required that
would obligate the government to transfer assets or provide services to the
citizenry in the future. Some possibilities are:

1. Effective date of legislation to establish the program.
2. Appropriation of the necessary funds.
3. Specific identification of the classes or groups of individuals or entities who
   are eligible to receive the assets or services.
4. Performance by individuals or entities making them eligible to apply.
5. Receipt of applications that meet eligibility requirements.
6. Approval of applications.
7. Approval of the transfer of assets (e.g., cash payment) or provision of services
to recipients.
Does the Board regard any of these points as better candidates for obligating events in general? Can any of these points be ruled out?

An additional consideration is whether the obligating event creates a liability only with respect to the current period, or a defined number of future periods, or whether the liability extends for an indefinite number of periods.

IFAC-PSC

To date, little research has been done into when a government incurs a liability for the provision of goods and services. However, some research is currently underway. In addition to the UK-ASB’s proposal, the IFAC-PSC has initiated a study of liabilities for the provision of social benefits.

The IFAC-PSC began to consider the issue of potential obligations for the provision of goods and services to the citizenry in IPSAS 19, Provisions, Contingent Liabilities and Contingent Assets. IPSAS 19 is based substantially on the IASC’s International Accounting Standard 37, which has the same title. (In both standards, the term provision is defined as “a liability of uncertain timing and amount” and is distinguished by degree of uncertainty from trade payables and accruals, such as those for amounts owed to employees. The distinction is used in establishing standards for recognition or disclosure of a provision and does not appear to affect the IFAC-PSC’s view of the conceptual characteristics of a liability.)

In IPSAS 19, the IFAC-PSC defines social benefits (par. 7) as “goods, services and other benefits provided in the pursuit of the social policy objectives of a government,” including:

(a) The delivery of health, education, housing, transport and other social services to the community. In many cases, there is no requirement for the beneficiaries of these services to pay an amount equivalent to the value of these services; and

(b) Payment of benefits to families, the aged, the disabled, the unemployed, veterans and others. That is, governments at all levels may provide financial assistance to individuals and groups in the community to access services to meet their particular needs, or to supplement their income.

Exchange vs. nonexchange transactions

The second sentence of (a) above indicates that the provision of social benefits is generally a nonexchange transaction. The IFAC-PSC excluded potential
liabilities for social benefits from the scope of IPSAS 19 when “the entity providing the benefit will not receive consideration that is approximately equal to the value of goods and services provided, directly in return from the recipients of the benefit” (that is, the transaction is nonexchange), even when “a charge is levied in respect of the benefit but there is no direct relationship between the charge and the benefit received” (par. 9).

The Committee explains that the exclusion is based on the Committee’s view (para. 9):

... that both the determination of what constitutes the “obligating event” and the measurement of the liability require further consideration before proposed Standards are exposed. For example, the Committee is aware that there are differing views about whether the obligating event occurs when the individual meets the eligibility criteria for the benefit or at some earlier stage. Similarly, there are differing views about whether the amount of any obligation reflects an estimate of the current period’s entitlement or the present value of all expected future benefits determined on an actuarial basis.

As the FASAB is aware, the IFAC-PSC is currently examining these and related issues and has outstanding an Invitation to Comment on Accounting for Social Policies of Government.

The FASAB’s reasoning in SFFAS 5, Accounting for Liabilities of the Federal Government, appears similar to that contained in IPSAS 19. In SFFAS 5, the Board concluded that “[f]or federal nonexchange transactions, a liability should be recognized for any unpaid amounts due as of the reporting date” (par. 24). Furthermore, “estimates of future nonexchange payments should not be recognized as a current period liability,” even though the Board acknowledges that “it is possible to make meaningful estimates of the future amounts required to continue present policies regarding such programs” (par. 131). Liabilities for exchange transactions, in contrast, should be recognized in the period when the exchange occurs (par. 23).

In SFFAS 5, the Board does not distinguish between definition and recognition of a liability. That is, the standard addresses the timing of recognition of liabilities and does not address the possibility that an item might meet the definition of a liability and not be recognized in the balance sheet. In the elements project, however, the Board distinguishes definition from recognition. This suggests that the FASAB should discuss whether the differences between exchange and nonexchange transactions affect only the timing of recognition of elements or whether the differences are fundamental to the definitions of elements.

Specifically, does the Board believe that:
(a) In an *exchange* transaction, a liability is incurred when the exchange occurs?

(b) In a *nonexchange* transaction, a liability is incurred when the settlement amount becomes due and payable (and not earlier)?

If the Board agrees with (b), then staff believes that the nature of a transaction—whether it is exchange or nonexchange—is an essential characteristic of any liability that results from that transaction. A key consideration is that the timing of settlement would affect the definition of a liability under a nonexchange transaction, but not under an exchange transaction. If the nature of the transaction (exchange or nonexchange) affects the definition of a liability, then, the Board should consider adding the nature of the transaction to the three essential characteristics of a liability identified by the FASB (assuming that the FASAB agrees with those characteristics).

Consideration also might be given to the concept of an “exchange-like” transaction. That is, whether some transactions of the federal government are neither wholly exchange transactions nor wholly nonexchange transactions, but have some features of each. If so, how should those transactions be classified, and how, if at all, would they affect the definition of a liability?

The GASB defines an *exchange-like transaction* as:

\[ \ldots \text{one in which the values exchanged, though related, may not be quite equal or in which the direct benefits may not be exclusively for the parties to the transaction. Nevertheless, the exchange characteristics of the transaction are strong enough to justify treating the transaction as an exchange for accounting purposes (GASB Statement No. 33, Accounting and Financial Reporting for Nonexchange Transactions, footnote 1).} \]

It should be noted that GASB Statement 33 addresses the recognition of elements resulting from nonexchange transactions, not their definition, and the GASB has not yet developed proposed definitions of elements for public comment. Therefore, it is unknown what effect, if any, the GASB’s classification of transactions into exchange, nonexchange, and exchange-like would have on its definitions of elements of the financial statements. The FASAB is not, of course, bound by the GASB’s definition of “exchange-like” and, if the overall concept has appeal, the Board may wish to develop its own definition.

**LEGAL VERSUS CONSTRUCTIVE OBLIGATIONS**

As previously discussed with the Board in the Social Insurance and Elements projects, the FASB and other standard setters (those who have adopted essentially the FASB’s conceptual framework) believe that liabilities are not limited to obligations that are
legally enforceable. Rather, they include so-called “constructive obligations.” The FASB and others are not precise about the scope of constructive obligations. Most would include promises made and announced to beneficiaries, reliance of the beneficiaries on those promises, precedent or past practices of the entity, and so forth. Others would appear to include more comprehensive notions of “fairness” or “doing what is right”—notions that are more difficult to define and make operational than when there is evidence of promises and past actions.

The FASB’s conceptual framework does not address governments, and the frameworks that most of the other authorities we have consulted (e.g., Australia, New Zealand, and the United Kingdom) have adopted for governments are based on and very similar to their frameworks for businesses. Some believe that these common business/governmental/not-for-profit frameworks are not appropriate for governments because, in the pursuit of homogeneity of accounting standards across sectors, they do not sufficiently take into account the unique features of governments, including the rule of law. Thus, a significant issue for the FASAB is whether “legal enforceability” is an essential characteristic of a liability of the federal government.

**Legal Enforceability**

In considering this issue, the FASAB would need to determine first of all what is meant by “legal enforceability.” Some would say that it means that “the federal government can be sued”—e.g., for settlement of the liability, in the context of this paper. More precisely, the supposed beneficiary of the liability has the right to sue for redress. It should be noted, however, that individuals also may have the ability to sue for redress, and prevail, on the basis of “constructive” rather than “legal” obligations. So, it is appropriate to examine what is meant by each.

The IFAC-PSC has addressed “legal obligations” and “constructive obligations” in its January 2004 ITC, *Accounting for Social Policies of Governments*.

Legal obligations are defined (par. 3.9) as (a) contracts, (b) legislation, or (c) other operation of law (e.g., court judgments that may be sought for negligence or other matters not covered by contract or statute; common law in some jurisdictions, etc.). A contract is defined (footnote 1) as having the “general meaning of an agreement with specific terms between two or more persons or entities in which there is a promise to do something in return for valuable benefits known as consideration.” It seems likely that the FASAB would agree that contracts give rise to a liability that has “legal enforceability.”

The IFAC-PSC notes (par. 3.10) that:

Legislation frequently imposes obligations on governments to provide social benefits on a collective basis to the community or sections of the community, rather than to identifiable individuals.
IPSAS 19 paragraph 28 . . . clarifies that the inability to identify specific recipients of benefits does not itself preclude a present obligation from arising.

Note how the last sentence differs from the proposal of the UK-ASB discussed earlier. The UK proposal suggests that, to qualify as a liability, a specific commitment of a government might require identification of recipients or beneficiaries, contrary to the FASB’s (and the UK-ASB’s) definition of a liability. The IFAC-PSC proposal disagrees with that view.

Paragraph 28 of IPSAS 19 states as follows:

An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed—indeed the obligation may be to the public at large. Because an obligation always involves a commitment to another party, it follows that a decision by an entity’s management, governing body or controlling entity does not give rise to a constructive obligation at the reporting date unless the decision has been communicated before the reporting date to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will discharge its responsibilities.

The IFAC-PSC elaborates (par. 3.11) that

Constructive obligations may arise with respect to rights specified in legislation, but the existence of legislation is not necessary for such obligation to arise. The key issue is identifying what constitutes the obligating event—that is the past event that leads to a present obligation that the entity has no realistic alternative to settling.

Some believe that the federal government always has an alternative to settling obligations, especially those incurred in nonexchange transactions, in that the Congress can agree on a different course of action. However, the emphasis of the IFAC-PSC proposal is on whether there is a realistic alternative. It may be that, technically, the government can adopt an alternative, but if the consequences are likely to be significant enough, economically, socially, or politically, that the Congress would not take alternative action, then it would appear that the government has a liability (a present obligation to transfer assets or provide services in the future), whether it is technically “legally enforceable” or not.

Further, it should be noted that so-called constructive obligations can be legally enforceable. In a June 2004 memo to the FASAC (the FASB’s advisory council), FASB staff states that the indication, in FASB Concepts Statement 6, that
constructive obligations are not legally enforceable appears to be inconsistent
with the legal literature. Citing Black’s Law Dictionary (7th edition), the staff
notes that “constructive” is defined as “legally imputed; having an effect in law
though not necessarily in fact,” and references the term “legal fiction.” According
to the same Dictionary, a legal fiction is “an assumption that something is true
even though it may be untrue, made esp. in judicial reasoning to alter how a legal
rule operates. The constructive trust is an example of a legal fiction.”

As a result of these considerations, the FASB staff, in the same memo, defines a
legal obligation as “an obligation that a party is required to settle as a result of
existing or enacted law, statute, ordinance, written or oral contract or by legal
construction under the doctrine of promissory estoppel.” This is a broader
concept than the IFAC-PSC’s reference to “legal enforceability.” The FASB staff
memo explains promissory estoppel as follows:

The courts have developed the doctrine of promissory estoppel as a
legal means for dealing with certain injustices that might otherwise
be done by business enterprises and others absent legislation,
regulation, or contractual relationships. The requirements for
promissory estoppel include:
(a) a promise that the promisor should foresee is likely to induce
reliance on the part of the promisee,
(b) significant reliance on the promise by the promisee, and
(c) injustice as a result of reliance if the promise is not enforced.

Promissory estoppel is fundamentally different from the traditional
type of contract law in that it protects reliance rather than
bargained exchanges. It is used to enforce promises that are not
supported by consideration and oral promises that ordinarily would
be required to be in writing. As a result, certain obligations can
now be accorded legal compulsion under the doctrine of
promissory estoppel.

FASAB staff notes the similarity between the concept of promissory estoppel and
the notion of constructive obligations, as presented by the IFAC-PSC, the FASB,
and other standard-setting authorities. Although most of those presentations have
been oriented to the obligations of business entities, staff believes that the same
principles apply to governments—perhaps more so, in the sense that the mission
of governments is to provide for the welfare of the citizenry, in contrast to the
objectives of private profit and wealth-maximization of businesses.

Staff believes, moreover, that the doctrine of promissory estoppel offers an
appropriate bridge or compromise between two different positions: (a) that federal
liabilities should be based on legally enforceable actions and (b) that government
commitments, whether technically legally enforceable or not, can give rise to
liabilities, especially when the commitments have been made public and potential 
recipients have relied upon them and have adjusted their actions accordingly.

Staff has not found clear support in the U.S. or international accounting literature 
for a notion that liabilities could be based purely on considerations of equity 
(fairness), custom, moral sanction, etc., except to the extent that those notions are 
subsumed in the notion of constructive obligation. Moreover, staff believes that 
such an equity or moral sanctions approach is insufficient alone and should be 
supported by some notion of legal enforceability, such as the notion of promissory 
estoppel just described.

Staff recommends that the Board not establish strict legal enforceability as an 
essential characteristic of a liability. Rather, staff would propose the Board 
develop a definition of “constructive obligation” that would include a broader 
notion of legal enforceability than references to contracts and legislation.

SUMMARY OF QUESTIONS FOR THE BOARD

Provision of Goods and Services to Suppliers

1. Does the Board agree that a federal entity can incur liabilities to suppliers for 
goods and services, rather than cash? [Discussion: page 3]

Provision of Goods and Services to the Citizenry

2. Does the Board regard any of the following points as, generally, better 
candidates for obligating events than the other points? Can any of these 
points be ruled out? [Discussion: pages 3 through 8]

   1. Effective date of legislation to establish the program.
   2. Appropriation of the necessary funds.
   3. Specific identification of the classes or groups of individuals or 
      entities who are eligible to receive the assets or services.
   4. Performance by individuals or entities making them eligible to 
      apply.
   5. Receipt of applications that meet eligibility requirements.
   6. Approval of applications.
      1) Approval of the transfer of assets (e.g., cash payment) or provision 
         of services to recipients.

Exchange vs. nonexchange transactions

[Discussion: pages 6 through 8]
3. Does the Board believe that, in an *exchange* transaction, a liability is incurred when the exchange occurs?

4. Does the Board believe that, in a *nonexchange* transaction, a liability is incurred when the settlement amount becomes due and payable (and not earlier)?

5. Does the Board wish to explore further the concept of *exchange-like* transactions?

**Legal vs. constructive obligations**

[Discussion: pages 8 through 12]

6. Does the Board agree that liabilities do NOT have to be legally enforceable, in the sense of being based on contracts and legislation?

7. Does the Board agree that liabilities should include certain kinds of constructive obligations, particularly those contemplated in the doctrine of promissory estoppel?

8. Does the Board agree that liabilities should NOT be based on notions of equity (fairness), custom, moral sanction, etc., except to the extent that those notions are subsumed in the notion of construction obligation underlying question 7?