30 Cannon Street, London EC4M 6XH, United Kingdom
Phone: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: http://www.iasb.org

International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting: **18 July 2006, London**

Project: **Amendments to IAS 37 (Agenda Paper 4A)**

Amendments to IAS 37: Eliminating the term contingent liability

INTRODUCTION

1. The ED clarifies that only present obligations (not possible obligations) give rise to liabilities and requires an entity to recognise *all* liabilities resulting from present obligations unless those liabilities cannot be measured reliably.[1] To emphasise these points, the ED proposes eliminating the term 'contingent liability' from IAS 37.

2. Responses to this proposal are mixed. Many respondents agree with Board's analysis included in the Basis for Conclusions accompanying the ED and, therefore, support the proposal. But a significant minority disagree. Moreover, several respondents are concerned that eliminating the term 'contingent liability' will reduce the amount of useful disclosure provided about an entity's possible obligations.

3. Accordingly, the purpose of this paper is to revisit the proposal to eliminate the term 'contingent liability' in the light of the comments received, and to consider whether additional disclosure requirements are necessary to achieve the disclosure principle underlying the ED: 'an entity shall disclose sufficient information to enable users of the financial statements to understand the amount and nature of an entity's liabilities and the uncertainty relating to the future outflows of economic benefits that will be required to settle them.'[2]

---

[1] And subject to scope exclusions.
[2] Confirmed at the February 2006 Board meeting. Refer to agenda paper 8 for further detail.

4. The paper is divided into four sections:

   a. Summary of recommendations

   b. A reminder of the Board's previous discussions [*paragraphs 6 – 12*]

   c. Comment letter analysis [*paragraphs 13 – 21*]

   d. Staff discussion

      i. The term 'contingent liability' is well understood and consistently applied in practice [*paragraphs 23 – 31*]

      ii. Reduced disclosure about potentially significant risks [*paragraphs 32 – 51*]

SUMMARY OF RECOMMENDATIONS

5. The staff recommends that:

   a. the Board affirm its proposal to eliminate the term 'contingent liability' from IAS 37. [*paragraphs 23 – 31*]

   b. any final Standard should include disclosure of the factors influencing an entity's judgement in situations when it is not certain whether a past event gives rise to a liability and no liability is deemed to exist. [*paragraphs 41 – 51*]

A REMINDER OF THE BOARD'S PREVIOUS DISCUSSIONS

6. This section of the paper provides a summary of the Board's previous discussions leading to the proposal to eliminate the term 'contingent liability' and the accompanying disclosure requirements. The Board's full reasoning, as presented in the ED, is provided in Appendix A.

Eliminating the term 'contingent liability'

7. IAS 37 defines a contingent liability as[3]:

   (a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

   (b) a present obligation that arises from past events but is not recognised because:

      (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or

      (ii) the amount of the obligation cannot be measured with sufficient reliability.

---

[3] IAS 37, paragraph 10.

8. When developing the ED the Board observed that this definition contains two distinct notions. The first notion is a *possible* obligation, arising when the existence of a present obligation is uncertain and will be confirmed only by a future event. The second notion is an unrecognised *present* obligation – ie a liability that fails qualify for recognition.

9. The Board concluded that although IAS 37 treats the two items similarly, combining these two notions was conceptually unsatisfactory. First, the Board concluded that some items described as contingent liabilities are in fact liabilities according to the *Framework*[4]. This is because the uncertainty relates to future events that affect the amount that will ultimately be required to settle the obligation, not the existence of the obligation itself. In other words, the obligation is non-contingent (or unconditional). Describing these items as *contingent* liabilities is contradictory: they are *present* obligations.

10. Secondly, the Board concluded that it is misleading to describe *possible* obligations as liabilities, even with the modifier 'contingent'. This is because the *Framework* highlights that the existence of a present obligation is an essential characteristic of a liability. Hence, a possible obligation cannot logically be described as a liability, even with the modifier 'contingent'[5]. That is to say, however probable, a possible obligation is not a present obligation.

Disclosure of contingent liabilities

11. The Basis for Conclusions[6] acknowledged that a consequence of withdrawing the term 'contingent liability' was the withdrawal of the current disclosure requirements for possible obligations. However, the Board explained that it did not expect there be a loss of disclosure in most cases for two main reasons.

- First, for items currently described as contingent liabilities that are in fact liabilities (including some items that entities currently label possible obligations) there would be no loss of disclosure. This is because the ED carries forward the current IAS 37 disclosure requirements for recognised and unrecognised liabilities.

- Secondly, for those contingent liabilities that do not meet the definition of a liability (ie some items that entities currently label possible obligations), the Board concluded that these items are business risks. Therefore, disclosure of these items does not need to be addressed in a standard about liabilities. The Board noted that discussion of such items would typically be included in management's discussion and analysis accompanying the financial statements and the effect of such items would often be disclosed in accordance with paragraph 116 of IAS 1 *Presentation of Financial Statements*[7].

---

[4] IAS 37, paragraph 10(b) "A contingent liability is a *present obligation* that arises from past events but is not recognised …" (emphasis added)
[5] This conclusion was based on the Board's earlier analysis of contingent assets, as explained in paragraph BC12.
[6] ED, paragraphs BC31 – BC35
[7] IAS 1, paragraph 116: 'An entity shall disclose in the notes information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing material adjustment to the carrying amount of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of (a) their nature; and (b) their carrying amount as at the balance sheet date'.

12. Paragraph omitted from observer notes.

COMMENT LETTER ANALYSIS

13. A summary analysis of the comments received is provided in Appendix B

The term is inconsistent with the Framework

14. Many respondents agree with the Board' conclusion that the notion of a contingent liability is inconsistent with the *Framework's* definition of a liability and support the proposal to eliminate the term 'contingent liability'. But others disagree because they believe that the term 'contingent liability' appropriately captures the requirements in the *Framework's* probability recognition criterion[8]. For example, in a joint letter [a representative group] state[s] 'we do not really understand the need to delete the concept of 'contingent liability'. The probability criterion is a good method to define when and how to carry out a liability linked to 'probable future events' …'

Using the same term to describe two different notions is confusing

15. Many respondents also agree that using the same term to describe two different notions is confusing. For example, [one respondent] comments 'we agree that the term is currently used in two different ways, which is confusing. Therefore, we in principle agree with eliminating the term 'contingent liability' because we believe this will add to clarity'. But others do not agree. [one respondent] argues '… the existing term is well understood and, in our view, should be retained…' and [another respondent] states that '… 'contingent liability' is a well recognised concept in accounting guidance … as such we do not believe the term 'contingent liability' should be eliminated'.

16. Others suggest improving the current definition of a contingent liability, rather than eliminating the term. For example, [one respondent] comments '… some of the confusion may have been caused by the 'mixed bag' character of this term, because it includes (i) obligations contingent upon a future event, (ii) obligations that are not probable, and (iii) obligations that are not measureable. This confusion could be solved by reserving the term for the category (i) obligations'. Alternatively, others recommend replacing rather than eliminating the term 'contingent liability'. Suggestions include 'contingencies', 'loss contingencies' or 'potential liabilities'.

Disagree with the proposal to eliminate the term 'contingent liability' because of disagreement with other proposals in the ED

17. Some respondents clearly differentiate their response to the proposal to eliminate the term 'contingent liability' from the other proposals in the ED. But others do not. Therefore some respondents oppose eliminating the term 'contingent liability' because they disagree with other aspects of the ED. In particular, many respondents state that they disagree with the proposal to eliminate the term 'contingent liability' because the new analysis fails to provide adequate guidance on how to determine whether an unconditional obligation exists. For example, [one respondent] disagrees with eliminating

[8] *Framework*, paragraphs 82 - 85

the term ‘contingent liability’ due to ‘the ambiguity of the notion of an unconditional obligation to stand ready to fulfil a conditional obligation’.

18. Others disagree with the proposal to eliminate the term ‘contingent liability’ because they do not think that the Board’s new analysis of liabilities into conditional and unconditional obligations is sufficiently robust to be consistently implemented at this time. For example, [one respondent] explains ‘…we do not support, at this point in time, the conditional/unconditional obligation model proposed by the Board. Therefore we would prefer that the Board retain the term ‘contingent liability’ along with much of the current accounting model for non-financial liabilities’.

Need to retain disclosure about items which do not meet the definition of a liability

19. Several respondents are concerned by the Board’s decision to remove the current contingent liability disclosure requirements from IAS 37. These respondents think that disclosing information about conditional obligations[9] (for which no liability is recognised because an unconditional obligation does not exist) provides useful and relevant information to users of financial statements. For example, [one respondent] comments ‘We believe that potentially significant items could go unreported. For example, a law that is virtually certain to be enacted would not be recognised as a non-financial liability (because it has not been substantively enacted) and it would not be disclosed in the notes to the financial statements because no liability has been recognised. We believe that such items could have a significant impact on the financial position of an entity and are therefore important disclosures’.

20. Other respondents extend their recommendation to include items which are not recognised as liabilities because uncertainty about the existence of a present obligation means an entity has concluded that no liability exists at the balance sheet date. For example, [one respondent] comments ‘The definition and disclosure of contingent liabilities under existing IAS 37 is useful because it enables the users of accounts to be made aware of an entity’s exposures which are not sufficiently certain to justify booking a liability, but which should nonetheless be considered as part of the entity’s risk profile. For users of accounts, it does not matter whether it is the existence or the value of an obligation that is in doubt: their concern is whether an entity may have to pay out money in the future which is not currently in the balance sheet’.

21. Several respondents note the Board’s observation that discussion of items which do not meet the definition of a liability would typically be included in management’s discussion and analysis accompanying the financial statements.[10] But some think that adopting this approach may mean that important information about significant risks is not clearly presented and, therefore, will be less transparent and useful to users. For example, [one respondent] notes that ‘empirical research indicates that the completeness of disclosures influences the extent to which investors incorporate the disclosure in to their valuation-related judgments’. Similarly, [another respondent’s] view is that ‘… the proposed amendments will result in less clear and more fragmented disclosures of the uncertainties relating to recognised non-

[9] Although it is not always clear whether respondents are referring to items currently described as possible obligations in IAS 37, or general business risks which may give rise to future liabilities.
[10] ED, paragraph BC32

financial liabilities and unrecognised standalone conditional obligations than was previously required for 'contingent liabilities' under the existing Standard'.

STAFF DISCUSSION

22. The staff notes that several concerns articulated in the comment letters regarding the proposal to eliminate the term 'contingent liability' relate to other proposals included in the ED. Most notably these include omitting the probability recognition criterion, determining when a liability exists, the potential scope of stand ready obligations and the new analysis of liabilities into conditional and unconditional obligations. These topics either have been, or will be, separately addressed during the redeliberations of the ED. Therefore discussion of these topics will not be repeated in this paper. In this paper, the staff discussion will focus on the two concerns that specifically relate to the proposal to eliminate the term 'contingent liability':

    A. The term 'contingent liability' is well understood and consistently applied in practice, and

    B. Reduced disclosure about potentially significant risks.

A. The term 'contingent liability' is well understood and consistently applied in practice

23. The staff does not agree that the term 'contingent liability' is well understood and consistently applied in practice. A number of respondents agree that using the same term to describe two different notions is confusing. This suggests that the distinction between a contingent liability that is an unrecognised *present* obligation and a contingent liability that is a *possible* obligation is not well understood by all entities in all jurisdictions.

24. The limitations of the current definition of a 'contingent liability' in relation to the *Framework's* definition of a liability have been discussed by the Board on a number of previous occasions. The outcome of these discussions is summarised in paragraphs 8 – 10 above. The staff continues to support these conclusions.

Using the term 'contingent liability' to describe unrecognised present obligations

25. In addition, the staff notes that using the term 'contingent liability' to describe unrecognised present obligations creates conflicts between IAS 37 and other Standards. Items that are deemed to be liabilities in other Standards (and recognised as such) would be described as *contingent* liabilities (and therefore not recognised) following the guidance in IAS 37. For example:

    - financial guarantee contracts (ie contractual obligations to reimburse the holder for a loss incurred because a debtor fails to make payment when due) are recognised as liabilities in accordance with IAS 39 *Financial Instruments: Recognition and Measurement*. But following IAS 37, these contracts would be classified as contingent liabilities until it is considered probable that the debtor will fail to make payment when due. For this reason, some continue to think that the probability of the debtor failing to make its payment is the determining factor in concluding whether a liability exists.

- in accordance with IFRS 2 *Share-based Payment*, share appreciation rights granted to employees as part of their remuneration package (whereby employees become entitled to future cash payments, rather than equity instruments, if the entity's share price increases to a specified level over a specified period of time) are recognised as liabilities. Following IAS 37, these rights would be described as contingent liabilities until it is considered probable that the share price will increase to the specified level within the specified time period.

- most insurance policies, considered individually, would meet the definition of a contingent liability in IAS 37.

26. Conceptually, therefore, it is difficult to rationalise the anomalies between IAS 37 and other Standards.

Using the term 'contingent liability' to describe possible obligations

27. IAS 37 suggests that a possible obligation is an item 'that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity'. The staff notes that this description of a contingent liability is less problematic from a conceptual perspective, because it is clear that possible obligations do not satisfy the definition of a liability. In other words, we are not labelling something that is a liability a contingent liability. Therefore, as suggested by some respondents, one option would be to retain the term 'contingent liability' to describe possible obligations only.

28. However, the staff thinks that even if the notion of a possible obligation (as described by IAS 37) is retained, it is not appropriate to describe a possible obligation as a *contingent* liability. As noted in paragraph 10, this is because the term 'contingent liability' is itself contradictory. By definition a liability is non-contingent. Hence, using the modifier 'contingent' is awkward and confusing.

Conclusion

29. Based on the discussion above, the staff continues to think that the definition of a 'contingent liability' in IAS 37 is confusing because it is used to describe both unrecognised present obligations (ie liabilities) and possible obligations (ie non-liabilities). Additionally, the staff notes that using the term to describe unrecognised present obligations contradicts the *Framework's* definition of a liability – such items are liabilities and should not be described as contingent. It also creates inconsistencies with other Standards in which liabilities that IAS 37 would describe as contingent are recognised.

30. The staff thinks that the notion of a possible obligation is less problematic. But the term 'contingent liability' itself is awkward and confusing when used to describe possible obligations. Therefore, the staff recommends the Board affirms its proposal to eliminate the term from IAS 37.

31. *Does the Board agree?*

B. Reduced disclosure about potentially significant risks

32. A common concern articulated in the comment letters is that eliminating the term 'contingent liability' would result in reduced disclosure about items that, at the balance sheet date, do not meet the definition of a liability. The staff thinks that there may well be a gap in the disclosure requirements proposed in the ED. But we think that gap specifically relates to disclosure about situations when the existence of a liability is uncertain and therefore no liability is deemed to exist, rather than disclosure of all potentially significant risks that the entity faces at the balance sheet date.

Gap in the disclosure requirements proposed in the ED

33. As noted in paragraph 11, the Board previously concluded that information about some items currently described possible obligations would be captured in management's discussion and analysis and as a result of the disclosure requirements in IAS 1. But management discussion and analysis is not required by current IFRS. Neither is management discussion and analysis mandatory for all entities in all jurisdictions. For example, the UK White Paper 'Modernising Company Law' incorporates proposed legislation on including an Operating and Financial Review (OFR) in an entity's published financial statements. But mandatory preparation of an OFR is limited to 'major' companies. Similarly in Australia, all entities are required to include a review of operations and the results of those operations in their directors' report. But only listed companies are required to disclose information shareholders would reasonably require to make an informed assessment of an entity's operations, financial position, business strategies and prospects for future financial years.[11]

34. Equally, the staff thinks that paragraph 116 of IAS 1 is unlikely to capture information about all items currently labelled possible obligations. Paragraph 116 requires disclosure of key sources of *estimation* uncertainty that have a significant risk of causing material adjustments to the carrying amount of assets and liabilities within the next financial year. In the context of IAS 37 this suggests that paragraph 116 captures uncertainties associated only with the measurement of *recognised* liabilities, rather than items which do not meet the definition of a liability and therefore have not been recognised.

Disclosure of all potentially significant risks

35. The concerns about the loss of disclosure in the comment letters suggest that some regard the IAS 37 notion of a possible obligation as a requirement to disclose information about a general business risk which may give rise to a future liability. For example, some respondents consider an anticipated change in law to be a contingent liability (possible obligation). However, the staff thinks that the IAS 37 notion of a possible obligation is narrower than this. In this example we would argue that the entity does not have a contingent liability because it is certain that the entity does *not* have a liability until the law has been substantively enacted.

[11] CA299(1)(a) and CA299A(1)

36. The staff considered whether we should be looking to broaden disclosures to capture general business risks as part of this project. But the staff does not believe that such an approach is appropriate

37. First, this is because IAS 37 provides accounting guidance on liabilities not within the scope of another Standard. General business risks are not liabilities and, therefore, are not within the scope of IAS 37.

38. Secondly, the disclosure principle underlying the ED is that an entity shall disclose sufficient information to enable users of the financial statements to understand the amount and nature of an entity's liabilities which exist at the balance sheet date[12]. Consequently, the staff thinks that including disclosure requirements to capture information about general business risks would be inconsistent with the principles underlying the ED.

39. Furthermore, as discussed in May 2006, many respondents are concerned that the ED's notion of a stand ready obligation is too broad and seems to capture items that were not previously considered to be liabilities[13]. Thus, many respondents ask the Board to clarify which transactions and event give rise to stand ready obligations and how such items are distinguished from general business risks. The staff thinks that extending the disclosure requirements in IAS 37 to include general business risks may further blur the distinction between liabilities and general business risks and create more confusion.

40. Accordingly, the staff does not recommend extending the disclosure requirements of IAS 37 to capture all potentially significant risks that may give rise to a future liability.

Disclosure in situations when it is not certain that a liability exists

41. However, the staff thinks that it would be useful to require disclosure of the factors influencing an entity's judgement in situations when it is not certain that a past event gives rise to a liability in any final Standard.

42. In May 2006 the Board agreed that situations arise when it is not certain that a liability exists ("element uncertainty")[14]. Over the last two months, the Board has discussed a number of different scenarios to assist the staff in developing guidance to determine when and why a liability exists. The precise nature and extent of this guidance is work in progress. But the direction of deliberations thus far indicates that situations will arise that require an entity to exercise judgement in determining whether a liability exists and, thus, is recognised in the financial statements.

43. In adopting such an approach it is inevitable that two entities faced with the same fact pattern could reach different conclusions on whether a liability exists. This is because an entity has to exercise judgement. One obvious example is litigation. Often litigation arises because two entities have a different interpretation of the law or a different view about alleged facts and circumstances. Currently the disclosure requirements proposed in the ED

---

[12] And the uncertainty relating to the future outflows of economic benefits that will be required to settle those liabilities. The principles underpinning the ED's proposals were affirmed by the Board in February 2006 (see agenda paper 8)

[13] Refer to agenda paper 10D presented in May 2006.

[14] Refer to agenda paper 10A presented in May 2006.

relate only to liabilities. Hence, when element uncertainty exists and an entity concludes that it has a liability, that liability will be recognised (if it can be measured) and additional information about the liability disclosed. (If it cannot be measured reliably, and hence it is not recognised, information about the liability will still be disclosed.) But if the entity concludes that it has no liability, no information about the item is provided in the financial statements. In other words, if we accept the notion of element uncertainty there is a comparability trade off because, in an identical situation, one entity may conclude that a liability exists whereas as another entity may not.

44. Paragraph 42 of the *Framework* states that users must be able to compare the financial statements of different entities in order to evaluate their relative financial position and performance. The *Framework* also requires faithful representation of an entity's financial position and performance. (Although paragraph 34 of the *Framework* acknowledges that 'most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. That is not due to bias, but rather to *inherent difficulties either in identifying the transactions and other events to be measured* or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events. …' (emphasis added).

45. In situations when it is not certain that a liability exists, the staff thinks that disclosure of the factors influencing an entity's judgement may provide users of the financial statements with decision-useful information[15]. This is because disclosure will compensate for the potential lack of comparability when element uncertainty creates a comparability trade-off.

46. The staff thinks that its proposal is consistent with paragraph 113 of IAS 1 which requires disclosure of judgements made by management in applying an entity's accounting policies[16].

47. However, in order to meet the objective of IAS1.113, the staff thinks that additional guidance in IAS 37 is required. Paragraph 115 of IAS 1 provides a precedent by giving examples of individual Standards that specify when disclosure of judgements made by management is required: '… IAS 27 requires an entity to disclose the reasons why the entity's ownership interest does not constitute control, in respect of an investee that is not a subsidiary even though more than half of its voting or potential voting power is owned directly or indirectly through subsidiaries. IAS 40 requires disclosure of the criteria developed by the entity to distinguish investment property from owner-occupied property and from property held for sale in the ordinary course of business, when classification of the property is difficult.'

Conclusion

[15] *Framework*, paragraph 26: "to be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations".

[16] IAS 1, paragraph 113: "An entity shall disclose, in the summary of significant accounting policies or other notes, the judgments, apart from those involving estimations (see paragraph 116), that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements."

48. Based on the analysis above the staff thinks that any final Standard should include disclosure of the factors influencing an entity's judgement in situations when it is not certain that a past event gives rise to a liability.

49. The staff does not believe management discussion and analysis and the IAS 1 requirements will be sufficient to ensure that important information is disclosed about situations in which the existence of a liability is uncertain and no liability is deemed to exist. Therefore, in such situations the staff recommends that additional disclosure requirements be included in IAS 37. Specific disclosure requirements should include:

- a description of the item that has required management to exercise judgement ;
- a statement that no liability is deemed to exist because it is not certain that the item satisfies the definition of a liability;
- an explanation of the uncertainties associated with item; and
- an estimation of the financial effect of the item on an entity's statement of financial position and performance if subsequent events confirm that a liability exists at the balance sheet date.

50. Also, in light of concerns about the influence of financial information on the outcome of ongoing litigation (discussed in agenda paper 4B), the staff proposes that the prejudicial disclosure exemption in paragraph 71 of the ED should extend to the additional disclosures recommended above.

51. *Does the Board agree?*

APPENDIX A: Extracts from the Basis for Conclusions to the IAS 37 ED

Contingent liabilities

BC19 The Board then considered contingent liabilities. The Board observed that in contrast to the definition of a contingent asset, the present definition of a contingent liability includes two notions. The first notion, a possible obligation, is symmetrical with the definition of a contingent asset and arises when the existence of a present obligation at the balance sheet date is uncertain, but some future event will confirm whether the entity has that obligation. The second notion, an unrecognised present obligation, arises when the entity has a present obligation, but that obligation is not recognised as a liability, because either an outflow of economic resources to settle the obligation is not probable or the entity is not able to measure the obligation reliably.

Possible obligations

BC20 The Board had previously considered such obligations in the context of a business combination. In IFRS 3, it specified that an acquirer should recognise at the acquisition date the acquiree's contingent liabilities—and hence its possible obligations—if their fair values could be measured reliably.

BC21 In arriving at this requirement in IFRS 3, the Board took the view that the existence of possible obligations in an acquiree point to the existence of present obligations and, therefore, if their fair value could be measured reliably, the possible obligations should be recognised as liabilities. Furthermore, the Board concluded that it was appropriate that an acquiree's possible obligations should be recognised as liabilities as part of the process of allocating the cost of the business combination, because they have the effect of reducing the price that an acquirer is prepared to pay for the acquiree. In effect, the acquirer is paid to assume an obligation by paying a reduced purchase price for the acquiree.

BC22 In the light of its observations about unconditional and conditional rights and obligations and its conclusions about contingent assets described above, the Board decided that it could refine its conclusions in IFRS 3. It reasoned that its revised analysis of items previously described as contingent assets was also applicable to items previously described as contingent liabilities (possible obligations). The Board also noted that if it refined the analysis of items described as contingent liabilities in IAS 37, there would be no need to specify different requirements for such items in a business combination. Furthermore, all such items would be treated consistently, regardless of whether they are acquired in a business combination or generated internally (subject to the different measurement requirements of IAS 37 and the revised IFRS 3).

BC23 Accordingly, the Board decided to eliminate the term 'contingent liability'. Instead of using 'contingent' to refer to uncertainty about whether a liability exists, the Board decided that the term should refer to one or more uncertain future events, the occurrence (or non-occurrence) of which affects the amount that will be required to settle an obligation.

BC24 These conclusions mean that, for example, an entity that issues a product warranty has a liability arising from its unconditional obligation to provide warranty coverage over the term of the warranty (ie to provide a service).

Uncertainty about whether the product will develop a fault, and hence require repair or replacement (ie the contingency), relates to whether the entity's conditional obligation to repair or replace the product if it develops a fault will become unconditional. (The entity's obligation to repair or replace the product is conditional because it depends on whether the product develops a fault.) Hence, the contingency does not determine whether the entity has a liability to provide warranty coverage. Rather, it affects the amount that will be required to settle the obligation. Similarly, in the case of an entity defending a lawsuit, the entity has a liability arising from its unconditional obligation to perform as directed by the courts. The contingency relates to the entity's conditional obligation to pay any penalties imposed by the court and affects the amount that will be required to settle the liability.

BC25 The Board's conclusions about the nature of the unconditional obligation in a warranty contract are consistent with the conclusions of the US Financial Accounting Standards Board (FASB) in Interpretation No. 45 *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (FIN 45), although the recognition and measurement requirements of FIN 45 do not apply to product warranties issued by an entity. FIN 45 describes the unconditional obligation as an 'obligation to stand ready to perform over the [contract] term'. Whilst the notion of an obligation to stand ready is derived from FASB Concepts Statement No. 6 *Elements of Financial Statements* (Concepts Statement 6), the Board decided to introduce the term into IAS 37 because it regards it as a helpful way of capturing the nature of the liability.

BC26 The Board acknowledged that its analysis of unconditional and conditional rights and obligations may appear complex and that some constituents may already have regarded some examples of liabilities arising from unconditional obligations accompanied by conditional obligations (eg product warranties) as examples of liabilities. Indeed, the Board noted that many financial liabilities within the scope of IAS 39 *Financial Instruments: Recognition and Measurement* could be analysed as containing both a conditional and unconditional obligation. However, as noted with assets, the objective of analysing transactions into unconditional and conditional obligations is to assist in identifying precisely the liability in existence at the balance sheet date, rather than relying on an assessment of some uncertain future event to determine whether a liability exists at that date. The Board concluded that if the liability is identified and accounted for, there is no need to identify the two obligations. Nonetheless, the Board observed that in practice the conditional obligation is sometimes the more readily identifiable obligation. Thus it can be used as a pointer to any associated unconditional obligation. Furthermore, the Board noted that it can be important to distinguish between the two obligations because, as discussed below, the probability recognition criterion in the *Framework* should be applied to the liability (ie unconditional obligation) rather than to the conditional obligation.

BC27 The main difference between the approach in the draft Standard to items previously described as contingent liabilities and that in the current version of IFRS 3 is that an entity is required to determine whether it has a present obligation that satisfies the definition of a liability before considering recognition and measurement. Put another way, the draft Standard does not use either recognition or measurement as a means of resolving uncertainty about whether a liability *exists*. As discussed in paragraph BC41 below, this is consistent with the *Framework*. In contrast, in the current version of IFRS 3, the contingent liability itself is recognised, and the measurement of the contingent liability reflects the uncertainty about whether the contingent liability had given rise to a present obligation. Therefore, the approach in the draft Standard places greater emphasis on determining whether the definition of a liability has been satisfied and does not allow recognition of possible liabilities. This is consistent with the overall objective of the second phase of the Business Combinations project in which an acquirer recognises the assets acquired and liabilities assumed at the date control is obtained. The Board also noted that the approach is consistent with recent standards of the FASB on liabilities that have adopted a fair value measurement basis. For example, both Statement No. 143 *Accounting for Asset Retirement Obligations* (SFAS 143) and Statement No. 146 *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS 146) prohibit the recognition of obligations that do not satisfy the definition of a liability in Concepts Statement 6.

BC28 However, although the proposed approach is different from that in IFRS 3, the Board emphasises that its proposals should not be regarded as a reversal of the requirement in IFRS 3 to recognise contingent liabilities. Rather, they should be viewed as a refinement of that earlier decision. Indeed, the Board observed that in most cases there would be no change in obligations recognised in accordance with the existing and proposed revised versions of IFRS 3. This is because some obligations previously described as contingent liabilities were, in fact, unrecognised *liabilities* and, therefore, will be recognised in a business combination in accordance with the proposed revised IFRS 3. In addition, in many cases, items previously described as possible obligations will be analysed more precisely into two obligations: an unconditional obligation and a conditional obligation. The effect of recognising the liability resulting from the unconditional obligation at fair value in accordance with the proposed revised IFRS 3 would be similar to recognising the contingent liability at fair value in accordance with the existing version. This is because the measurement of the liability will reflect the uncertainty about the conditional obligation.

BC29 Nonetheless, the Board observed that not all items previously described as contingent liabilities satisfy the definition of a liability in the *Framework*. This is because some such items contain only a conditional (or contingent) obligation and no unconditional obligation. Therefore, an item that might have been recognised in accordance with the current version of IFRS 3 will no longer qualify for recognition in accordance with the draft Standard or revised version of IFRS 3. For example, the Board considered a scenario in which an entity would be required to take back previously sold products for disposal if a new law were passed (in other words, the new law would have a retrospective effect). The Board noted that until the new law is substantively enacted, the entity would have no present unconditional obligation (unless the entity by its own actions created a constructive obligation before the law was enacted). Hence, the entity would have only a conditional obligation to take back products and, therefore, no liability. Expressed another way, the Board concluded that an entity does not have a stand ready obligation with respect to a possible change in the law. This is because it is the new law that creates new obligations and until the law is substantively enacted those obligations do not exist. Accordingly, an entity cannot have a present obligation with respect to that law.

Unrecognised present obligations

BC30 Having decided to eliminate the term ‘contingent liability’, the Board considered the notion of an unrecognised present obligation in IAS 37, which is also described as a contingent liability. As noted above, liabilities arise only from unconditional obligations. Hence, something that is a present obligation cannot be described as being contingent. The Board also noted that there was no need to define liabilities that fail to qualify for recognition because they can be described as unrecognised liabilities. Therefore, the Board does not propose to define such liabilities. Consistently with the current requirements in IAS 37 for contingent liabilities, liabilities that are not recognised in accordance with the draft Standard are required to be disclosed.

Disclosure of contingent assets and contingent liabilities

BC31 The amendments in the draft Standard relating to contingent assets and contingent liabilities are primarily concerned with correctly identifying the right and obligation (unconditional) and then accounting for that right and obligation. Consistently with those amendments, the Board decided to withdraw the requirement in IAS 37 to disclose contingent assets and contingent liabilities. Therefore, the draft Standard specifies only the disclosures required for liabilities (with or without associated contingencies), whereas assets with contingencies are disclosed in accordance with other Standards.

BC32 The Board noted that some might feel uncomfortable about this proposal, because it suggests that important information previously associated with contingencies, particularly contingent liabilities, will no longer be disclosed in the financial statements. However, with respect to contingent liabilities, the Board believes that in most cases there will be no loss of disclosure. This is because most items described as being contingent liabilities in IAS 37 will now be viewed as liabilities, with the contingency referring to the conditional obligation that affects the measurement of the liability. Hence, the disclosure required by paragraph 68 for the liability will capture the information previously presented for the contingent liability. In particular, an entity will be required to give an indication of the uncertainties about the amount or timing of the outflow of economic benefits. The Board concluded that those items described as contingent liabilities in IAS 37 that do not contain unconditional obligations are business risks. Hence, discussion about such items would typically be included in any financial review by management accompanying the financial statements. The Board also noted that the effects of such items would often be disclosed in accordance with paragraph 116 of IAS 1 *Presentation of Financial Statements*, because they may have a significant risk of causing a material adjustment to the carrying amount of assets and liabilities within the next financial year.

BC33 Other Standards also require disclosure of contingent assets and contingent liabilities. In the cases of IAS 11 *Construction Contracts*, IAS 12 *Income Taxes* and IAS 18 *Revenue*, the Board concluded that the disclosure of contingencies was designed to provide information about measurement uncertainty relating to items accounted for in accordance with those Standards. Therefore, the contingencies referred to in those Standards are unaffected by the proposed amendments to IAS 37. For example, IAS 11 explains that contingencies arise from warranty costs, claims and penalties, ie items that are accounted for in IAS 11 as part of contract revenue and contracts costs.

BC34 Accordingly, in the consequential amendments the Board proposes replacing the requirement in IASs 11, 12 and 18 to disclose contingent assets and liabilities with a requirement to disclose the key measurement uncertainty relating to construction contracts, income taxes and revenue.

BC35 In other Standards, for example IAS 28 *Investments in Associates*, the requirement to disclose contingent liabilities is a reminder of the requirement in IAS 37 to disclose (a) liabilities not recognised in accordance with IAS 37 and (b) possible obligations. In these cases, if the item previously described as a contingent liability is determined to be a liability in accordance with the draft Standard, it will be recognised unless it cannot be measured reliably. Therefore, the Board has amended the requirements to require disclosure of the unrecognised liabilities in accordance with IAS 37.

APPENDIX B: Summary analysis of respondents' comments to question 2 in the Invitation to Comment

A1. Question 2 in the Invitation to Comment asked:

A2. Do you agree with eliminating the term 'contingent liability'? If not, why not?

A3. Do you agree that when the amount that will be required to settle a liability (unconditional obligation) is contingent on the occurrence or non-occurrence of one or more uncertain future events, the liability should be recognised independently of the probability that the uncertain future event(s) will occur (or fail to occur)? If not, why not?

A4. In the following analysis the staff has categorised respondents' comments on question 2(a) as 'agree' or 'disagree'. Where possible the basis for respondents' agreement or disagreement has also been indicated. In some instances both respondents who agree and those who disagree do so for the same reason.

A5. Some respondents did not comment specifically on question 2(a). No response may be read as tacit agreement with the proposed amendment. It may also indicate the relatively low importance of the issue to the respondent in the context of all of the proposed amendments articulated in the ED. Therefore the staff has separately identified 'no specific response' in the table below.

A6. No prevalent background or geographical patterns were evident in the responses received, therefore no additional analysis has been provided on this basis.

Do you agree with eliminating the term 'contingent liability'? If not, why not?

Response	**Number**
Agree	
No further comment	17
The current definition of a contingent liability is inconsistent with the *Framework*	11
Using the same term to describe two different notions is confusing	10
But have concerns about other proposals in the ED	5
But need to retain disclosure about items which do not meet the definition of a liability*	8
TOTAL AGREE	**51**
Disagree	
No further comment	1
The term adequately captures the *Framework's* probability recognition criterions	7
The term is well understood	12
Disagree with other proposals included in the ED[17]	11
Need to retain disclosure about items which do not meet the definition of a liability*	4
TOTAL DISAGREE	**35**
No specific response	37
GRAND TOTAL	**123**

* A total of 12 respondents ask the Board to consider retaining disclosure about items which do not meet the definition of a liability.

[17] Most notably (a) the new analysis into conditional and unconditional obligations, (b) the lack of guidance on how to determine whether an obligation exists and the potential scope of stand ready obligations, and (c) omission of the probability recognition criterion. Five respondents who agree with the proposal also specifically comment that they are concerned about other proposals in the ED in their respondents to question 2(a).