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Liabilities and how to account for them:

an exploratory essay

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**ACCOUNTING
STANDARDS
BOARD**

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Foreword

The views presented in this paper are those of its author and not necessarily those of the Accounting Standards Board (ASB). There are no plans to develop proposals for an accounting standard directly from this paper.

The ASB is working closely with the International Accounting Standards Board (IASB) and other standard-setters to promote convergence of accounting standards. It is widely agreed that convergence promises considerable benefits. However, the greatest benefit will be obtained if the standards are not only similar but also of high quality, which requires that they be based on sound concepts. Even though the conceptual frameworks adopted by the ASB and other standard-setters have much in common, there are important differences in both wording and interpretation. It is also clear that the frameworks so far developed do not give clear answers to some fundamental issues. The importance of conceptual thinking on accounting is thus as great as it ever has been.

This paper is a contribution to this thinking about basic principles, and is directly relevant to a number of topics currently on standard-setters' agendas.

The most obvious example is revenue recognition, the subject of a Discussion Paper published by the ASB in 2001. In the main, this paper's conclusions are similar to those of the Discussion Paper, although its approach is slightly different. The IASB has now added to its agenda a project on revenue and related aspects of liabilities, and is undertaking work on the basic elements of financial statements in the conceptual frameworks. This paper highlights a difference in the definitions of liabilities used by different standard-setters and suggests that it may be important.

The IASB is also undertaking a review of concepts of accounting measurement. This paper suggests that the value to the business model provides a rationale for the use of entry values for liabilities; this seems to reinforce the case for the use of the value to the business model (and hence the widespread use of entry values) elsewhere in accounting.

The ASB would be interested to receive comments on any aspect of the paper: these will be taken account of in its future work. It would be helpful if comments were received by 31 March 2003.

“Once incurred, a liability continues as a liability of the entity until the entity settles it, or another event or circumstance discharges it or removes the entity’s responsibility to settle it.”

(FASB, Statement of Financial Accounting Concepts No. 6, paragraph 42)

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Introduction

- 1 Accounting is built on assets and liabilities. It is therefore fundamental that accountants should be clear on the identification of assets and liabilities and the amounts at which they should be reported. It is widely agreed that the reported performance of an enterprise should reflect changes in assets and liabilities, so doubt as to the amounts at which they should be reported directly affects the reporting of financial performance.
- 2 In the case of liabilities, accountants have often focused on the cost of settlement. Although in some cases this seems to lead to results that intuitively make sense, there are others where the result is, at least to some, disquieting.
- 3 For example, if an insurance company accepts a premium of £1,000 for a new policy, it presumably takes the view that it can probably settle any claims at less than that amount. Would it be right, then, to recognise on receipt of the premium a liability only for the likely cost of any claims, and a profit for the difference?
- 4 Section 1 of this paper explores the application of the value to the business model to such situations. It concludes that the value to the business model provides a rationale for stating liabilities in many circumstances at the amount received for taking them on – £1,000 in the insurance company example. For readers who are unfamiliar with, or would appreciate a refresher on, the value to the business model, a conventional description of it as it is usually explained by reference to assets is given in Appendix A.
- 5 The clearest application of the principle that liabilities are often most fairly stated at the amount received for taking them on is in connection with revenue recognition, which is the context of the discussion in Section 1. However, there are many other cases where accountants have tended to view liabilities exclusively in terms of their settlement and, arguably, have been led astray; a number of examples are reviewed in Section 2.
- 6 The following two sections of this paper consider arguments that have been put forward for measuring liabilities at the cost of settlement. Section 3 looks at the contention that the definition of a liability implies that its most relevant measure is the cost of settlement. Against this, it

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is pointed out that it does not seem to be necessary to refer to settlement in the definition of liabilities, and that, conceptually, issues of recognition and measurement are distinct from questions of definition.

- 7 Section 4 considers the assertion that, because the objective of financial statements is to assist users in forecasting future cash flows, financial statements are most useful if they measure assets and liabilities in terms of future cash flows. It suggests that it may be wise to be sceptical of this assertion.
- 8 Concluding comments are given where they seem most naturally to fit, which is at the end.

1 Contractual obligations and the value to the business model

- 9 If, as is widely believed to be the case, liabilities are mirror images of assets, it seems odd that a theory such as the value to the business model that provides valuable insights for the measurement concepts applicable to assets does not do the same for liabilities. However, even supporters of the value to the business model sometimes suggest this is so. For example, the Accounting Standards Board (ASB) has said:

“It is possible to select a value for liabilities in a manner analogous to the value to the business method (using the concept of ‘relief value’), but in practice this is an unnecessary complication. Because of the competitive nature of financial markets, it is unlikely that the exit price, entry price and present value of a loan will differ to an extent that requires a general rule for choosing between them.”¹

- 10 This seems a curious argument (and was omitted from the final version of the ASB’s *Statement of Principles for Financial Reporting*). It is a truism that choice of a measurement basis is a much less significant issue where items are traded in competitive financial markets: this is as true for assets as it is for liabilities. But not all liabilities are traded and in these cases the choice of measurement basis can very significantly affect reported financial performance and position.
- 11 To highlight the importance of this point, suppose a customer pays £100 on entering into a contract for the supply of goods or services. For simplicity we shall assume that £100 is the full price required, and that it is stated to be not refundable. As it is the supplier who has a liability, and this is a paper about liabilities, we shall primarily be concerned with the financial reporting by the supplier.
- 12 Normally the supplier will have entered into the contract in the belief that it can provide the goods or services, and so settle the liability, at a cost that is less than the amount received – let’s assume that the cost of such performance is £60. Some have argued² that, at least in some

1 *Exposure Draft of Statement of Principles for Financial Reporting* (1995), paragraph 5.27.

2 For example, Richard A Samuelson, *Accounting for Liabilities to Perform Services*, *Accounting Horizons* Vol. 7 No 3 pp. 32-45, 1993.

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circumstances, it would be right to record the business's obligation under the contract at £60, with the consequence that the balance of £40 would be credited to the profit and loss account at the time of receipt. The obligation of £60 would be released at the time of performance, so no net profit would be recognised in the accounting period in which performance takes place.

- 13 That is dramatically different from the way in which revenue is usually recognised, under which the company would keep a credit in its balance sheet – perhaps captioned 'deferred income' to acknowledge an unease that it fully merits the name liability – until performance occurs. Turnover (of £100) and profit (£40) would usually be recognised at the time performance occurs, matching the turnover with the costs (£60).
- 14 To determine which of these approaches is right, that is, whether the profit arises in the period in which payment is received or in the period in which performance occurs, we need to decide what is the right measure of the liability. And to decide that, we need to be reasonably clear about what the various possibilities are. When this has been achieved, we may, perhaps, have some chance of deciding which candidate to vote for, and also whether it would be right to settle for one option for all circumstances or whether, perhaps, different cases call for different answers.
- 15 As a first step, let us consider what it would cost the business to settle its liability: we shall call this 'settlement amount'.

Settlement amount

- 16 We have assumed that the contractual obligation can be settled, by performing, at a cost of £60. Note 'can be': although it is often assumed that a contract obliges a party to perform what it has promised, this is incorrect, both in law and in equity: there is always the alternative of seeking the customer's release from the contract.³

3 A further possibility is to transfer the liability to another party. But liabilities are more difficult to transfer than assets, as the consent of the creditor is usually required. Of course, a debtor can contract with a third party that it will perform the debtor's obligations, but, unless the creditor is a party to the arrangement, this does not settle the liability.

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- 17 Seeking the customer's release is, however, unlikely to be attractive in a typical case. If the business tells the customer it is going to renege on the contract, the customer will rightly expect – and generally be able to secure – at least the return of its money, even where it is stated to be 'non-refundable'. In our example, this will cost the supplier £100. Even the addition of interest may not provide adequate compensation, for if the customer had wanted interest it would have been better to place the money in a bank. What the customer wanted was the business to perform, and the supplier's failure to perform may cause loss of more than £100, and the customer may well be able to recover that loss from the supplier.
- 18 Whatever may be the precise amount of the ransom that the customer would have to be paid, the important point is that it is likely to be more than the cost of performing. The supplier is, therefore, likely to elect to perform rather than to seek release from the contract. This suggests that if there is a choice to be made between reporting the liability at the cost of performing and the cost of release, the cost of performing is likely to be more relevant: as long as seeking release is a remote possibility there is little relevance in reporting the liability at the cost of release. If the liability were recorded at £60 and the business were (for whatever reason) to seek release from its contractual obligation by paying rather more, it would report a loss: that would properly reflect the consequences of the renegotiation.
- 19 But things do not always go as planned. The business may have made a miscalculation and find that the cost of performing is much higher than it had assumed when it entered into the contract. The cost of performing may turn out to be so high that the most rational course is to seek release from the contract, that is, the cost of performing is now greater than the amount that would secure the customer's release. In this case, the liability should be reported at the latter amount.⁴

4 However upset the customer may be, it is reasonable to assume there is a price that is acceptable to secure release. However, before recording a liability at the amount payable on release, it would also be necessary to consider whether seeking release is a practicable course of action. It may not be, for example, if the business will be compelled to perform even at a very high cost to avoid damage to its commercial reputation: in such a case the liability would have to be recorded at the (higher) cost of performing.

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- 20 Another possibility is that it is the customer who has miscalculated and now seeks to end the contract. This makes things rather different. Because the contract specifies that the payment is non-refundable, the customer's bargaining position is rather weak. However, given that performance will cost the supplier £60, there should be a price at which the supplier will agree to pay to end the contract, and so relieve the obligation. Assuming none of the costs of performing have been incurred, or any costs that have been incurred can be recovered in another way, one would expect the supplier to agree to any price that is less than £60. So if the customer agrees to release the supplier from the contractual obligation for, say, £30, that appears to be the right amount at which to record the liability.
- 21 All of this rather laborious discussion may be summarised as follows. If liabilities are to be reported at settlement amount (and, of course, we have not agreed that they should be), there is a choice to be made between the cost of performing and the cost of obtaining release. Settlement amount will correspond to the lower of these two amounts, as performing or securing release will be the most rational course open to the supplier. Except where the customer is willing to grant release on favourable terms, the cost of performing will, in general, be less than the cost of release.

Consideration amount

- 22 A settlement amount is, of course, an 'exit value' notion. It seeks to answer the question 'what will it cost the business to get rid of this liability?'. The value to the business model points out that, in the case of assets, exit values are not the only possibility: often (indeed, typically) the value to the business model suggests that assets should be recorded at replacement cost – an entry value notion.
- 23 The rationale for this is that, in most cases, a business acquires an asset because the return that it will secure on its investment exceeds its cost. If deprived of the asset, the business would not lose those returns but would replace the asset. Hence the extent to which the business is better off as a result of its ownership of the asset is represented by the replacement cost of the asset. By providing a ceiling on the value of an asset, use of replacement cost ensures that

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- future ('unearned') returns are not anticipated, but are reflected only when they arise by use or disposal of the asset.
- 24 Another way of operating a business is to assume liabilities which the business is able to settle at a cost that is less than the consideration received for taking them on. This is the position of a business that takes payment at the time it enters into a contract, and so incurs a liability to its customer. If 'deprived of' that liability – for example, if the customer inexplicably renounced its rights under the contract – the business would be better off by the amount of the consideration received: it could now keep it and have no obligation whatsoever to the customer. Hence, arguably, at the time the contract is entered into, the consideration received typically represents the burden of the liability to the business. By providing a floor on the value of a liability, use of the consideration amount ensures that future ('unearned') returns are not anticipated, but are reflected only when they arise, on settlement of the liability.
- 25 To return to our example, the above argument suggests that there is a case for reporting the supplier's liability after payment is received at £100. However, we have already established that it is expected that the liability can be discharged for a lower amount, and that the customer cannot demand repayment. In what sense, then, is there a liability for £100? A liability of at least that amount exists from two perspectives.
- (i) The supplier is committed to provide goods or services that the contract values at £100; the customer also values them at that amount, or perhaps even more.
 - (ii) As we have seen, the supplier is not free to demand release from the obligation by paying less than £100 – except, of course, by performing. And it seems clearly right for financial statements to reflect performance when it occurs and not before.
- 26 So typically we would expect consideration received to be the relevant measure for a liability, just as replacement cost is for an asset. One satisfaction this conclusion affords is that of symmetry between the financial reporting by the customer and the supplier. The

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customer's balance sheet will (surely?) show an asset in respect of the claim on the supplier of £100: it would seem odd for the supplier's balance sheet to show the obligation at a different amount.

- 27 Are there circumstances when the amount of the consideration would not fairly reflect the supplier's liability? Yes, when things have gone wrong. When settlement amount (which we have seen should be taken as the lower of the cost of performance and securing the customer's release) is higher than the consideration received, it clearly represents the burden on the business and should be used. This will be the case only when the supplier's sums were significantly wrong: the cost of performance and the cost of release are now both higher than the consideration received, so the liability cannot be discharged for less than the consideration received. In this case the contract will clearly result in a loss. In the jargon of accountants, the contract has become onerous: IAS 37 and FRS 12 (both entitled *Provisions, Contingent Liabilities and Contingent Assets*) require measurement of such contracts at current settlement amount.⁵ It will be evident that onerous contractual liabilities precisely parallel impaired assets, which IAS 36, *Impairment of Assets* and FRS 11, *Impairment of Fixed Assets and Goodwill*, consistently with the value to the business model, require to be measured at recoverable amount.

Repricing

- 28 The value to the business model, and in particular the widespread use of entry values such as replacement cost, is often advocated in the context of an accounting system that seeks to reflect in financial statements the impact of changing prices. It is therefore disappointing for its adherents to be charged, as they sometimes are, with being defenders of historical cost accounting measures. This misunderstanding fails spectacularly to spot the real point: the problem with historical cost is that it is historical, not that it is a cost-based concept.

5 Current settlement amount implies that, where settlement will occur at a future time, the amount of the liability is discounted. Where liabilities (such as those under insurance policies) are measured at consideration amount, they will also in effect be discounted as the price for assuming a liability to be settled in the future will, assuming competitive markets, allow for the time value of money.

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- 29 To pre-empt these criticisms, it is necessary to emphasise that the perspective adopted here is entirely consistent with the use of current values.⁶ It is surely indefensible to assert that liabilities that are denominated in a foreign currency should be stated at anything other than the exchange rate prevailing on the balance sheet date.⁷ Equally, their measure should reflect other relevant economic circumstances such as interest rates and perhaps (though this is really tricky) the issuer's credit standing, all at the balance sheet date. If there is anything to be said to defend historical cost accounting in the context of modern trends in accounting thought, it is pragmatic rather than conceptual.
- 30 However, practical issues can be seen to loom large in the use of current values for liabilities arising under contracts for goods and services. To avoid a detour that is not central to the main aim of this paper, this question is discussed in Appendix B.

Summary

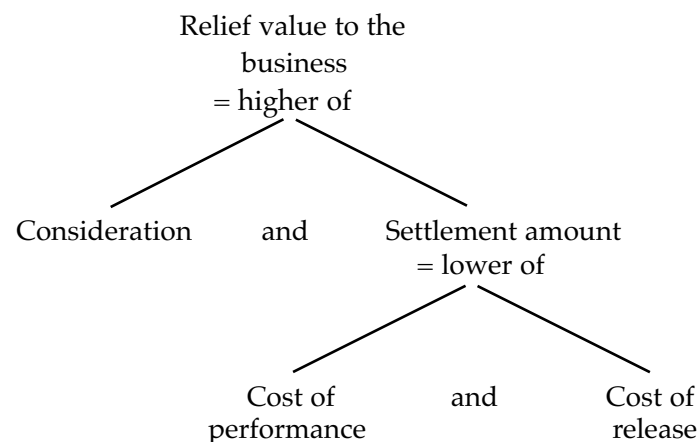
- 31 To recapitulate. The value to the business model holds that assets should be stated at replacement cost, unless replacement cost is not recoverable (recoverable amount is lower than replacement cost). In such a case the asset is said to be impaired and should be measured at recoverable amount, being the higher of value in use and net realisable value.
- 32 The above discussion shows that the value to the business model may similarly be applied to liabilities in respect of contractual obligations. Such liabilities should normally be stated at the consideration amount (strictly, *current* consideration amount), unless settlement would require payment of a higher amount (settlement amount is greater than consideration amount). In such a case the contract is said to be

6 I refrain from using the term 'fair values' as some who have appropriated that term insist that it can only mean exit values, with a zeal that is comparable to, but less understandable than, that of a company that holds a valuable trademark inveighing against those who imply that another company's product might be theirs.

7 A possible exception is that of a liability that forms part of a hedging strategy. However, if hedging strategies are to be reflected in financial statements, many would agree that this should be in a manner that does not result in liabilities being stated other than at current rates.

onerous, and the liability should be measured at settlement amount, being the lower of cost of performance and cost of securing the customer's release from the liability.⁸

- 33 Papers that review the value to the business model are generally regarded as incomplete unless they include a diagram showing the application of the model and the relationship between the various values. Appendix A presents such a diagram for assets: the corresponding diagram for liabilities is:



- 34 These conclusions support accounting for contractual liabilities in a manner consistent with prevailing practice. But the journey has been worthwhile for several reasons. First, it might bring cheer to those who support the value to the business model by showing that its supposed irrelevance to the measurement of liabilities is a fallacy. Secondly, it might cheer those who support the conclusions of the ASB's Discussion Paper *Revenue Recognition*⁹, as many of the conclusions of the above discussion are consistent with them, and if similar conclusions can be reached through somewhat different

8 An analysis of the application of the value to the business model to liabilities with a rather different emphasis is given by Richard Macve in *Accounting for liabilities: a comment on "deprival value" measurement for contract liabilities in revenue recognition*, LSE working paper (available at: <http://accfin.lse.ac.uk/staff/macve/>).

9 *Revenue Recognition*, ASB Discussion Paper, July 2001.

routes those conclusions seem more secure. Thirdly, it may be of interest to those who have criticised the conceptual frameworks adopted by several standard-setters, including the ASB's *Statement of Principles for Financial Reporting*. One of the points that such critics frequently find unsettling is the difficulty of fitting payments received in advance into these so-called 'balance sheet oriented' frameworks.¹⁰ The perspective given above provides a rationale for doing so.

- 35 But possibly the greatest significance of the above discussion is that it shows that it is wrong to suppose that liabilities should always be thought of in terms of their settlement. Accountants frequently go wrong when they suppose that because a situation will lead to no, or only a small, outflow of economic benefits then there must be no, or only a small, liability. On the contrary, in a typical case liabilities should be stated at an entry value. Settlement value is the exception – and that exception applies only when settlement value is greater.

10 For example, Ron Paterson, *Bring back deferred income* Accountancy, September 2001, p 108. However, in *Puzzle corner* Accountancy, September 2002, p. 76, Paterson reviews a condensed summary of the thesis of this paper and seems unconvinced.

2 A selection of liabilities

36 In the first section, issues concerning revenue recognition where payment is received in advance were considered. However, a theory that requires liabilities to be measured at no less than a current entry value has consequences for many other accounting issues. Some illustrations of these consequences are given in this section.

37 The examples have been grouped in three categories:

- (a) Further issues relating to revenue recognition
- (b) Derecognition
- (c) Debt/equity/ownership interest.

(a) *Further issues relating to revenue recognition*

Demand deposits/travellers cheques

38 It is not uncommon for businesses to accept money that can be claimed back by the customer for the same amount on demand, that is, without notice. Obvious examples are banks and (apart from the minor issue of commission and charges) businesses that issue travellers cheques. It is customary to record a liability in respect of such items. The correct measure of that liability is not, however, free from controversy.

39 Some believe that the correct way of measuring the liability is by discounting the future cash flows likely to arise. So if a customer deposits £100 with a bank, the bank would look at its records that show how long that deposit is likely to remain outstanding and discount it – say to £95 – and presumably go out and spend the ‘profit’ of £5.

40 However, if the measurement of a liability should normally be, as this paper contends, at entry values, it is clear that a liability of £100 should be reported. This is not to deny the probability that the customer will, for whatever reason, leave the money with the bank for a period; but it is to insist that the benefit of that is recognised over that period, and not at the time the deposit is made.

41 The position is that the bank hopes, quite rationally, that it will be able to satisfy its liability for less than £100. But at the balance sheet date that is the amount of its liability. It seems odd that it could ever be seriously suggested that where a customer has the right to demand immediate settlement of a liability in full, the liability could be fairly stated at a lower amount.

Vouchers

42 Suppose that a retailer normally purchases an item for £2 and sells it for £5. The retailer gives away a number of vouchers that entitle the customer to £1 off: that is, the customer can tender £4 plus the voucher to obtain one of these items. Is there a liability?

43 The answer seems to be ‘no’, because a commitment to enter into a sale at a lower price than might be obtainable otherwise is not an obligation to transfer economic resources. Of course, if the voucher enabled the customer to pay less than the retailer’s costs there would be a liability (or perhaps an impairment of stock) but this does not apply in the present example.

44 Now let’s change just one fact: instead of giving the vouchers away, the retailer sells them for 50p each. Is there a liability?

45 We might conclude that the facts at the balance sheet date are just the same as where the voucher was given away. All that the retailer has to do is to accept a sale at £4, which will still result in a profit, when the vouchers are tendered. If we rely wholly on this point, we would say that the fact that the vouchers have been sold rather than given away makes no difference, and so there is no liability. However, this has the disquieting result that the sale proceeds of the vouchers are included in profits of the period in which they are sold, which seems to permit today’s profits to be inflated at the expense of tomorrow’s almost without limit!

46 However, if the liability is quantified by reference to entry costs rather than exit values, it might be concluded that the retailer has received 50p in return for entering into a contractual relationship with its customers. Accordingly, the liability must be stated at no less than 50p

until it is satisfied.

- 47 Similar considerations would apply wherever a business sells vouchers or tokens that entitle customers to goods or services in the future. Several examples come to mind: gift vouchers, trading stamps, phone cards and so forth.

(b) Derecognition

Sale and leasebacks

- 48 Current proposals to abolish the distinction between finance and operating leases, whilst welcome, give rise to a number of troubling issues. One of these is the treatment of sale and leasebacks. In such a transaction the seller/lessee transfers legal title to an asset and simultaneously enters into a lease under which the right to use the asset is retained. Under current accounting standards, this transaction is reported (roughly) as a secured borrowing if the lease is a finance lease and otherwise as a sale – although with some uneasy rules about whether the ‘profit’ arising on the ‘sale’ should be deferred and, if so, over which period it should be fed into income.
- 49 The G4+1 paper that sets out the most recent proposals in this area¹¹ cannot rely on the finance/operating lease distinction, as it (quite rightly) proposes abolishing it. Instead it proposes that sale and leasebacks are regarded as partial sales. The general idea is that if the asset will last ten years and the leaseback is for four years, the seller/lessee should recognise approximately 6/10 of the ‘profit’ arising on the sale.
- 50 To the extent that a profit is recognised, the existence of a liability is denied. If £1,000 is received for entering into the sale/leaseback transaction and profit of £600 is recognised, the implication is that only £400 represents a liability. The G4+1 proposals regard only the payments required by the lease (at their present value) as a liability. If there is a residual value guarantee, that would be included at its fair

value, but this is not likely to be large if the amount guaranteed is reasonable. This, however, is not the only possible perspective.

- 51 On the date of the sale and leaseback the seller/lessee receives a sum of money (£1,000 was assumed above) and promises to do things in the future – pay rentals during the lease and transfer access to the property (at the *end* of the lease). Of course, the seller/lessee also transfers legal title to the property at the time of the sale and leaseback, but this does not necessarily inspire accounting: legal title has not been seen as a safe guide to whether an asset should be recorded ever since hire purchase transactions were first reflected in accounts as purchases on deferred terms.
- 52 It is arguable from this perspective that the correct quantification of the liability of the seller/lessee’s contractual obligations – to pay rentals and hand over the property in (say) four years’ time – is what has been received for entering into the contract. Thus, assuming the transaction is on arms’ length terms, the liability will correspond to the ‘sale’ proceeds. This points to the conclusion that many sale/leasebacks should be accounted for similarly to secured borrowings – which is how many debt rating agencies view them already.
- 53 Now this may be going a bit far. After all, if the sale and leaseback is straightforward, the seller has no interest in the property after the end of the lease: the purchaser, not the lessee, is exposed to changes in the value of the property. Come the fourth anniversary, the lessee can hand over the key and, even if the property is worthless, walk away: the purchaser has no further claim on the lessee. So perhaps no great harm is done if only the obligation to pay rentals is shown as a liability, that is, we allow the transfer of title to count as satisfaction of part of the lessee’s contractual promises.
- 54 But if the lease is not straightforward (and, in practice, many are not) some care is needed. In particular, if under the agreement the lessee undertakes to ensure that the purchaser/lessor will be fully paid out, perhaps by writing a put option or guaranteeing the residual value of the property, accounting for the full proceeds received as a liability – that is, at its entry value – seems entirely reasonable. It certainly seems a more satisfactory result than that proposed by the G4+1, which can

11 *Leases: Implementation of a New Approach*, ASB Discussion Paper, December 1999.

easily have the result that a transaction under which the purchaser/lessor is, in reality, relying entirely on the seller/lessee's credit standing to recover the sale proceeds is not shown on the seller/lessee's balance sheet.¹²

Derecognition of financial instruments

- 55 A surprisingly absorbing passage of the consultation document on financial instruments issued by the Joint Working Group (JWG) is that dealing with the subject of derecognition of financial assets. The essential issue is similar to that of sale/leasebacks. It is whether, and to what extent, a purported sale of financial assets should be reported as a sale or as a financing – that is, does the transferor have a liability? One of the more intriguing proposals is:

“If a transfer...results in the transferor having an obligation that could or will involve it repaying transfer consideration, the transfer is a loan to the extent of that obligation.”¹³

- 56 The JWG appears not to be entirely comfortable with this proposal, in particular with the implication that it results in transferees reporting liabilities at amounts that will often bear a closer relationship to the amount the transferee has received than the amount it is likely to pay. But the JWG proposal may well be right, because liabilities are (as is the central message of this paper) typically quantified at entry rather than exit values.

12 Further analysis of sale and leasebacks seems to be necessary. It is possible that the key to this issue (and other issues of derecognition) is a coherent account of the principles of offset. In other words, the question is whether (or more precisely in what circumstances) the lessee's interest in the property beyond the term of the lease should be offset against his liability to the purchaser/lessor. It seems unlikely that the material on offset in IAS 32, *Financial Instruments: Disclosure and Presentation* will be adequate for this task.

13 Financial Instruments Joint Working Group of standard setters, *Financial Instruments and Similar Items* Basis for conclusions, paragraph 3.63(d) (page 199).

(c) Debt/equity/ownership interest

- 57 There follow a few examples of issues arising in the troublesome distinction between debt, equity and ownership interest. A discussion of the interesting case of convertible debt that will, in all probability, be converted to equity, appears in Section 3 below.

Contingent consideration

- 58 Sometimes a business acquires another on terms that some or all of the consideration is to be deferred. Such consideration may be contingent, typically being determined by reference to the financial performance of the acquired business. More fundamentally, the acquiring business may have the option of paying such contingent consideration either in shares or in cash.
- 59 Requirements for accounting for contingent consideration are set out in FRS 7, *Fair Values in Acquisition Accounting*. Unfortunately that standard focuses on the method by which the acquirer will or may settle its obligation to the vendor: if it may be required to settle in cash, the acquirer reports its obligation to pay consideration as a liability, but if it has the option to settle in shares, the obligation is reported as part of shareholders' funds.
- 60 It is clear that the thought process that inspires this requirement sees liabilities solely in terms of how they may or will be settled – exit values. The principle that entry values are generally relevant suggests that the obligation for future consideration is, in fact, a liability. The acquirer has clearly received the interest in the acquired business, and is obliged to pay for it. The liability should be reported as a liability, not as part of shareholders' funds. The fact that it is possible, likely or probable that it may be satisfied by issuing shares rather than by a transfer of cash or other resources is interesting (probably interesting enough to merit disclosure) but does not negate the existence of a liability until that liability is discharged.
- 61 It should be noted that this analysis does not rely on the existence of an explicit cash alternative. It will be recalled that in the example discussed in Section 1 above, the contract specified that the customer's payment of

£100 was not refundable. Nonetheless it was concluded that, in normal circumstances, £100 was the correct quantum of the customer's claim on the supplier until the liability was satisfied. Similarly, even if the sale agreement specifies that the consideration will be paid in shares, there is an obligation to the vendor that will potentially require the transfer of economic benefits, and a liability should be reported.

Capital instruments: the 'shares to a value of' conundrum

- 62 The false step taken by FRS 7 has spawned other errors. Some businesses have issued instruments that enable the issuer to satisfy interest payments by issuing shares rather than by paying cash. The number of shares that may be issued is calculated so that their market value is a predetermined amount: it is convenient to refer to such an arrangement as a 'shares-to-the-value-of' feature. Building on the logic established by FRS 7, it has been argued that such instruments may legitimately be reported within shareholders' funds rather than as liabilities.
- 63 This result has struck many as rather odd: the instruments look, feel and smell like liabilities. Sharing this perception, standard-setters have proposed or required that such instruments are reported as liabilities. Their conclusion is that an obligation to issue shares to a specified value shall be regarded as a liability.¹⁴
- 64 This certainly must be the right answer. However, it is regrettable that the requirement has been seen as a rule, rather than a principle. The conceptual underpinning has been absent. Unless the conceptual basis for classifying these instruments as liabilities is properly

14 Requirements to this effect were introduced to International Accounting Standards in IAS 39, *Financial Instruments; Recognition and Measurement*, which was approved by IASC in December 1998 (paragraph 11). The FASB published an exposure draft with a similar proposal in 2000 entitled *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both*, together with a related proposal to amend FASB Concepts Statement No 6. The FASB is reported to have decided to proceed with this proposal. In the UK, the ASB's Urgent Issues Task Force issued Abstract 33, *Obligations in Capital Instruments* in 2002. This requires that, where the issuer has discretion to settle an obligation either by transferring economic benefits or by issuing shares, the obligation shall, subject to certain exceptions, be reported as a liability if there is a shares-to-the-value-of feature.

understood, there is a risk of confusion on the all-important distinction between liabilities and equity.

- 65 A troubling aspect of the requirement is that it is difficult to reconcile with the general agreement that an obligation to issue shares (such as arises under a share option or warrant) is not a liability, as there is no obligation to transfer economic benefits. If an obligation to do X amount of something is not an obligation to transfer economic benefits, then, logically, neither is an obligation to do any multiple of X. Equally, an obligation to do any amount of X determined by whatever formula may be specified cannot be an obligation to transfer economic benefits, and so cannot be a liability. So why is a share warrant not a liability while an undertaking to issue shares to a specified value is?
- 66 In an attempt to get closer to the bottom of the issue, let us consider why warrants do not represent liabilities. A company that has warrants in issue is clearly obliged to do something: it must issue shares if the warrant holder tenders the exercise price and complies with any other conditions contained in the warrant. But such an obligation is not an obligation to *transfer economic benefits*: the newly issued shares never were assets of the company and thus their issue does not represent a transfer of economic benefits. A typical warrant represents merely an interest in the ownership of the company: it has value if the company prospers, but, if the company fails, the warrant holder has no claim against the company and his position is little different from that of a shareholder.
- 67 In contrast, where an instrument is issued with a shares-to-the-value-of feature, the relationship between the company and the investor is governed by a contract under which the company is bound to perform. That obligation ensures that the investor will get back the amount invested, plus a return.
- 68 The issuer has received cash on issue of the instrument, and generally will have entered into obligations to transfer economic benefits in return. The company cannot repudiate the investor's claim, but must ensure it is satisfied. It is interesting that the issuer may elect to satisfy its obligation by issuing shares, but not interesting enough to justify not recording the liability until such time as it is settled. And the

correct measure for that liability is its current entry value, not its exit value. Again it deserves emphasis that this analysis does not depend on the existence of an explicit cash alternative: there may be none.¹⁵

Share-based payment: the credit before vesting date

69 The G4+1 paper on share-based payment¹⁶ proposes that, over the period in which an employee performs services, an accrual should be made to reflect the purchase of those services in return for the promise of share options. The cost would be recognised as employee remuneration and the credit would be reported as part of shareholders' funds. The paper recognises that initially the accrual will be an estimate: it proposes that its amount should be adjusted so that it represents the fair value at vesting date and that changes in the estimate should be reported in the profit and loss account.

15 If it is right that a shares-to-the-value-of feature is a symptom of a liability rather than a defining characteristic, it must, at least in principle, be possible to imagine an instrument with such a feature that is not a liability. Consider, for example, a special class of share, which enjoys absolutely no rights except that the holder can elect to pay a specified sum within a defined period, on which event the shares will convert into ordinary shares. It seems evident that such shares would not represent a liability, and that it is not relevant whether conversion would be into a specified number or a specified value of shares. The essential point is that there is no contractual relationship between the investor and the company: the investor has explicitly accepted rights that are limited to those set out in the Articles, and these do not include any provision for repayment.

Some might be troubled by this suggestion as they, rightly, point out that these special shares would not have the characteristics of equity—they would not change in value in line with the company's share price or, to put it another way, they are not truly residual. The answer to this problem may be to abandon the stark dichotomy in most standard-setters' frameworks between debt and equity, and instead use a wider vocabulary, which allows room for those instruments that neither contain an obligation to transfer economic benefits nor represent a residual interest. A suitable structure might be to contrast liabilities with ownership interest rather than equity, and in turn analyse ownership interest into equity and non-equity elements. (An attempt along these lines is FRS 4, *Capital Instruments*.) A similar classification is proposed in *Evaluation of the FASB's Proposed Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both* by Stephen G Ryan, Chair; Robert H Herz; Teresa E Iannaconi; Lauren A Maines; Krishna Palepu; Catherine M Schrand; Douglas J Skinner; Linda Vincent in *Accounting Horizons* Vol 15 No 4 pp 387-400.

16 Contained in *Share-based Payment*, ASB Discussion Paper, July 2000.

70 There is a serious conceptual problem here: reporting a gain or loss that does not represent a change in an asset or liability during the period, but a change in an amount previously reported in shareholders' funds, cannot be reconciled to the standard-setters' frameworks. Although this issue may appear unimportant, cracks in the conceptual framework are worrying because they suggest that a false step has been taken, and the false trail may be followed by analogy on issues that crop up in the future.¹⁷

71 The false step is reporting the credit that arises other than as a liability. In turn this seems to stem from a focus on how the obligation will be settled, rather than on whether it is, at the balance sheet date, an obligation to transfer economic benefits. At any balance sheet date after services have been received and before vesting date, the entity has received consideration under a contract for employee services and is therefore obliged to pay for them. That this obligation will ultimately be settled by the issue of equity instruments does not negate the fact that, at the balance sheet date, the obligation is a liability: the company is not free unilaterally to revoke the share scheme without offering alternative compensation.

72 Thus amounts accrued in respect of past services before vesting date represent a liability and are appropriately measured initially at the value of the consideration received. If they were reported as a liability, there would, of course, be no conceptual oddity in reporting changes in that liability as gains and losses.

73 This leads to the issue of how such changes should be reported in the statement of financial performance. It is clear that the original accrual represents the receipt of employee services and may appropriately be described as the cost of employee remuneration. But changes in that accrual do not change the value of services received: they do not relate directly to the employees' services, but rather to the manner in which they are paid. As such, changes in the accrued amount might be reported within 'financing' or, possibly, elsewhere in the performance

17 The problem highlighted here could alternatively be avoided by specifying that the cost of share options is to be fixed at grant date. An evaluation of the respective merits of grant date and vesting date measurement is not attempted here: the discussion simply addresses how a particular issue arising under vesting date measurement could be approached in a conceptually satisfactory manner.

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statement. They should no more be described as ‘employee remuneration’ than should translation differences on an accrued cash bonus that is payable in a foreign currency.¹⁸

18 A similar distinction is made in FRS 17, *Retirement Benefits* between the service cost which represents the value of pensions earned by employees in the period and actuarial gains and losses: these two quite separate items are to be reported separately.

3 The definition of liabilities and its implications for measurement

74 It is sometimes argued that it follows from the definition of a liability that they are required to be valued at exit prices. For example, the Joint Working Group of Standard Setters (JWG) has stated:

“...a ‘liability’ is defined as a present obligation that is expected to require future outflows of enterprise resources. The exit price of a financial liability is the market’s estimate of the current value of the future resources that the enterprise will have to sacrifice to be relieved of that liability.”¹⁹

75 Superficially convincing, this argument may, perhaps, omit some important steps. Presumably (although this is not stated) the JWG is referring to the definition contained in the IASB’s *Framework for the Preparation and Presentation of Financial Statements*.

76 The definitions of liabilities from several standard-setters’ conceptual frameworks (or equivalent document) are set out in the table on the next page.

19 Financial Instruments Joint Working Group of standard setters, *Financial Instruments and Similar Items* Basis for Conclusions, paragraph 4.2 (page 212). It should be emphasised that the JWG’s exit price conclusion applies only to financial instruments: the JWG did not address the measurement of non-financial items. A similar line of argument is taken by Samuelson *op cit*.

Definitions of liabilities

International Accounting Standards Board: Framework for the Preparation and Presentation of Financial Statements	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(b))
Financial Accounting Standards Board (US): Statement of Financial Accounting Concepts No. 6 Elements of Financial Statements	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) [footnote references omitted]
Australian Accounting Research Foundation: Statement of Accounting Concepts 4 Definition and Recognition of the Elements of Financial Statements	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)
New Zealand Society of Accountants: Statement of Concepts for General Purpose Financial Reporting	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)
Canadian Institute of Chartered Accountants: Handbook, Section 1000, Financial Statement Concepts	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)
UK Accounting Standards Board: Statement of Principles for Financial Reporting.	Liabilities are obligations of an entity to transfer economic benefits as a result of past transactions or events. (Chapter 4, paragraph 4.23)

- 77 Certainly the IASB definition requires that an outflow of economic benefits is expected; similarly the US definition requires probable future sacrifices of economic benefits. The Australian and New Zealand definitions require that there is a present obligation to make a future sacrifice; but because they equate a liability with a future sacrifice, it could appear that, if it can be established that no sacrifice will arise, the present obligation does not matter, and can be ignored. The Canadian definition requires that a transfer of assets (or something similar) *may* occur but leaves open the possibility that it may not.
- 78 The UK definition, in contrast to the others, is clear on this point. It is necessary for there to be a present obligation to transfer economic benefits; but the manner in which that liability may be settled is irrelevant to the existence of a liability. And this is surely right.
- 79 For example, suppose a company has in issue convertible debt that matures shortly after the end of an accounting period. The conversion terms and share price are such that conversion rather than redemption is, at the balance sheet date, very favourable to the holders, and in due course, and before the financial statements are finalised, the holders elect to convert. Conversion requires the company to issue ordinary shares: it is generally accepted that when a company issues ordinary shares it makes no transfer of economic benefits. Accordingly, applying the IASB and US definitions of liabilities, it might be argued that there is no liability to report.
- 80 It would be a radical departure from present practice – and from the reporting required by both IASB and US standards – not to report a liability for the soon-to-be-converted debt in the balance sheet. Conversion would be seen as a non-adjusting post balance sheet event. This seems to be necessary: at the balance sheet date the company owed its debt holders money. The company may have felt secure that it would not, in the event, be required to give them their money back, and that confidence may well be justified. But it does not follow that, at the balance sheet date, there was no liability. For a liability to exist there must be an obligation to transfer economic benefits; but whether that transfer is likely or not to take place is

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irrelevant.²⁰ So the JWG's argument that measurement of liabilities at exit values is required by the definition of liabilities appears to rest on a flawed definition.

81 There is a further point. The ASB has noted:

*"[It does not] follow that the characteristics qualifying an item as an element (or a recognised element) in the financial statements will be those that determine the basis of measurement. For example...the definition of an asset is based on the notion of future economic benefits, but it does not follow that the carrying value of assets should necessarily reflect a measurement of those future benefits."*²¹

82 Quite so, and this applies equally to liabilities. Definition of elements, their recognition and measurement are distinct issues and merit separate attention. Thus even if the definition of a liability should refer explicitly to future settlement, it might nonetheless be right for liabilities to be recognised in financial statements at amounts that are not explicitly based on the future cost of settlement.

20 Equally irrelevant here is whether or not 'split accounting' is used for the convertible debt, under which the debt and equity components are accounted for separately. Even under 'split accounting' the amount of the debt that represents a liability is reported as such, irrespective of the probability of conversion.

21 *Exposure Draft of Statement of Principles for Financial Reporting* (1995), paragraph 3.3. Although a corresponding statement does not appear in the final version of the ASB's *Statement of Principles for Financial Reporting* (December 1999), it is implicit in the *Statement's* recognition that current replacement cost will be the current value of an asset in most cases (paragraph 6.7).

4 The objective of financial statements and users' needs

83 If it makes a difference (and I hope it does) whether liabilities are viewed from an entry ('consideration') or exit ('settlement') perspective, it is tempting to suppose that the latter must be the more relevant. ('It is tempting' is, of course, code for 'understandable, but wrong'.)

84 The way to fall into this trap is to start from (relatively uncontroversial) fundamentals. According to the IASB's *Framework for the Preparation and Presentation of Financial Statements* the objective of financial statements is:

*"to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions."*²²

85 It goes on to note:

*"The economic decisions that are taken by users of financial statements require an evaluation of the ability of an enterprise to generate cash and cash equivalents and of the timing and certainty of their generation."*²³

86 From this starting point, it is often concluded that the most relevant basis of measurement for any asset or liability is one that reflects the cash flows associated with it. Some suggest that exit values are required, on the grounds that selling prices represent the market's assessment of the amount, timing and certainty of future cash flows associated with the asset or liability.

87 There is a non sequitur here. It is quite reasonable to set as the objective of financial statements the provision of information that is *useful* in making an assessment of future cash flows. It is quite another to assert that balance sheets should consist of *representations* of future cash flows. Part of the problem may be a difference in understanding as to who is responsible for making the evaluation referred to in the

22 *Framework*, paragraph 12.

23 Paragraph 15.

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second quotation from the IASB's *Framework* above: is it the accountant, or is it the user?²⁴

- 88 This is only one corner of a debate that, in various guises, underlies many current accounting controversies, and arises in the context of assets just as much as (if not more than) in the context of liabilities. It would be exhausting to give an exhaustive treatment of it here, but this essay would be incomplete without a discussion, however cursory, of the issue. Inevitably a cursory discussion will oversimplify, but it will highlight the main points.

Two schools of thought

- 89 In the blue²⁵ corner stand those who would have financial statements reflect all future cash flows to the extent, at least, that they can be identified and measured with reasonable precision. These would then be reduced to present value, using market rates to reflect the effects of timing and uncertainty. The cleverer we get at doing this, the closer the total of the balance sheet should approximate to the market value of the company. Ultimately it should be possible, with the aid of the share price from the morning newspaper, to decide from the balance sheet whether the shares should be bought or sold. On this view, taken to its extreme, no additional information is provided by the profit and loss account; all one needs is the balance sheet and a note of the number of shares in issue.²⁶
- 90 In the red corner stand a more modest bunch. They are unconcerned at the discrepancy between the book value of a company's assets and its market value. They are not persuaded that an accounting technique that narrows the gap is to be favoured simply on those

24 Although there is some ambiguity on this point in the extract quoted, a careful reading of the IASB's *Framework* (and the corresponding documents issued by other standard-setters) shows that it is intended that the evaluation is that of the user.

25 The terms 'blue' and 'red' in this passage have been used arbitrarily, and no political or other connotation is intended.

26 Of course, some recognise that this is unattainable in practice, but nonetheless see it as an ideal to which financial reporting should aspire, and so favour the use of exit values wherever practicable.

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grounds. The vision of the reds is more limited than that of the blues. They believe financial reporting does its job if it provides useful information to investors, but do not aspire to reforms that enable buy/hold/sell decisions to be read instantly off the face of financial statements. But if the reds are less optimistic than the blues, they are not necessarily less cheerful. In their view, financial reporting can provide a rich set of information that goes a long way towards meeting a wide range of users' reasonable demands. If this can be achieved, the reds believe that the contribution of financial reporting to economic prosperity will be very significant.

What do investors need?

- 91 If the blues are right, all any investor needs to know is the present value of the company: if it is more than the current market price the share should be bought; if less it should be sold. Given perfect knowledge (and an ability to respond to it before the market) the prospect of unlimited wealth beckons.
- 92 Unfortunately, but not surprisingly, this vision is unlikely to be realised. One reason is that it is impossible to imagine how the true value of a company could be calculated with reasonable degrees of credibility and objectivity. It also reflects a misunderstanding of the information needs of professional investors.
- 93 Investors need to assess not only the value of a company but also the risks and opportunities that an investment in the company will bring. It is easy to imagine an investor who identifies an investment that appears to be undervalued, but nonetheless declines to invest because the associated risks are not appropriate for the relevant portfolio, having regard to factors such as the overall objectives and strategy for the portfolio and other investments held.
- 94 The risks that investors need to assess include not only exposure to the general economic climate (interest rates, economic growth and suchlike) but also more specific factors, such as the quality of the company's management. Investors need information on how the company's economic resources have been managed and how those resources are converted into earnings. In order to assess risks,

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investors also need information on the company's financial and operational flexibility.

- 95 The Association of Investment Management and Research has made the point:

*"The starting point in analysis of a specific company is to look at the record. How has that management and company performed in the past and what is its status at present? Answers to these questions are found in the company's financial statements. Past performance is evaluated in terms of profitability and liquidity, current status in terms of financial position. Financial statements are valuable to the extent that they provide useful and comprehensive information that allow financial analysts to evaluate how well management has done with the resources at its command."*²⁷

- 96 Professional analysts repeatedly make the point that they do not want financial reporting to value the company (or any part of it): that is *their* job. What they want financial reporting to do is to provide information that will assist them to take rational investment decisions.²⁸

- 97 But the information that can be contained in financial statements can provide only a starting point. This is because, by their nature, financial statements provide a historical perspective: they are

27 *Financial Reporting in the 1990s and Beyond*, 1993.

28 It is instructive to compare the simplistic view that users need to know the value of the company with the (now largely discredited) view that the goal of financial reporting should be the presentation of a 'useful' income measure. Pursuing this well-intentioned aim, accountants assumed the responsibility for deciding which items of income are really relevant to users and which will merely confuse the poor dears. If a gain or (more often) a loss was considered to be 'noise' it might be reported, for example, as an extraordinary item. Or 'irrelevant' bad news such as a crashing loss in the pension fund was sliced into an arbitrary number of pieces each reported in a single year (sometimes long after the loss arose) in the hope that each piece would be small enough to escape notice. Thankfully, recent developments in financial reporting involve the gradual abandonment of these and similar stratagems. In the reporting of income, at least, there is a clear trend towards 'telling it like it is', and assisting users to make their own assessments of the significance of the gains and losses that the accountant tries to present as neutrally and fairly as possible; the current buzzword is 'transparency'. But in the context of the balance sheet, accountants are still tempted to believe they can best serve users by usurping their role.

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concerned with reporting what has happened in the past. Rational investment decisions, in contrast, require an assessment of what will happen in the future. Information on past events is clearly useful for such an assessment, but it should not be confused with it. The AIMR report referred to above states:

"Financial reporting and financial analysis cross paths because, ultimately, economic value (wealth) is created by expectations of future inflows of economic benefits, primarily in the form of or the equivalent of cash flows. The amounts and timing of future cash flows are in most cases uncertain to various degrees. It is the function of analysis to deal rationally with that uncertainty. It is the function of financial reporting to provide data useful to analysts making assessments of an enterprise's future cash flows and its value today."

- 98 It may therefore be suggested that the reds have a strong case for limiting their ambitions to reporting essentially historical information and thereby provide a foundation for financial analysis. If financial reporting were to aspire to provide a valuation of the firm or part of it, the data and its analysis would become hopelessly confused.

- 99 It remains to indicate two important respects in which it might be argued that the general use of entry rather than exit values will tend to meet more completely the reds' aspirations for financial reporting.

Aggregation

- 100 One of the problems of the general use of exit values is that it requires a view to be taken of the manner in which an asset or a liability will be used, disposed of or discharged. For many assets, immediate sale on an individual basis will not be an economically rational course: this is because they contribute to cash flows jointly with other assets. A shopkeeper would not usually contemplate the separate sale of his shop fittings (unless they were obsolete). If exit values are to be used, and it is agreed that scrap values are irrelevant, a value reflecting the whole of the business must be used. Although such a value could be allocated to individual assets, and any residual reported as goodwill, such an allocation is inevitably arbitrary, and the resulting values of limited use.

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- 101 In contrast, entry values reflect the way in which the business actually acquires assets (and, of course, liabilities). Whilst the sale value of shop fittings as individual assets has little relevance (as long as the business is a going concern), it is obviously relevant to ask what it would cost for the business to buy them. Thus the general use of entry values leads naturally to disaggregation. The degree of this disaggregation is not arbitrary but corresponds to transactions that are relevant to the business, and the values used reflect the prices of those transactions. Moreover, the returns relative to a current replacement cost provide a powerful insight into the economic efficiency of the firm.

Objectivity

- 102 The blues face another sort of problem. The economic values of assets and liabilities reflect all associated future cash flows. All of these are uncertain, but some are the subject of contractual promises whilst others are not. For example, an insurance company may be able to sell a policy to another insurer: if so, the value will reflect the income that is expected to be derived from future renewals, even though the policyholder is under no obligation to renew.²⁹ How many renewals is the accountant to take account of? And if future renewals are to be reflected, why not other events after the balance sheet date – for example, events suggesting a change in the probability of future claims? If there is value in reporting the value of the business in financial statements, should that not be updated to the latest date practicable? If adverse publicity reduces the chance of the company winning future contracts – should that also be reflected in the financial statements?³⁰
- 103 In contrast, an entry value perspective is founded on a careful analysis of the position that existed at the balance sheet date. It is not

29 Even if there are constraints on selling policies, the insurance company as a whole could be sold, in which case its economic value will reflect future renewals.

30 It has been suggested that the daily changes in the value of a company's equity far exceed what could be attributed to events internal to the company, but reflect changes in the market's perception of risks and circumstances that are external to the company. To the extent this is the case, financial statements that purport to report the company's financial position and performance cannot hope to encapsulate all the information that is relevant to an assessment of the company's value.

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- an economic analysis, but it provides a perspective that is useful for those who wish to place an economic value on the firm.
- 104 In particular, an entry value perspective reflects liabilities at the amount of the obligation that existed at the end of the year.³¹ It is interesting to know that a liability may be settled for less than the amount at which it is stated, probably interesting enough to warrant disclosure. But it seems that in general it will be more helpful to acknowledge the existence of large unsettled liabilities, rather than anticipate their settlement.

31 A similar example of a close focus on position at the balance sheet date is the requirement of FRS 4, *Capital Instruments* that the maturity of debt be assessed (with limited exceptions) without regard to facilities that permit it to be refinanced (paragraphs 34 and 35). Thus debt payable one month after the balance sheet date is shown as such even if it has subsequently been refinanced. It is regrettable that this example was not followed by IASC in IAS 1, *Presentation of Financial Statements* (revised 1997), paragraph 63, which seems to be inspired by a different set of standards, and commendable that the IASB has, as part of its Improvements project, proposed moving towards the precedent established by FRS 4.

Concluding comments

- 105 This paper has argued that it is a mistake to see liabilities purely in terms of a settlement value, but that an entry value perspective should often – indeed typically – be used. The most obvious consequence of this point is in connection with the recognition of revenue on contracts where consideration is received in advance; however, enough has been said to illustrate that it is relevant to a number of other accounting issues.
- 106 Possibly some will judge the thrust of this paper as conservative, whilst others will see it as radical; perhaps each camp will split between those who approve and those who disapprove of its conservatism or radicalism, as the case may be. However, the fundamental premises of standard-setters’ conceptual frameworks are not touched, or even questioned, by this essay. The suggestion is that the frameworks are incomplete rather than wrong, and an attempt has been made to sketch a direction for their completion.³²
- 107 If viewing liabilities from an entry perspective solves some problems, it must be admitted that it creates others. In particular there is the question of identification of a liability. To determine whether a liability exists in a particular situation accountants have tended to ask whether the business will be compelled to transfer economic benefits to settle it. However, the thrust of this paper suggests that this will not always be enough. Clearly if the business cannot avoid a transfer then there is a liability (provided, of course, that the other parts of the definition are met) but the converse does not hold. It may be that there is a liability – a present obligation to transfer economic benefits – that is likely, probable or certain to be settled by some means other than the transfer of economic benefits: if so, the business has a liability.
- 108 Financial statements cannot hope faithfully to portray economic resources and claims – assets and liabilities – unless all liabilities are

included at relevant amounts. If settlement amount is not always the most relevant amount the challenge is, perhaps, more daunting than it would otherwise be. To secure the prizes to be gained from high quality financial reporting we need to be clear about both when a liability exists and how it should be measured. This paper has not attempted to give a comprehensive answer to these questions, but it may have shone a light down an alley to help judge whether it seems to merit exploring.

32 From the perspective of the Kuhnian view of the history of ideas, this point may be expressed by saying that this essay is intended as a contribution to ‘normal science’ and an opposition to the ‘paradigm shift’ advocated by those who favour a wholesale move to exit values. (See Thomas S Kuhn, *The Structure of Scientific Revolutions* Second Edition, Enlarged, 1972.)

APPENDIX A

The value to the business model as applied to assets

The purpose of this Appendix is to provide an overview of the value to the business model as applied to assets, to provide a context for the discussion in Section 1 of the paper of its application to liabilities.

In most cases, a business acquires an asset because the return that it will secure on its investment exceeds its cost. Thus a retailer buys a box of chocolate bars wholesale because it can sell the bars at a higher price in the retail market: a haulage contractor buys a fleet of lorries because its charges to customers will more than reimburse its costs. To assess the extent to which a business is better off as a result of ownership of an asset, it is helpful to consider what the asset brings to the business, i.e. what would be the economic consequences of losing the asset or, in the jargon of accounting theorists, its 'deprival value'.

Because the returns the asset will yield are greater than its cost, typically the rational response to the loss of the asset would be to replace it: rather than lose the returns, the business would lose the cost of replacing the asset. Hence the typical measure of an asset is its replacement cost. It should be emphasised that, in principle, replacement cost is a *current* value concept: it looks not to the historical cost of the asset, but to what it would cost to replace it in the economic circumstances at the balance sheet date, including the prices prevailing at that date. Implementing replacement cost in practice gives rise to a number of considerations such as whether it is relevant to look to the cost of new or second-hand assets and how to handle assets that are subject to technological change; however, these need not be discussed here.

An important consequence of the points made above is that the returns the asset is expected to provide are not directly reflected in the balance sheet measurement of the asset. They justify the use of replacement cost, because they are higher, but they are not directly taken account of because they lie in the future and would not be lost if the asset were lost. The excess of future returns over replacement cost may be seen either as the goodwill of the business as a whole or as 'unrealised' future profits, both of which accounting has traditionally been reluctant to recognise.

Although replacement cost will typically be the most relevant measurement basis, there are cases where it will not be. If the returns from an asset are

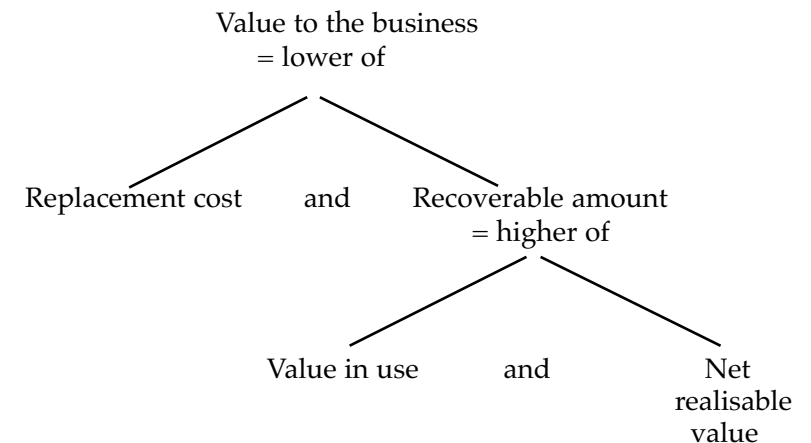
insufficient to warrant its replacement (either the returns have fallen from that originally expected or replacement cost has risen, or some combination of the two) then another basis must be used. Here the optimal decision for the business will be to recover what it can from the asset. There are two ways in which such recovery can be made:

- continue to use the asset and reap the returns it offers (the current value of which is referred to as 'value in use'); or
- sell the asset and receive the sale proceeds (net realisable value).

Typically the business should adopt whichever of these courses gives it the optimal outcome. Hence if value in use is greater than net realisable value it should continue to operate the asset; conversely, if net realisable value is greater it should sell the asset.

Thus where the returns from an asset do not justify its replacement it should be stated at recoverable amount, being the higher of value in use and net realisable value.

These conclusions may be portrayed diagrammatically as follows:



An important implication of the value to the business model is that, even in a current value system, assets should not usually be stated at exit values, such as net realisable value. Many assets – particularly fixed assets – are more

or less specialised: they are selected for the business's purposes and would not necessarily be as suitable for another business. A purchaser of such assets would not therefore typically pay as much as the existing business for them. The maximum amount a purchaser would rationally offer to pay would also be reduced to reflect uncertainties about the condition and history of the asset, about which any purchaser will have less information than the seller. For these reasons, businesses are unlikely in a typical case to be able to sell such assets for an amount that would fairly compensate them for their loss.

APPENDIX B

The repricing of liabilities to supply goods and services

The central aim of this essay is to consider whether, when a business receives £100 in exchange for a promise that it can fulfil for £60, it should record a liability for £100 or £60. It sets out a case that £100 is typically the most relevant measure, but also notes that where the contract becomes onerous the liability should be increased to settlement amount (which will usually be at least £100).

The general use of entry values is entirely consistent with the use of current values. Any defence of historical values can only be pragmatic rather than conceptual. However, pragmatic issues seem to be very important in the case of contracts for goods and services. This Appendix seeks to comment briefly on some of these.

Using the simple example we have referred to above, suppose that the business increases its price, so that it would now enter into a contract identical to that with its customer only if paid £110. Should the amount of the liability be revised?

Restating the liability to £110 can be defended, if some assumptions are made – but they are rather heroic. The business has been able to raise its prices, and its competitors will, presumably, match this price rise. If the business were to seek the customer's agreement for release from the contract, and we are operating in perfect markets, the customer will now demand £110, as that is what it will cost him to get the same contractual right elsewhere. However, this is, perhaps, irrelevant because we have seen that settlement, and especially the cost of release, do not generally provide the appropriate basis for the measurement of liabilities.

It must also give pause for thought that if a business is fortunate enough to be able to raise its prices (say from £100 to £110) it will report a loss, corresponding to the increase in the liability. However, this may not be the knockdown argument it seems, as the loss may be seen as arising from entering into the contract on terms that, as things have turned out, are not the most favourable that might have been secured. Had the business waited, it would be able later to enter into an identical contract for £110.

Liabilities and how to account for them

Possibly even more intuitively disturbing is where prices fall. If the price for a new contract falls to £90, a principle of *current* consideration amount would require the liability to be reduced by £10 and a corresponding *gain* recognised. Again this might be rationalised. Theoretically the customer will accept £90 in satisfaction of what is due under the contract, as the same rights can be obtained from another supplier for that amount. The gain arising from a fall in selling prices can be seen as a reward for the astuteness of negotiating terms that are more favourable than those that can be obtained later.

The best available conclusion appears to be that whilst, conceptually, current consideration amount should be the measure for liabilities (except where a contract is onerous), in practice adjusting to current values will often be an unnecessary complication. The case for it relies on restrictive assumptions that may be relevant to contracts that are traded on markets, such as financial forwards, but are less likely to be true of contracts to build fences or supply widgets.